whole, but not in part, to discharges of indebtedness that occur on or before March 21, 2005, and after August 29, 2003. For discharges of indebtedness occurring on or before March 21, 2005, and after August 29, 2003, with respect to which a group chooses not to apply this section, see §1.1502–28T as contained in 26 CFR part 1 revised as of April 1, 2004. Furthermore, groups may apply paragraph (b)(4) of this section to discharges of indebtedness that occur on or before August 29, 2003, in cases in which section 1017(b)(3)(D) was applied. Paragraph (b)(5)(i) of this section and the last sentence of paragraph (b)(5)(ii) of this section applies to transactions occurring in consolidated return years beginning on or after December 24, 2008.

[T.D. 9192, 70 FR 14404, Mar. 22, 2005, as amended by T.D. 9442, 73 FR 79334, Dec. 29, 2008]

BASIS, STOCK OWNERSHIP, AND EARNINGS AND PROFITS RULES

§ 1.1502–30 Stock basis after certain triangular reorganizations.

(a) *Scope*. This section provides rules for determining the basis of the stock of an acquiring corporation as a result of a triangular reorganization. The definitions and nomenclature contained in §1.358–6 apply to this section.

(b) *General rules*—(1) *Forward triangular merger, triangular C reorganization, or triangular B reorganization. P* adjusts its basis in the stock of S as a result of a forward triangular merger, triangular C reorganization, or triangular B reorganization under §1.358–6(c) and (d), except that §1.358–6 (c)(1)(ii) and (d)(2) do not apply. Instead, *P* adjusts such basis by taking into account the full amount of—

(i) *T* liabilities assumed by *S* or the amount of liabilities to which the *T* assets acquired by *S* are subject, and

(ii) The fair market value of any consideration not provided by *P* pursuant to the plan of reorganization.

(2) *Reverse triangular merger*. If *P* adjusts its basis in the *T* stock acquired as a result of a reverse triangular merger under §1.358–6 (c)(2)(i) and (d), §1.358–6 (c)(1)(ii) and (d)(2) do not apply. Instead, *P* adjusts such basis by taking into account the full amount of—

(i) *T* liabilities deemed assumed by *S* or the amount of liabilities to which the *T* assets deemed acquired by *S* are subject, and

(ii) The fair market value of any consideration not provided by *P* pursuant to the plan of reorganization.

(3) *Excess loss accounts*. Negative adjustments under this section may exceed *P*'s basis in its *S* or *T* stock. The resulting negative amount is *P*'s excess loss account in its *S* or *T* stock. See §1.1502–19 for rules treating excess loss accounts as negative basis, and treating references to stock basis as including references to excess loss accounts.

(4) *Application of other rules of law*. If a transaction otherwise subject to this section is also a group structure change subject to §1.1502–31, the provisions of §1.1502–31 and not this section apply to determine stock basis. See §1.1502–80(a) regarding the general applicability of other rules of law and a limitation on duplicative adjustments. See §1.1502–80(d) for the non-application of section 357(c) to P.

(5) *Examples*. The rules of this paragraph (b) are illustrated by the following examples. For purposes of these examples, *P*, *S*, and *T* are domestic corporations, *P* and *S* file consolidated returns, *P* owns all of the only class of *S* stock, the *P* stock exchanged in the transaction satisfies the requirements of the applicable triangular reorganization provisions, the facts set forth the only corporate activity, and tax liabilities are disregarded.

Example 1. Liabilities. (a) *Facts*. *T* has assets with an aggregate basis of $60 and fair market value of $100. *T*'s assets are subject to $70 of liabilities. Pursuant to a plan, *P* forms *S* with $5 of cash (which S retains), and *T* merges into *S*. In the merger, the *T* shareholders receive *P* stock worth $30 in exchange for their *T* stock. The transaction is a reorganization to which sections 368 (a)(1)(A) and (a)(2)(D) apply.

(b) *Basis adjustment*. Under §1.358–6, *P* adjusts its $5 basis in the *S* stock as if *P* had acquired the *T* assets with a carryover basis under section 362 and transferred these assets to *S* in a transaction in which *P* determines its basis in the *S* stock under section 358. Under the rules of this section, the limitation described in §1.358–6(c)(1)(ii) does not apply. Thus, *P* adjusts its basis in the *S* stock by –$10 (the aggregate adjusted basis of *T*'s assets decreased by the amount of liabilities to which the *T* assets are subject). Consequently, as a result of the reorganization, *P* has an excess loss account of $5 in its *S* stock.

Example 2. Consideration not provided by P. (a) *Facts. T* has assets with an aggregate basis of $10 and fair market value of $100 and no liabilities. *S* is an operating company with substantial assets that has been in existence for several years. *P* has a $5 basis in its *S* stock. Pursuant to a plan, *T* merges into *S* and the *T* shareholders receive $70 of *P* stock provided by *P* pursuant to the plan of reorganization and $30 of cash provided by *S* in exchange for their *T* stock. The transaction is a reorganization to which sections 368 (a)(1)(A) and (a)(2)(D) apply.

(b) *Basis adjustment.* Under §1.358–6, *P* adjusts its $5 basis in the *S* stock as if *P* had acquired the *T* assets with a carryover basis under section 362 and transferred these assets to *S* in a transaction in which *P* determines its basis in the *S* stock under section 358. Under the rules of this section, the limitation described in §1.358–6(d)(2) does not apply. Thus, *P* adjusts its basis in the *S* stock by –$20 (the aggregate adjusted basis of *T*'s assets decreased by the fair market value of the consideration provided by *S*). As a result of the reorganization, *P* has an excess loss account of $15 in its *S* stock.

(c) *Appreciated asset.* The facts are the same as in paragraph (a) of this *Example 2*, except that in the reorganization *S* provides an asset with a $20 adjusted basis and $30 fair market value instead of $30 cash. The basis is adjusted in the same manner as in paragraph (b) of this *Example 2*. In addition, because *S* recognizes a $10 gain from the asset under section 1001, *P*'s basis in its *S* stock is increased under §1.1502–32(b) by *S*'s $10 gain. Consequently, as a result of the reorganization, *P* has an excess loss account of $5 in its *S* stock. (The results would be the same if the appreciated asset provided by *S* was *P* stock with respect to which *S* recognized gain. See §1.1032–2(c)).

Example 3. Reverse triangular merger. (a) *Facts. T* has assets with an aggregate basis of $60 and fair market value of $100. *T*'s assets are subject to $70 of liabilities. *P* owns all of the only class of *S* stock. *P* has a $5 basis in its *S* stock. Pursuant to a plan, *S* merges into *T* with *T* surviving. In the merger, the *T* shareholders exchange their *T* stock for $2 cash from *P* and $28 worth of *P* stock provided by *P* pursuant to the plan. The transaction is a reorganization to which sections 368 (a)(1)(A) and (a)(2)(E) apply.

(b) *Basis adjustment.* Under §1.358–6, *P*'s basis in the *T* stock acquired equals its $5 basis in its *S* stock immediately before the transaction adjusted by the $60 basis in the *T* assets deemed transferred, and the $70 of liabilities to which the *T* assets are subject. Under the rules of this section, the limitation described in §1.358–6(c)(1)(ii) does not apply. Consequently, *P* has an excess loss account of $5 in its *T* stock as a result of the transaction.

(c) *Effective/applicability date.* This section applies to reorganizations occurring on or after December 21, 1995. However, paragraph (b)(4) of this section applies to reorganizations occurring on or after September 17, 2008.

[T.D. 8648, 60 FR 66082, Dec. 21, 1995, as amended by T.D. 9424, 73 FR 53949, Sept. 17, 2008]

§ 1.1502–31 Stock basis after a group structure change.

(a) *In general*—(1) *Overview.* If one corporation (P) succeeds another corporation (T) under the principles of §1.1502–75(d) (2) or (3) as the common parent of a consolidated group in a group structure change, the basis of members in the stock of the former common parent (or the stock of a successor) is adjusted or determined under this section. See §1.1502–33(f)(1) for the definition of group structure change. For example, if P owns all of the stock of another corporation (S), and T merges into S in a group structure change that is a reorganization described in section 368(a)(2)(D) in which P becomes the common parent of the T group, P's basis in S's stock must be adjusted to reflect the change in S's assets and liabilities. The rules of this section coordinate with the earnings and profits adjustments required under §1.1502–33(f)(1), generally conforming the results of transactions in which the T group continues under §1.1502–75 with P as the common parent. By preserving in P the relationship between T's earnings and profits and asset basis, these adjustments limit possible distortions under section 1502 (e.g., in the deconsolidation rules for earnings and profits under §1.1502–33(e), and the continued filing requirements under §1.1502–75(a)). This section applies whether or not T continues to exist after the group structure change.

(2) *Application of other rules of law.* If a transaction subject to this section is also a triangular reorganization otherwise subject to §1.1502–30, the provisions of this section and not those of §1.1502–30 apply to determine stock basis. See §1.1502–80(a) regarding the general applicability of other rules of

law and a limitation on duplicative adjustments.

(b) *General rules.* Except as otherwise provided in this section—

(1) *Asset acquisitions.* If a corporation acquires the former common parent's assets (and any liabilities assumed or to which the assets are subject) in a group structure change, the basis of members in the stock of the acquiring corporation is adjusted immediately after the group structure change to reflect the acquiring corporation's allocable share of the former common parent's net asset basis as determined under paragraph (c) of this section. For example, if S acquires all of T's assets in a group structure change that is a reorganization described in section 368(a)(2)(D), P's basis in S's stock is adjusted to reflect T's net asset basis. If P owned some of T's stock before the group structure change, the results would be the same because P's basis in the T stock is not taken into account in determining P's basis in S's stock. If T's net asset basis is a negative amount, it reduces P's basis in S's stock and, if the reduction exceeds P's basis in S's stock, the excess is P's excess loss account in S's stock. See §1.1502–19 for rules treating P's excess loss account as negative basis, and treating a reference to P's basis in S's stock as including an excess loss account.

(2) *Stock acquisitions.* If a corporation acquires stock of the former common parent in a group structure change, the basis of the members in the former common parent's stock immediately after the group structure change (including any stock of the former common parent owned before the group structure change) that is, or would otherwise be, transferred basis property is redetermined in accordance with the results for an asset acquisition described in paragraph (b)(1) of this section. For example, if all of T's stock is contributed to P in a group structure change to which section 351 applies, P's basis in T's stock is T's net asset basis, rather than the amount determined under section 362. Similarly, if S merges into T in a group structure change described in section 368(a)(2)(E) and P acquires all of the T stock, P's basis in T's stock is the basis that P would have in S's stock under paragraph (b)(1) of this section if T had merged into S in a group structure change described in section 368(a)(2)(D).

(c) *Net asset basis.* The former common parent's net asset basis is the basis it would have in the stock of a newly formed subsidiary, if—

(1) The former common parent transferred its assets (and any liabilities assumed or to which the assets are subject) to the subsidiary in a transaction to which section 351 applies;

(2) The former common parent and the subsidiary were members of the same consolidated group (see §1.1502–80(d) for the non-application of section 357(c) to the transfer); and

(3) The asset basis taken into account is each asset's basis immediately after the group structure change (e.g., taking into account any income or gain recognized in the group structure change and reflected in the asset's basis).

(d) *Additional adjustments.* In addition to the adjustments in paragraph (b) of this section, the following adjustments are made:

(1) *Consideration not provided by P.* The basis is reduced to reflect the fair market value of any consideration not provided by the member. For example, if S acquires T's assets in a group structure change described in section 368(a)(2)(D), and S provides an appreciated asset (e.g., stock of P) as partial consideration in the transaction, P's basis in S's stock is reduced by the fair market value of the asset.

(2) *Allocable share*—(i) *Asset acquisitions.* If a corporation receives less than all of the former common parent's assets and liabilities in the group structure change, the former common parent's net asset basis taken into account under paragraph (b)(1) of this section is adjusted accordingly.

(ii) *Stock acquisitions.* If less than all of the former common parent's stock is subject to the redetermination described in paragraph (b)(2) of this section, the percentage of the former common parent's net asset basis taken into account in the redetermination equals the percentage (by fair market value) of the former common parent's stock subject to the redetermination. For example, if P owns less than all of the former common parent's stock immediately after the group structure change and such stock would otherwise be transferred basis property, only an allocable part of the basis determined under this section is reflected in the shares owned by P (and the amount allocable to shares owned by nonmembers has no effect on the basis of their shares). Alternatively, if P acquired 10 percent of the former common parent's stock in a transaction in which the stock basis was determined by P's cost, and P later acquires the remaining 90 percent of the former common parent's stock in a separate transaction that is described in paragraph (b)(2) of this section, P retains its cost basis in its original stock and the basis of P's newly acquired shares reflects only an allocable part of the former common parent's net asset basis.

(3) *Allocation among shares of stock.* The basis determined under this section is allocated among shares under the principles of section 358. For example, if P owns multiple classes of the former common parent's stock immediately after the group structure change, only an allocable part of the basis determined under this section is reflected in the basis of each share. See §1.1502–19(d), for special allocations with respect to excess loss accounts.

(4) *Higher-tier members.* To the extent that the former common parent is owned by members other than the new common parent, the basis of members in the stock of all subsidiaries owning, directly or indirectly, in whole or in part, an interest in the former common parent's assets or liabilities is adjusted in accordance with the principles of this section. The adjustments are applied in the order of the tiers, from the lowest to the highest.

(e) *Waiver of loss carryovers of former common parent*—(1) *General rule.* An irrevocable election may be made to treat all or any portion of a loss carryover attributable to the common parent as expiring for all Federal income tax purposes immediately before the group structure change. Thus, if the loss carryover is treated as expiring under the election, it will not result in a negative adjustment to the basis of P's stock under §1.1502–32(b).

(2) *Election.* The election described in paragraph (e)(1) of this section must be made in a separate statement entitled, ''ELECTION TO TREAT LOSS CARRYOVER AS EXPIRING UNDER §1.1502–31(e).'' The election must be filed by including the statement on or with the consolidated group's income tax return for the year that includes the group structure change. The statement must identify the amount of each loss carryover deemed to expire (or the amount of each loss carryover deemed not to expire, with any balance of any loss carryovers being deemed to expire).

(f) *Predecessors and successors.* For purposes of this section, any reference to a corporation includes a reference to a successor or predecessor as the context may require. See §1.1502–32(f) for definitions of predecessor and successor.

(g) *Examples.* For purposes of the examples in this section, unless otherwise stated, all corporations have only one class of stock outstanding, the tax year of all persons is the calendar year, all persons use the accrual method of accounting, the facts set forth the only corporate activity, all transactions are between unrelated persons, and tax liabilities are disregarded. The principles of this section are illustrated by the following examples:

Example 1. Forward triangular merger. (i) *Facts.* P is the common parent of one group and T is the common parent of another. T has assets with an aggregate basis of $60 and fair market value of $100 and no liabilities. T's shareholders have an aggregate basis of $50 in T's stock. In Year 1, pursuant to a plan, P forms S and T merges into S with the T shareholders receiving $100 of P stock in exchange for their T stock. The transaction is a reorganization described in section 368(a)(2)(D). The transaction is also a reverse acquisition under §1.1502–75(d)(3) because the T shareholders, as a result of owning T's stock, own more than 50% of the value of P's stock immediately after the transaction. Thus, the transaction is a group structure change under §1.1502–33(f)(1), and P's earnings and profits are adjusted to reflect T's earnings and profits immediately before T ceases to be the common parent of the T group.

(ii) *Analysis.* Under paragraph (b)(1) of this section, P's basis in S's stock is adjusted to reflect T's net asset basis. Under paragraph (c) of this section, T's net asset basis is $60, the basis T would have in the stock of a subsidiary under section 358 if T had transferred all of its assets and liabilities to the subsidiary in a transaction to which section 351 applies. Thus, P has a $60 basis in S's stock.

(iii) *Pre-existing S.* The facts are the same as in paragraph (i) of this *Example 1,* except that P has owned the stock of S for several years and P has a $50 basis in the S stock before the merger with T. Under paragraph (b)(1) of this section, P's $50 basis in S's stock is adjusted to reflect T's net asset basis. Thus, P's basis in S's stock is $110 ($50 plus $60).

(iv) *Excess loss account included in former common parent's net asset basis.* The facts are the same as in paragraph (i) of this *Example 1,* except that T has two assets, an operating asset with an $80 basis and $90 fair market value, and stock of a subsidiary with a $20 excess loss account and $10 fair market value. Under paragraph (c) of this section, T's net asset basis is $60 ($80 minus $20). *See* sections 351 and 358, and §1.1502–19. Consequently, P has a $60 basis in S's stock. Under section 362 and §1.1502–19, S has an $80 basis in the operating asset and a $20 excess loss account in the stock of the subsidiary.

(v) *Liabilities in excess of basis.* The facts are the same as in paragraph (i) of this *Example 1,* except that T's assets have a fair market value of $170 (and $60 basis) and are subject to $70 of liabilities. Under paragraph (c) of this section, T's net asset basis is negative $10 ($60 minus $70). *See* sections 351 and 358, and §§1.1502–19 and 1.1502–80(d). Thus, P has a $10 excess loss account in S's stock. Under section 362, S has a $60 basis in its assets (which are subject to $70 of liabilities). (Under paragraph (a)(2) of this section, because the liabilities are taken into account in determining net asset basis under paragraph (c) of this section, the liabilities are not also taken into account as consideration not provided by P under paragraph (d)(1) of this section.)

(vi) *Consideration provided by S.* The facts are the same as in paragraph (i) of this *Example 1,* except that P forms S with a $100 contribution at the beginning of Year 1, and during Year 6, pursuant to a plan, S purchases $100 of P stock and T merges into S with the T shareholders receiving P stock in exchange for their T stock. Under paragraph (b)(1) of this section, P's $100 basis in S's stock is increased by $60 to reflect T's net asset basis. Under paragraph (d)(1) of this section, P's basis in S's stock is decreased by $100 (the fair market value of the P stock) because the P stock purchased by S and used in the transaction is consideration not provided by P.

(vii) *Appreciated asset provided by S.* The facts are the same as in paragraph (i) of this *Example 1,* except that P has owned the stock of S for several years, and the shareholders of T receive $60 of P stock and an asset of S with a $30 adjusted basis and $40 fair market value. S recognizes a $10 gain from the asset under section 1001. Under paragraph (b)(1) of this section, P's basis in S's stock is increased by $60 to reflect T's net asset basis. Under paragraph (d)(1) of this section, P's basis in S's stock is decreased by $40 (the fair market value of the asset provided by S). In addition, P's basis in S's stock is increased under §1.1502–32(b) by S's $10 gain.

(viii) *Depreciated asset provided by S.* The facts are the same as in paragraph (i) of this *Example 1,* except that P has owned the stock of S for several years, and the shareholders of T receive $60 of P stock and an asset of S with a $50 adjusted basis and $40 fair market value. S recognizes a $10 loss from the asset under section 1001. Under paragraph (b)(1) of this section, P's basis in S's stock is increased by $60 to reflect T's net asset basis. Under paragraph (d)(1) of this section, P's basis in S's stock is decreased by $40 (the fair market value of the asset provided by S). In addition, S's $10 loss is taken into account under §1.1502–32(b) in determining P's basis adjustments under that section.

Example 2. Stock acquisition. (i) *Facts.* P is the common parent of one group and T is the common parent of another. T has assets with an aggregate basis of $60 and fair market value of $100 and no liabilities. T's shareholders have an aggregate basis of $50 in T's stock. Pursuant to a plan, P forms S and S acquires all of T's stock in exchange for P stock in a transaction described in section 368(a)(1)(B). The transaction is also a reverse acquisition under §1.1502–75(d)(3). Thus, the transaction is a group structure change under §1.1502–33(f)(1), and the earnings and profits of P and S are adjusted to reflect T's earnings and profits immediately before T ceases to be the common parent of the T group.

(ii) *Analysis.* Under paragraph (d)(4) of this section, although S is not the new common parent of the T group, adjustments must be made to S's basis in T's stock in accordance with the principles of this section. Although S's basis in T's stock would ordinarily be determined under section 362 by reference to the basis of T's shareholders in T's stock immediately before the group structure change, under the principles of paragraph (b)(2) of this section, S's basis in T's stock is determined by reference to T's net asset basis. Thus, S's basis in T's stock is $60.

(iii) *Higher-tier adjustments.* Under paragraph (d)(4) of this section, P's basis in S's stock is increased by $60 (to be consistent with the adjustment to S's basis in T's stock).

(iv) *Cross ownership.* The facts are the same as in paragraph (i) of this *Example 2*, except S purchased 10% of T's stock from an unrelated person for cash. In an unrelated transaction, S acquires the remaining 90% of T's stock in exchange for P stock. S's basis in the initial 10% of T's stock is not redetermined under this section. However, S's basis in the additional 90% of T's stock is redetermined under this section. S's basis in that stock is adjusted to $54 (90% of T's net asset basis).

(v) *Allocable share*. The facts are the same as in paragraph (i) of this *Example 2*, except that P owns only 90% of S's stock immediately after the group structure change. S's basis in T's stock is the same as in paragraph (ii) of this *Example 2*. Under paragraph (d)(2) of this section, P's basis in its S stock is increased by $54 (90% of S's $60 adjustment).

Example 3. Taxable stock acquisition. (i) *Facts*. P is the common parent of one group and T is the common parent of another. T has assets with an aggregate basis of $60 and fair market value of $100 and no liabilities. T's shareholders have an aggregate basis of $50 in T's stock. Pursuant to a plan, P acquires all of T's stock in exchange for $70 of P's stock and $30 in a transaction that is a group structure change under §1.1502–33(f)(1). P's acquired T stock is not transferred basis property. (Because of P's use of cash, the acquisition is not a transaction described in section 368(a)(1)(B).)

(ii) *Analysis*. The rules of this section do not apply to determine P's basis in T's stock. Therefore, P's basis in T's stock is $100.

(h) *Effective/applicability dates*—(1) *General rule*. This section applies to group structure changes that occur after April 26, 2004. However, a group may apply this section to group structure changes that occurred on or before April 26, 2004, and in consolidated return years beginning on or after January 1, 1995. In addition, paragraph (a)(2) of this section applies to group structure changes that occurred on or after September 17, 2008. Paragraph (e)(2) of this section applies to any original consolidated Federal income tax return due (without extensions) after June 14, 2007. For original consolidated Federal income tax returns due (without extensions) after May 30, 2006, and on or before June 14, 2007, see §1.1502–31T as contained in 26 CFR part 1 in effect on April 1, 2007. For original consolidated Federal income tax returns due (without extensions) on or before May 30, 2006, see §1.1502–31 as contained in 26 CFR part 1 in effect on April 1, 2006.

(2) *Prior law*. For group structure changes that occur on or before April 26, 2004, and in consolidated return years beginning on or after January 1, 1995, with respect to which the group does not elect to apply the provisions of this section, see §1.1502–31 as contained in the 26 CFR part 1 edition revised as of April 1, 2003. For group structure changes that occur in consolidated return years beginning before January 1, 1995, see §1.1502–31T as contained in the 26 CFR part 1 edition revised as of April 1, 1994.

[T.D. 8560, 59 FR 41683, Aug. 15, 1994, as amended by T.D. 9122, 69 FR 22400, Apr. 26, 2004; T.D. 9264, 71 FR 30602, May 30, 2006; T.D. 9329, 72 FR 32804, June 14, 2007; T.D. 9424, 73 FR 53949, Sept. 17, 2008]

§ 1.1502–32 Investment adjustments.

(a) *In general*—(1) *Purpose*. This section provides rules for adjusting the basis of the stock of a subsidiary (S) owned by another member (M). These rules modify the determination of M's basis in S's stock under applicable rules of law by adjusting M's basis to reflect S's distributions and S's items of income, gain, deduction, and loss taken into account for the period that S is a member of the consolidated group. The purpose of the adjustments is to treat M and S as a single entity so that consolidated taxable income reflects the group's income. For example, if M forms S with a $100 contribution, and S takes into account $10 of income, M's $100 basis in S's stock under section 358 is increased by $10 under this section to prevent S's income from being taken into account a second time on M's disposition of S's stock. Comparable adjustments are made for tax-exempt income and noncapital, nondeductible expenses that S takes into account, to preserve their treatment under the Internal Revenue Code.

(2) *Application of other rules of law, duplicative adjustments*. See §1.1502–80(a) regarding the general applicability of other rules of law and a limitation on duplicative adjustments. The rules of this section are in addition to other rules of law. See, e.g., section 358 (basis determinations for distributees), section 1016 (adjustments to basis), §1.1502–11(b) (limitations on the use of losses), §1.1502–19 (treatment of excess loss accounts), §1.1502–31 (basis after a group structure change), and §1.1502–35 (additional rules relating to stock loss, including losses attributable to worthlessness and certain dispositions not followed by a separate return year).

M's basis in S's stock must not be adjusted under this section and other rules of law in a manner that has the effect of duplicating an adjustment.

(3) *Overview*—(i) *In general.* The amount of the stock basis adjustments and their timing are determined under paragraph (b) of this section. Under paragraph (c) of this section, the amount of the adjustment is allocated among the shares of S's stock. Paragraphs (d) through (g) of this section provide definitions, an anti-avoidance rule, successor rules, and recordkeeping requirements.

(ii) *Excess loss account.* Negative adjustments under this section may exceed M's basis in S's stock. The resulting negative amount is M's excess loss account in S's stock. See §1.1502–19 for rules treating excess loss accounts as negative basis, and treating references to stock basis as including references to excess loss accounts.

(iii) *Tiering up of adjustments.* The adjustments to S's stock under this section are taken into account in determining adjustments to higher-tier stock. The adjustments are applied in the order of the tiers, from the lowest to the highest. For example, if M is also a subsidiary, M's adjustment to S's stock is taken into account in determining the adjustments to stock of M owned by other members.

(b) *Stock basis adjustments*—(1) *Timing of adjustments*—(i) *In general.* Adjustments under this section are made as of the close of each consolidated return year, and as of any other time (an interim adjustment) if a determination at that time is necessary to determine a tax liability of any person. For example, adjustments are made as of M's sale of S's stock in order to measure M's gain or loss from the sale, and if M's interest in S's stock is not uniform throughout the year (e.g., because M disposes of a portion of its S stock, or S issues additional shares to another person), the adjustments under this section are made by taking into account the varying interests. An interim adjustment may be necessary even if tax liability is not affected until a later time. For example, if M sells only 50% of S's stock and S becomes a nonmember, adjustments must be made for the retained stock as of the disposition (whether or not M has an excess loss account in that stock). Similarly, if S liquidates during a consolidated return year, adjustments must be made as of the liquidation (even if the liquidation is tax free under section 332).

(ii) *Special rule for discharge of indebtedness income.* Adjustments under this section resulting from the realization of discharge of indebtedness income of a member that is excluded from gross income under section 108(a) (excluded COD income) and from the reduction of attributes in respect thereof pursuant to sections 108 and 1017 and §1.1502–28 (including reductions in the basis of property) when a member (the departing member) ceases to be a member of the group on or prior to the last day of the consolidated return year that includes the date the excluded COD income is realized are made immediately after the determination of tax for the group for the taxable year during which the excluded COD income is realized (and any prior years) and are effective immediately before the beginning of the taxable year of the departing member following the taxable year during which the excluded COD income is realized. Such adjustments when a corporation (the new member) is not a member of the group on the last day of the consolidated return year that includes the date the excluded COD income is realized but is a member of the group at the beginning of the following consolidated return year are also made immediately after the determination of tax for the group for the taxable year during which the excluded COD income is realized (and any prior years) and are effective immediately before the beginning of the taxable year of the new member following the taxable year during which the excluded COD income is realized. If the new member was a member of another group immediately before it became a member of the group, such adjustments are treated as occurring immediately after it ceases to be a member of the prior group.

(iii) *Allocation of items.* If §1.1502–76(b) applies to S for purposes of an adjustment before the close of the group's consolidated return year, the amount of the adjustment is determined under that section. If §1.1502–76(b) does not apply to the interim adjustment, the adjustment is determined under the principles of §1.1502–76(b), consistently applied, and ratable allocation under the principles of §1.1502–76(b)(2)(ii) or (iii) may be used without filing an election under §1.1502–76(b)(2). The principles would apply, for example, if M becomes a nonmember but S remains a member.

(2) *Amount of adjustments.* M's basis in S's stock is increased by positive adjustments and decreased by negative adjustments under this paragraph (b)(2). The amount of the adjustment, determined as of the time of the adjustment, is the net amount of S's—

(i) Taxable income or loss;

(ii) Tax-exempt income;

(iii) Noncapital, nondeductible expenses; and

(iv) Distributions with respect to S's stock.

(3) *Operating rules.* For purposes of determining M's adjustments to the basis of S's stock under paragraph (b)(2) of this section—

(i) *Taxable income or loss.* S's taxable income or loss is consolidated taxable income (or loss) determined by including only S's items of income, gain, deduction, and loss taken into account in determining consolidated taxable income (or loss), treating S's deductions and losses as taken into account to the extent they are absorbed by S or any other member. For this purpose:

(A) To the extent that S's deduction or loss is absorbed in the year it arises or is carried forward and absorbed in a subsequent year (e.g., under section 172, 465, or 1212), the deduction or loss is taken into account under paragraph (b)(2) of this section in the year in which it is absorbed.

(B) To the extent that S's deduction or loss is carried back and absorbed in a prior year (whether consolidated or separate), the deduction or loss is taken into account under paragraph (b)(2) of this section in the year in which it arises and not in the year in which it is absorbed.

(ii) *Tax-exempt income*—(A) *In general.* S's tax-exempt income is its income and gain which is taken into account but permanently excluded from its gross income under applicable law, and which increases, directly or indirectly, the basis of its assets (or an equivalent amount). For example, S's dividend income to which §1.1502–13(f)(2)(ii) applies, and its interest excluded from gross income under section 103, are treated as tax-exempt income. However, S's income not recognized under section 1031 is not treated as tax- exempt income because the corresponding basis adjustments under section 1031(d) prevent S's nonrecognition from being permanent. Similarly, S's tax-exempt income does not include gain not recognized under section 332 from the liquidation of a lower-tier subsidiary, or not recognized under section 118 or section 351 from a transfer of assets to S.

(B) *Equivalent deductions.* To the extent that S's taxable income or gain is permanently offset by a deduction or loss that does not reduce, directly or indirectly, the basis of S's assets (or an equivalent amount), the income or gain is treated as tax-exempt income and is taken into account under paragraph (b)(3)(ii)(A) of this section. In addition, the income and the offsetting item are taken into account under paragraph (b)(3)(i) of this section. For example, if S receives a $100 dividend with respect to which a $70 dividends received deduction is allowed under section 243, $70 of the dividend is treated as tax-exempt income. Accordingly, M's basis in S's stock increases by $100 because the $100 dividend and $70 deduction are taken into account under paragraph (b)(3)(i) of this section (resulting in $30 of the increase), and $70 of the dividend is also taken into account under paragraph (b)(3)(ii)(A) of this section as tax-exempt income (resulting in $70 of the increase). (See paragraph (b)(3)(iii) of this section if there is a corresponding negative adjustment under section 1059.) Similarly, income from mineral properties is treated as tax-exempt income to the extent it is offset by deductions for depletion in excess of the basis of the property.

(C) *Discharge of indebtedness income*—(*1*) *In general.* Excluded COD income is treated as tax-exempt income only to the extent the discharge is applied to reduce tax attributes attributable to any member of the group under section 108, section 1017 or §1.1502–28. However, if S is treated as realizing excluded

COD income pursuant to §1.1502–28(a)(3), S shall not be treated as realizing excluded COD income for purposes of the preceding sentence.

(*2*) *Expired loss carryovers.* If the amount of the discharge exceeds the amount of the attribute reduction under sections 108 and 1017, and §1.1502–28, the excess nevertheless is treated as applied to reduce tax attributes to the extent a loss carryover attributable to S expired without tax benefit, the expiration was taken into account as a noncapital, nondeductible expense under paragraph (b)(3)(iii) of this section, and the loss carryover would have been reduced had it not expired.

(D) *Basis shifts.* An increase in the basis of S's assets (or an equivalent as described in paragraph (b)(3)(iv)(B) of this section) is treated as tax-exempt income to the extent that the increase is not otherwise taken into account in determining stock basis, it corresponds to a negative adjustment that is taken into account by the group under this paragraph (b) (or incurred by the common parent), and it has the effect (viewing the group in the aggregate) of a permanent recovery of the reduction. For example, S's basis increase under section 50(c)(2) is treated as tax-exempt income to the extent the preceding basis reduction under section 50(c)(1) is reflected in the basis of a member's stock. On the other hand, if S increases the basis of an asset as the result of an accounting method change, and the related positive section 481(a) adjustment is taken into account over time, the basis increase is not treated as tax-exempt income.

(iii) *Noncapital, nondeductible expenses*—(A) *In general.* S's noncapital, nondeductible expenses are its deductions and losses that are taken into account but permanently disallowed or eliminated under applicable law in determining its taxable income or loss, and that decrease, directly or indirectly, the basis of its assets (or an equivalent amount). For example, S's Federal taxes described in section 275 and loss not recognized under section 311(a) are noncapital, nondeductible expenses. Similarly, if a loss carryover (e.g., under section 172 or 1212) attributable to S expires or is reduced under section 108(b) and §1.1502–28, it becomes a noncapital, nondeductible expense at the close of the last tax year to which it may be carried. However, when a tax attribute attributable to S is reduced as required pursuant to §1.1502–28(a)(3), the reduction of the tax attribute is not treated as a noncapital, nondeductible expense of S. Finally, if S sells and repurchases a security subject to section 1091, the disallowed loss is not a noncapital, nondeductible expense because the corresponding basis adjustments under section 1091(d) prevent the disallowance from being permanent.

(B) *Nondeductible basis recovery.* Any other decrease in the basis of S's assets (or an equivalent as described in paragraph (b)(3)(iv)(B) of this section) may be a noncapital, nondeductible expense to the extent that the decrease is not otherwise taken into account in determining stock basis and is permanently eliminated for purposes of determining S's taxable income or loss. Whether a decrease is so treated is determined by taking into account both the purposes of the Code or regulatory provision resulting in the decrease and the purposes of this section. For example, S's noncapital, nondeductible expenses include any basis reduction under section 50(c)(1), section 1017, section 1059, §1.1502–35(b) or (f)(2). Also included as a noncapital, nondeductible expense is the amount of any gross-up for taxes paid by another taxpayer that S is treated as having paid (e.g., income included under section 78, or the portion of an undistributed capital gain dividend that is treated as tax deemed to have been paid by a shareholder under section 852(b)(3)(D)(ii), whether or not any corresponding amount is claimed as a tax credit). In contrast, a decrease generally is not a noncapital, nondeductible expense if it results because S redeems stock in a transaction to which section 302(a) applies, S receives assets in a liquidation to which section 332 applies and its basis in the assets is less than its basis in the stock canceled, or S distributes the stock of a subsidiary in a distribution to which section 355 applies.

(iv) *Special rules for tax-exempt income and noncapital, nondeductible expenses.* For purposes of paragraphs (b)(3)(ii) and (iii) of this section:

(A) *Treatment as permanent.* An amount is permanently excluded from gross income, or permanently disallowed or eliminated, if it is so treated by S even though another person may take a corresponding amount into account. For example, if S sells property to a nonmember at a loss that is disallowed under section 267(a), S's loss is a noncapital, nondeductible expense even though under section 267(d) the nonmember may treat a corresponding amount of gain as not recognized. (If the nonmember is a subsidiary in another consolidated group, its gain not recognized under section 267(d) is tax-exempt income under paragraph (b)(3)(ii)(A) of this section.)

(B) *Amounts equivalent to basis and adjustments to basis.* Amounts equivalent to basis include the amount of money, the amount of a loss carryover, and the amount of an adjustment to gain or loss under section 475(a) for securities described in section 475(a)(2). An equivalent to a basis increase includes a decrease in an excess loss account, and an equivalent to a basis decrease includes the denial of basis for taxable income.

(C) *Timing.* An amount is taken into account in the year in which it would be taken into account under paragraph (b)(3)(i) of this section if it were subject to Federal income taxation.

(D) *Tax sharing agreements.* Taxes are taken into account by applying the principles of section 1552 and the percentage method under §1.1502–33(d)(3) (and by assuming a 100% allocation of any decreased tax liability). The treatment of amounts allocated under this paragraph (b)(3)(iv)(D) is analogous to the treatment of allocations under §1.1552–1(b)(2). For example, if one member owes a payment to a second member, the first member is treated as indebted to the second member. The right to receive payment is treated as a positive adjustment under paragraph (b)(3)(ii) of this section, and the obligation to make payment is treated as a negative adjustment under paragraph (b)(3)(iii) of this section. If the obligation is not paid, the amount not paid generally is treated as a distribution, contribution, or both, depending on the relationship between the members.

(v) *Distributions.* Distributions taken into account under paragraph (b)(2) of this section are distributions with respect to S's stock to which section 301 applies and all other distributions treated as dividends (e.g., under section 356(a)(2)). See §1.1502–13(f)(2)(iv) for taking into account distributions to which section 301 applies (but not other distributions treated as dividends) under the entitlement rule.

(4) *Waiver of loss carryovers from separate return limitation years*—(i) *General rule.* If S has a loss carryover from a separate return limitation year when it becomes a member of a consolidated group, the group may make an irrevocable election to treat all or any portion of the loss carryover as expiring for all Federal income tax purposes immediately before S becomes a member of the consolidated group (deemed expiration). If S was a member of another group immediately before it became a member of the consolidated group, the expiration is also treated as occurring immediately after it ceases to be a member of the prior group.

(ii) *Stock basis adjustments from a waiver*—(A) *Qualifying transactions.* If S becomes a member of the consolidated group in a qualifying cost basis transaction and an election under this paragraph (b)(4) is made, the noncapital, nondeductible expense resulting from the deemed expiration does not result in a corresponding stock basis adjustment for any member under this section. A qualifying cost basis transaction is the purchase (i.e., a transaction in which basis is determined under section 1012) by members of the acquiring consolidated group (while they are members) in a 12-month period of an amount of S's stock satisfying the requirements of section 1504(a)(2).

(B) *Nonqualifying transactions.* If S becomes a member of the consolidated group other than in a qualifying cost basis transaction and an election under this paragraph (b)(4) is made, the basis of its stock that is owned by members immediately after it becomes a member is subject to reduction under the principles of this section to reflect the deemed expiration. The reduction occurs immediately before S becomes a member, but after it ceases to be a member of any prior group, and it therefore does not result in a corresponding stock basis adjustment for any higher-tier member of the transferring or acquiring consolidated group. Any basis reduction under this paragraph (b)(4)(ii)(B) is taken into account in making determinations of basis under the Code with respect to S's stock (e.g., a determination under section 362 because the stock is acquired in a transaction described in section 368(a)(1)(B)), but it does not result in corresponding stock basis adjustments under this section for any higher-tier member. If the basis reduction exceeds the basis of S's stock, the excess is treated as an excess loss account to which the members owning S's stock succeed.

(C) *Higher-tier corporations.* If S becomes a member of the consolidated group as a result, in whole or in part, of a higher-tier corporation becoming a member (whether or not in a qualifying cost basis transaction), additional adjustments are required. The highest-tier corporation (T) whose becoming a member resulted in S becoming a member, and T's chain of lower-tier corporations that includes S, are subject to the adjustment. The deemed expiration of S's loss carryover that results in a negative adjustment for the first higher-tier corporation is treated as an expiring loss carryover of that higher-tier corporation for purposes of applying paragraph (b)(4)(ii)(B) of this section to that corporation. For example, if M purchases all of the stock of T, T owns all of the stock of T1, T1 owns all of the stock of S, S becomes a member as a result of T becoming a member, and the election under this paragraph (b)(4) is made, the basis of the S stock is reduced and the reduction tiers up to T1, T1 treats the negative adjustment to its basis in S's stock as an expiring loss carryover of T1, and T then adjusts its basis in T1's stock. In addition, if T becomes a member of the acquiring group in a transaction other than a qualifying cost basis transaction, the amount that tiers up to T also reduces the basis of its stock under paragraph (b)(4)(ii)(B) of this section (but the amount does not tier up to higher-tier members).

(iii) *Net asset basis limitation.* Basis reduced under this paragraph (b)(4) is restored before S becomes a member (and before the basis of S's stock is taken into account in determining basis under the Code) to the extent necessary to conform a share's basis to its allocable portion of net asset basis. In the case of higher-tier corporations under paragraph (b)(4)(ii)(C) of this section, the restoration does not tier up but is instead applied separately to each higher-tier corporation. For purposes of determining each corporation's net asset basis (including the basis of stock in lower-tier corporations), the restoration is applied in the order of tiers, from the lowest to the highest. For purposes of the restoration:

(A) A member's net asset basis is the positive or negative difference between the adjusted basis of its assets (and the amount of any of its loss carryovers that are not deemed to expire) and its liabilities. Appropriate adjustments must be made, for example, to disregard liabilities that subsequently will give rise to deductions (e.g., liabilities to which section 461(h) applies).

(B) Within a class of stock, each share has the same allocable portion of net asset basis. If there is more than one class of common stock, the net asset basis is allocated to each class by taking into account the terms of each class and all other facts and circumstances relating to the overall economic arrangement.

(iv) *Election.* The election described in paragraph (b)(4) of this section must be made in a separate statement entitled, ''ELECTION TO TREAT LOSS CARRYOVER OF [INSERT NAME AND EMPLOYER IDENTIFICATION NUMBER OF S] AS EXPIRING UNDER §1.1502–32(b)(4).'' The election must be filed by including a statement on or with the consolidated group's income tax return for the year S becomes a member. A separate statement must be made for each member whose loss carryover is deemed to expire. The statement must identify the amount of each loss carryover deemed to expire (or the amount of each loss carryover deemed not to expire, with any balance of any loss carryovers being deemed to expire) and the basis of any stock reduced as a result of the deemed expiration.

(v) *Special rule for loss carryovers of a subsidiary acquired in a transaction for which an election under §1.1502–20(i)(2) is made*—(A) *Expired losses.* Notwithstanding paragraph (b)(4)(iv) of this section, unless a group otherwise chooses, to the extent that S's loss carryovers are increased by reason of an election under §1.1502–20(i)(2) and such loss carryovers expire or would have been properly used to offset income in a taxable year for which the refund of an overpayment is prevented by any law or rule of law as of the date the group files its original return for the taxable year in which S receives the notification described in §1.1502–20(i)(3)(iv) and at all times thereafter, the group will be deemed to have made an election under paragraph (b)(4) of this section to treat all of such loss carryovers as expiring for all Federal income tax purposes immediately before S became a member of the consolidated group. A group may choose not to apply the rule of the previous sentence to all of such loss carryovers of S by taking a position on an original or amended tax return for each relevant taxable year that is consistent with having made such choice.

(B) *Available losses.* Notwithstanding paragraph (b)(4)(iv) of this section, to the extent that S's loss carryovers are increased by reason of an election under §1.1502–20(i)(2) and such loss carryovers have not expired and would not have been properly used to offset income in a taxable year for which the refund of an overpayment is prevented by any law or rule of law as of the date the group files its original return for the taxable year in which S receives the notification described in §1.1502–20(i)(3)(iv) and at all times thereafter, the group may make an election under paragraph (b)(4) of this section to treat all or a portion of such loss carryovers as expiring for all Federal income tax purposes immediately before S became a member of the consolidated group. Such election must be filed with the group's original return for the taxable year in which S receives the notification described in §1.1502–20(i)(3)(iv).

(C) *Effective dates.* Paragraph (b)(4)(v) of this section is applicable on and after March 3, 2005. For prior periods, see §1.1502–32T(b)(4)(v) as contained in the 26 CFR part 1 in effect on March 2, 2005.

(vi) *Special rules in the case of certain transactions subject to §1.1502–35.* If a member of a consolidated group transfers stock of a subsidiary and such stock has a basis that exceeds its value immediately before such transfer or a subsidiary is deconsolidated and any stock of such subsidiary owned by members of the group immediately before such deconsolidation has a basis that exceeds its value, all members of the group are subject to the provisions of §1.1502–35(b), which generally require a redetermination of members' basis in all shares of subsidiary stock.

(vii) *Special rules for amending waiver of loss carryovers from separate return limitation year*—(A) *Waivers that increased allowable loss or reduced basis reduction required.* If, in connection with the acquisition of S, the group made an election pursuant to paragraph (b)(4) of this section to treat all or any portion of S's loss carryovers as expiring, and the prior group elected to determine the amount of the allowable loss or the basis reduction required with respect to the stock of S or a higher-tier corporation of S by applying the provisions described in §1.1502–20(i)(2)(i) or (ii), then the group may reduce the amount of any loss carryover deemed to expire (or increase the amount of any loss carryover deemed not to expire) as a result of the election made pursuant to paragraph (b)(4) of this section. The aggregate amount of loss carryovers that may be treated as not expiring as a result of amendments made pursuant to this paragraph (b)(4)(vii)(A) with respect to S and any higher- and lower-tier corporation of S may not exceed the amount described in §1.1502–20(c)(1)(iii) with respect to the acquired stock (computed without regard to the effect of the group's election or elections pursuant to paragraph (b)(4) of this section, but with regard to the effect of the prior group's election pursuant to §1.1502–20(g), if any, prior to the application of §1.1502–20(i)(3)). For purposes of determining the aggregate amount of loss carryovers that may be treated as not expiring as a result of amendments made pursuant to this paragraph (b)(4)(vii)(A) with respect to S and any higher- and lower-tier corporation of S, the group may rely on a written notification provided by the prior group. Nothing in this paragraph shall be construed as permitting a group to increase the amount of any loss carryover deemed to expire (or reduce the amount of any loss carryover deemed not to expire) as a result of the election made pursuant to paragraph (b)(4) of this section.

(B) *Inadvertent waivers of loss carryovers previously subject to an election described in §1.1502–20(g).* If, in connection with the acquisition of S, the group made an election pursuant to paragraph (b)(4) of this section to waive loss carryovers of S by identifying the amount of each loss carryover deemed not to expire, the prior group elected to determine the amount of the allowable loss or the basis reduction required with respect to the stock of S or a higher-tier corporation of S by applying the provisions described in §1.1502–20(i)(2)(i) or (ii), and the amount of S's loss carryovers treated as reattributed to the prior group pursuant to the election described in §1.1502–20(g) is reduced pursuant to §1.1502–20(i)(3), then the group may amend its election made pursuant to paragraph (b)(4) of this section to provide that all or a portion of the loss carryovers of S that are treated as loss carryovers of S as a result of the prior group's election to apply the provisions described in §1.1502–20(i)(2)(i) or (ii) are deemed not to expire. This paragraph (b)(4)(vii)(B), however, does not permit a group to reduce the amount of any loss carryover deemed not to expire as a result of the election made pursuant to paragraph (b)(4) of this section.

(C) *Time and manner of amending an election under §1.1502–32(b)(4).* The amendment of an election made pursuant to paragraph (b)(4) of this section must be made in a statement entitled *Amendment of Election to Treat Loss Carryover as Expiring Under §1.1502–32(b)(4) Pursuant to §1.1502–32(b)(4)(vii).* The statement must be filed with or as part of any timely filed (including extensions) original return for the taxable year that includes August 26, 2004, or with or as part of an amended return filed before the date the original return for the taxable year that includes August 26, 2004, is due (with regard to extensions). A separate statement shall be filed for each election made pursuant to paragraph (b)(4) of this section that is being amended pursuant to this paragraph (b)(4)(vii). For purposes of making this statement, the group may rely on the statements set forth in a written notification provided by the prior group. The statement filed under this paragraph must include the following—

(*1*) The name and employer identification number (E.I.N.) of S;

(*2*) In the case of an amendment made pursuant to paragraph (b)(4)(vii)(A), a statement that the group has received a written notification from the prior group confirming that the group's prior election or elections pursuant to paragraph (b)(4) of this section had the effect of either increasing the prior group's allowable loss on the disposition of subsidiary stock or reducing the prior group's amount of basis reduction required;

(*3*) The amount of each loss carryover of S deemed to expire (or the amount of loss carryover deemed not to expire) as set forth in the election made pursuant to paragraph (b)(4) of this section;

(*4*) The amended amount of each loss carryover of S deemed to expire (or the amended amount of loss carryover deemed not to expire); and

(*5*) In the case of an amendment made pursuant to paragraph (b)(4)(vii)(A) of this section, a statement that the aggregate amount of loss carryovers of S and any higher- and lower-tier corporation of S that will be treated as not expiring as a result of amendments made pursuant to paragraph (b)(4)(vii)(A) of this section will not exceed the amount described in §1.1502–20(c)(1)(iii) with respect to the acquired stock (computed without regard to the effect of the group's election or elections pursuant to paragraph (b)(4) of this section, but with regard to the effect of the prior group's election pursuant to §1.1502–20(g), if any, prior to the application of §1.1502–20(i)(3)).

(D) *Items taken into account in open years.* An amendment to an election made pursuant to paragraph (b)(4) of this section affects the group's items of income, gain, deduction, or loss only to the extent that the amendment gives rise, directly or indirectly, to items or amounts that would properly be taken into account in a year for which an assessment of deficiency or a refund for overpayment, as the case may be, is not prevented by any law or rule of law. Under this paragraph, if the year to which a loss previously deemed to expire as a result of an election made pursuant to paragraph (b)(4) of this section is deemed not to expire as a result of an election made pursuant to this paragraph would have been carried back or carried forward is a year for which a refund of overpayment is prevented by law, then to the extent that the absorption of such loss in such year would have affected the tax treatment of another item (e.g., another loss that was absorbed in such year) that has an effect in a year for which a refund of overpayment is not prevented by any law or rule of law, the amendment to the election made pursuant to paragraph (b)(4) of this section will affect the treatment of such other item. Therefore, if the absorption of such loss (the first loss) in a year for which a refund of overpayment is prevented by law would have prevented the absorption of another loss (the second loss) in such year and such second loss would have been carried to and used in a year for which a refund of overpayment is not prevented by any law or rule of law (the other year), the amendment of the election makes the second loss available for use in the other year.

(E) *Higher- and lower-tier corporations of S.* A *higher-tier corporation of S* is a corporation that was a member of the prior group and, as a result of such higher-tier corporation becoming a member of the group; S became a member of the group. A *lower-tier corporation of S* is a corporation that was a member of the prior group and became a member of the group as a result of S becoming a member of the group.

(F) *Effective date.* This paragraph (b)(4)(vii) is applicable on and after March 3, 2005. For prior periods, see §1.1502–32T(b)(4)(vii) as contained in the 26 CFR part 1 in effect on March 2, 2005.

(5) *Examples*—(i) *In general.* For purposes of the examples in this section, unless otherwise stated, M owns all of the only class of S's stock, the stock is owned for the entire year, S owns no stock of lower-tier members, the tax year of all persons is the calendar year, all persons use the accrual method of accounting, the facts set forth the only corporate activity, preferred stock is described in section 1504(a)(4), all transactions are between unrelated persons, and tax liabilities are disregarded.

(ii) *Stock basis adjustments.* The principles of this paragraph (b) are illustrated by the following examples.

Example 1. Taxable income. (a) *Current taxable income.* For Year 1, the M group has $100 of taxable income when determined by including only S's items of income, gain, deduction, and loss taken into account. Under paragraph (b)(1) of this section, M's basis in S's stock is adjusted under this section as of the close of Year 1. Under paragraph (b)(2) of this section, M's basis in S's stock is increased by the amount of the M group's taxable income determined by including only S's items taken into account. Thus, M's basis in S's stock is increased by $100 as of the close of Year 1.

(b) *Intercompany gain that is not taken into account.* The facts are the same as in paragraph (a) of this *Example 1,* except that S also sells property to another member at a $25 gain in Year 1, the gain is deferred under §1.1502–13 and taken into account in Year 3, and M sells 10% of S's stock to nonmembers in Year 2. Under paragraph (b)(3)(i) of this section, S's deferred gain is not additional taxable income for Year 1 or 2 because it is not taken into account in determining the M group's consolidated taxable income for either of those years. The deferred gain is not tax-exempt income under paragraph (b)(3)(ii) of this section because it is not permanently excluded from S's gross income. The deferred gain does not result in a basis adjustment until Year 3, when it is taken into account in determining the M group's consolidated taxable income. Consequently, M's basis in the S shares sold is not increased to reflect S's gain from the intercompany sale of the property. In Year 3, the deferred gain is taken into account, but the amount allocable to the shares sold by M does not increase their basis because these shares are held by nonmembers.

(c) *Intercompany gain taken into account.* The facts are the same as in paragraph (b) of this *Example 1,* except that M sells all of S's stock in Year 2 (rather than only 10%). Under §1.1502–13, S takes the $25 gain into account immediately before S becomes a nonmember. Thus, M's basis in S's stock is increased to reflect S's gain from the intercompany sale of the property.

Example 2. Tax loss. (a) *Current absorption.* For Year 2, the M group has a $50 consolidated net operating loss when determined by taking into account only S's items of income, gain, deduction, and loss. S's loss is absorbed by the M group in Year 2, offsetting M's income for that year. Under paragraph (b)(3)(i)(A) of this section, because S's loss is absorbed in the year it arises, M has a $50 negative adjustment with respect to S's stock. Under paragraph (b)(2) of this section, M reduces its basis in S's stock by $50. Under paragraph (a)(3)(ii) of this section, if the decrease exceeds M's basis in S's stock, the excess is M's excess loss account in S's stock.

(b) *Interim determination from stock sale.* The facts are the same as in paragraph (a) of this *Example 2*, except that S's Year 2 loss arises in the first half of the calendar year, M sells 50% of S's stock on July 1 of Year 2, and M's income for Year 2 does not arise until after the sale of S's stock. M's income for Year 2 (exclusive of the sale of S's stock) is offset by S's loss, even though the income arises after the stock sale, and no loss remains to be apportioned to S. See §§1.1502–11 and 1.1502–21(b). Under paragraph (b)(3)(i)(A) of this section, because S's $50 loss is absorbed in the year it arises, it reduces M's basis in the S shares sold by $25 immediately before the stock sale. Because S becomes a nonmember, the loss also reduces M's basis in the retained S shares by $25 immediately before S becomes a nonmember.

(c) *Loss carryback.* The facts are the same as in paragraph (a) of this *Example 2*, except that M has no income or loss for Year 2, S's $50 loss is carried back and absorbed by the M group in Year 1 (offsetting the income of M or S), and the M group receives a $17 tax refund in Year 2 that is paid to S. Under paragraph (b)(3)(i)(B) of this section, because the $50 loss is carried back and absorbed in Year 1, it is treated as a tax loss for Year 2 (the year in which it arises). Under paragraph (b)(3)(ii) of this section, the refund is treated as tax-exempt income of S. Under paragraph (b)(3)(iv)(C) of this section, the tax- exempt income is taken into account in Year 2 because that is the year it would be taken into account under S's method of accounting if it were subject to Federal income taxation. Thus, under paragraph (b)(2) of this section, M reduces its basis in S's stock by $33 as of the close of Year 2 (the $50 tax loss, less the $17 tax refund).

(d) *Loss carryforward.* The facts are the same as in paragraph (a) of this *Example 2*, except that M has no income or loss for Year 2, and S's loss is carried forward and absorbed by the M group in Year 3 (offsetting the income of M or S). Under paragraph (b)(3)(i)(A) of this section, the loss is not treated as a tax loss under paragraph (b)(2) of this section until Year 3.

Example 3. Tax-exempt income and noncapital, nondeductible expenses. (a) *Facts.* For Year 1, the M group has $500 of consolidated taxable income. However, the M group has a $100 consolidated net operating loss when determined by including only S's items of income, gain, deduction, and loss taken into account. Also for Year 1, S has $80 of interest income that is permanently excluded from gross income under section 103, and S incurs $60 of related expense for which a deduction is permanently disallowed under section 265.

(b) *Analysis.* Under paragraph (b)(3)(i)(A) of this section, S has a $100 tax loss for Year 1. Under paragraph (b)(3)(ii)(A) of this section, S has $80 of tax-exempt income. Under paragraph (b)(3)(iii)(A) of this section, S has $60 of noncapital, nondeductible expense. Under paragraph (b)(3)(iv)(C) of this section, the tax-exempt income and noncapital, nondeductible expense are taken into account in Year 1 because that is the year they would be taken into account under S's method of accounting if they were subject to Federal income taxation. Thus, under paragraph (b) of this section, M reduces its basis in S's stock as of the close of Year 1 by an $80 net amount (the $100 tax loss, less $80 of tax-exempt income, plus $60 of noncapital, nondeductible expenses).

Example 4. Discharge of indebtedness. (a) *Facts.* M forms S on January 1 of Year 1 and S borrows $200. During Year 1, S's assets decline in value and the M group has a $100 consolidated net operating loss. Of that amount, $10 is attributable to M and $90 is attributable to S under the principles of §1.1502–21(b)(2)(iv). None of the loss is absorbed by the group in Year 1, and S is discharged from $100 of indebtedness at the close of Year 1. M has a $0 basis in the S stock. M and S have no attributes other than the consolidated net operating loss. Under section 108(a), S's $100 of discharge of indebtedness income is excluded from gross income because of insolvency. Under section 108(b) and §1.1502–28, the consolidated net operating loss is reduced to $0.

(b) *Analysis.* Under paragraph (b)(3)(iii)(A) of this section, the reduction of $90 of the consolidated net operating loss attributable to S is treated as a noncapital, nondeductible expense in Year 1 because that loss is permanently disallowed by section 108(b) and §1.1502–28. Under paragraph (b)(3)(ii)(C)(*1*) of this section, all $100 of S's discharge of indebtedness income is treated as tax-exempt income in Year 1 because the discharge results in a $100 reduction to the consolidated net operating loss. Consequently, the loss and the cancellation of the indebtedness result in a net positive $10 adjustment to M's basis in its S stock.

(c) *Insufficient attributes.* The facts are the same as in paragraph (a) of this Example 4, except that S is discharged from $120 of indebtedness at the close of Year 1. Under section 108(a), S's $120 of discharge of indebtedness income is excluded from gross income because of insolvency. Under section 108(b) and §1.1502–28, the consolidated net operating loss is reduced by $100 to $0 after the determination of tax for Year 1. Under paragraph (b)(3)(iii)(A) of this section, the reduction of $90 of the consolidated net operating loss attributable to S is treated as a noncapital, nondeductible expense. Under paragraph (b)(3)(ii)(C)(*1*) of this section, only $100 of the discharge is treated as tax-exempt income because only that amount is applied to reduce tax attributes. The remaining $20 of discharge of indebtedness income excluded from gross income under section 108(a) has no effect on M's basis in S's stock.

(d) *Purchase price adjustment.* Assume instead that S buys land in Year 1 in exchange for S's $100 purchase money note (bearing interest at a market rate of interest in excess of the applicable Federal rate, and providing for a principal payment at the end of Year 10), and the seller agrees with S in Year 4 to discharge $60 of the note as a purchase price adjustment to which section 108(e)(5) applies. S has no discharge of indebtedness income that is treated as tax-exempt income under paragraph (b)(3)(ii) of this section. In addition, the $60 purchase price adjustment is not a noncapital, nondeductible expense under paragraph (b)(3)(iii) of this section. A purchase price adjustment is not equivalent to a discharge of indebtedness that is offset by a deduction or loss. Consequently, the purchase price adjustment results in no net adjustment to M's basis in S's stock under paragraph (b) of this section.

Example 5. Distributions. (a) *Amounts declared and distributed.* For Year 1, the M group has $120 of consolidated taxable income when determined by including only S's items of income, gain, deduction, and loss taken into account. S declares and makes a $10 dividend distribution to M at the close of Year 1. Under paragraph (b) of this section, M increases its basis in S's stock as of the close of Year 1 by a $110 net amount ($120 of taxable income, less a $10 distribution).

(b) *Distributions in later years.* The facts are the same as in paragraph (a) of this *Example 5*, except that S does not declare and distribute the $10 until Year 2. Under paragraph (b) of this section, M increases its basis in S's stock by $120 as of the close of Year 1, and decreases its basis by $10 as of the close of Year 2. (If M were also a subsidiary, the basis of its stock would also be increased in Year 1 to reflect M's $120 adjustment to basis of S's stock; the basis of M's stock would not be changed as a result of S's distribution in Year 2, because M's $10 of tax-exempt dividend income under paragraph (b)(3)(ii) of this section would be offset by the $10 negative adjustment to M's basis in S's stock for the distribution.)

(c) *Amounts declared but not distributed.* The facts are the same as in paragraph (a) of this *Example 5*, except that, during December of Year 1, S declares (and M becomes entitled to) another $70 dividend distribution with respect to its stock, but M does not receive the distribution until after it sells all of S's stock at the close of Year 1. Under §1.1502–13(f)(2)(iv), S is treated as making a $70 distribution to M at the time M becomes entitled to the distribution. (If S is distributing an appreciated asset, its gain under section 311 is also taken into account under paragraph (b)(3)(i) of this section at the time M becomes entitled to the distribution.) Consequently, under paragraph (b) of this section, M increases its basis in S's stock as of the close of Year 1 by only a $40 net amount ($120 of taxable income, less two distributions totalling $80). Any further adjustments after S ceases to be a member and the $70 distribution is made would be duplicative, because the stock basis has already been adjusted for the distribution. Accordingly, the distribution will not result in further adjustments or gain, even if the distribution is a payment to which section 301(c)(2) or (3) applies.

Example 6. Reorganization with boot. (i) *Facts.* M owns all the stock of S and T. M owns ten shares of the same class of common stock of S and ten shares of the same class of common stock of T. The fair market value of each share of S stock is $10 and the fair market value of each share of T stock is $10. On January 1 of Year 1, M has a $5 basis in each of its ten shares of S stock and a $10 basis in each of its ten shares of T stock. S and T have no items of income, gain, deduction, or loss for Year 1. S and T each have substantial earnings and profits. At the close of Year 1, T merges into S in a reorganization described in section 368(a)(1)(A) (and in section 368(a)(1)(D)). M receives no additional S stock, but does receive $10 which is treated as a dividend under section 356(a)(2).

(ii) *Analysis.* The merger of T into S is a transaction to which §1.1502–13(f)(3) applies. Under §1.1502–13(f)(3) and §1.358–2(a)(2)(iii), M is deemed to receive ten additional shares of S stock with a total fair market value of $100 (the fair market value of the T stock surrendered by M). Under §1.358–2(a)(2)(i), M will have a basis of $10 in each share of S stock deemed received in the reorganization. Under §1.358–2(a)(2)(iii), M is deemed to surrender all twenty shares of its S stock in a recapitalization under section 368(a)(1)(E) in exchange for the ten shares of S stock, the number of shares of S stock held by M immediately after the transaction. Thus, under §1.358–2(a)(2)(i), M has five shares of S stock each with a basis of $10 and five shares of S stock each with a basis of $20. The $10 M received is treated as a dividend distribution under section 301 and, under paragraph (b)(3)(v) of this section, the $10 is a distribution to which paragraph (b)(2)(iv) of this section applies. Accordingly, M's total basis in the S stock is decreased by the $10 distribution.

Example 7. Tiering up of basis adjustments. M owns all of S's stock, and S owns all of T's stock. For Year 1, the M group has $100 of consolidated taxable income when determined by including only T's items of income, gain, deduction, and loss taken into account, and $50 of consolidated taxable income when determined by including only S's items taken into account. S increases its basis in T's stock by $100 under paragraph (b) of this section. Under paragraph (a)(3) of this section, this $100 basis adjustment is taken into account in determining M's adjustments to its basis in S's stock. Thus, M increases its basis in S's stock by $150 under paragraph (b) of this section.

Example 8. Allocation of items. (a) *Acquisition in mid-year.* M is the common parent of a consolidated group, and S is an unaffiliated corporation filing separate returns on a calendar-year basis. M acquires all of S's stock and S becomes a member of the M group on July 1 of Year 1. For the entire calendar Year 1, S has $100 of ordinary income and under §1.1502–76(b) $60 is allocated to the period from January 1 to June 30 and $40 to the period from July 1 to December 31. Under paragraph (b) of this section, M increases its basis in S's stock by $40.

(b) *Sale in mid-year.* The facts are the same as in paragraph (a) of this *Example 8,* except that S is a member of the M group at the beginning of Year 1 but ceases to be a member on June 30 as a result of M's sale of S's stock. Under paragraph (b) of this section, M increases its basis in S's stock by $60 immediately before the stock sale. (M's basis increase would be the same if S became a nonmember because S issued additional shares to nonmembers.)

(c) *Absorption of loss carryovers.* Assume instead that S is a member of the M group at the beginning of Year 1 but ceases to be a member on June 30 as a result of M's sale of S's stock, and a $100 consolidated net operating loss attributable to S is carried over by the M group to Year 1. The consolidated net operating loss may be apportioned to S for its first separate return year only to the extent not absorbed by the M group during Year 1. Under paragraph (b)(3)(i) of this section, if the loss is absorbed by the M group in Year 1, whether the offsetting income arises before or after M's sale of S's stock, the absorption of the loss carryover is included in the determination of S's taxable income or loss for Year 1. Thus, M's basis in S's stock is adjusted under paragraph (b) of this section to reflect any absorption of the loss by the M group.

Example 9. Gross-ups. (a) *Facts.* M owns all of the stock of S, and S owns all of the stock of T, a newly formed controlled foreign corporation that is not a passive foreign investment company. In Year 1, T has $100 of subpart F income and pays $34 of foreign income tax, leaving T with $66 of earnings and profits. The M group has $100 of consolidated taxable income when determined by taking into account only S's items (the inclusion under section 951(a), taking into account the section 78 gross-up). As a result of the section 951(a) inclusion, S increases its basis in T's stock by $66 under section 961(a).

(b) *Analysis.* Under paragraph (b)(3)(i) of this section, S has $100 of taxable income. Under paragraph (b)(3)(iii)(B) of this section, the $34 gross-up for taxes paid by T that S is treated as having paid is a noncapital, nondeductible expense (whether or not any corresponding amount is claimed by the M group as a tax credit). Thus, M increases its basis in S's stock under paragraph (b) of this section by the net adjustment of $66.

(c) *Subsequent distribution.* The facts are the same as in paragraph (a) of this *Example 9,* except that T distributes its $66 of earnings and profits in Year 2. The $66 distribution received by S is excluded from S's income under section 959(a) because the distribution represents earnings and profits attributable to amounts that were included in S's income under section 951(a) for Year 1. In addition, S's basis in T's stock is decreased by $66 under section 961(b). The excluded distribution is not tax-exempt income under paragraph (b)(3)(ii) of this section because of the corresponding reduction to S's basis in T's stock. Consequently, M's basis in S's stock is not adjusted under paragraph (b) of this section for Year 2.

Example 10. Recapture of tax-exempt items. (a) *Facts.* S is a life insurance company. For Year 1, the M group has $200 of consolidated taxable income, determined by including only S's items of income, gain, deduction, and loss taken into account (including a $300 small company deduction under section 806). In addition, S has $100 of tax-exempt interest income, $60 of which is S's *company share.* The remaining $40 of tax-exempt income is the *policyholders' share* that reduces S's deduction for increase in reserves.

(b) *Tax-exempt items generally.* Under paragraph (b)(3)(i) of this section, S has $200 of taxable income for Year 1. Also for Year 1, S has $100 of tax-exempt income under paragraph (b)(3)(ii)(A) of this section, and another $300 is treated as tax-exempt income under paragraph (b)(3)(ii)(B) of this section because of the deduction under section 806. Under paragraph (b)(3)(iii) of this section, S has $40 of noncapital, nondeductible expenses for Year 1 because S's deduction under section 807 for its increase in reserves has been permanently reduced by the $40 policyholders' share of the tax-exempt interest income. Thus, M increases its basis in S's stock by $560 under paragraph (b) of this section.

(c) *Recapture.* Assume instead that S is a property and casualty company and, for Year 1, S accrues $100 of estimated salvage recoverable under section 832. Of this amount, $87 (87% of $100) is excluded from gross income because of the ''fresh start'' provisions of

Sec. 11305(c) of P.L. 101–508 (the Omnibus Budget Reconciliation Act of 1990). Thus, S has $87 of tax-exempt income under paragraph (b)(3)(ii)(A) of this section that increases M's basis in S's stock for Year 1. (S also has $13 of taxable income over the period of inclusion under section 481.) In Year 5, S determines that the $100 salvage recoverable was overestimated by $30 and deducts $30 for the reduction of the salvage recoverable. However, S has $26.10 (87% of $30) of taxable income in Year 5 due to the partial recapture of its fresh start. Because S has no basis corresponding to this income, S is treated under paragraph (b)(3)(iii)(B) of this section as having a $26.10 noncapital, nondeductible expense in Year 5. This treatment is necessary to reflect the elimination of the erroneous fresh start in S's stock basis and causes a decrease in M's basis in S's stock by $30 for Year 5 (a $3.90 taxable loss and a $26.10 special adjustment).

(c) *Allocation of adjustments among shares of stock*—(1) *In general*—(i) *Distributions*. The adjustment that is described in paragraph (b)(2)(iv) of this section (negative adjustments for distributions) is allocated to the shares of S stock to which the distribution relates.

(ii) *Special rules applicable in the case of certain loss transfers of subsidiary stock*—(A) *Losses reattributed pursuant to an election under §1.1502–36(d)(6)*—(*1*) *General rule*. If a member transfers loss shares of S stock and the common parent elects under §1.1502–36(d)(6) to reattribute all or a portion of S's attributes, S's resulting noncapital, nondeductible expense is allocated to all loss shares of S stock transferred by members in the transaction. The expense is allocated among those S shares in proportion to the loss in the shares. The tier-up of that expense is included in the remaining adjustment (see paragraph (c)(1)(iii) of this section).

(*2*) *Reattribution of attributes of a subsidiary that is lower-tier to S*. If a member transfers loss shares of S stock and the common parent elects under §1.1502–36(d)(6) to reattribute attributes of a subsidiary (S2) that is lower-tier to S, S2's resulting noncapital, nondeductible expense is allocated among S2 shares held by members as of the transaction, other than those transferred in the transaction and with respect to which gain or loss was recognized (recognition transfer), in a manner that permits the full amount of the expense to tier up and be applied to the bases of the loss shares of S stock transferred by members in the transaction. The expense is allocated among those S2 shares with positive basis in a manner that, first, reduces the bases of S2's preferred shares to equalize and then eliminate loss and, second, reduces the bases of S2's common shares in a manner that reduces disparity among the bases of those common shares to the greatest extent possible. The noncapital, nondeductible expense applied to the S2 shares tiers up and is applied to the stock of any subsidiaries that are lower-tier to S (middle-tier subsidiaries) in a manner that will permit the full amount of this expense to be applied to reduce the bases of the loss shares of S stock transferred by members in the transaction. Similar to the allocation among the S2 shares, the tier-up of this expense is allocated among the middle-tier subsidiary shares held by members as of the transaction, other than those transferred in a recognition transfer, in a manner that permits the full amount of the expense to tier up and be applied to the bases of the loss shares of S stock transferred by members in the transaction. The tier-up of this expense is allocated among those middle-tier subsidiary shares with positive basis in a manner that, first, reduces the bases of the middle-tier subsidiary's preferred shares to equalize and then eliminate loss and, second, reduces the bases of the middle-tier subsidiary's common shares in a manner that reduces disparity among the bases of those common shares to the greatest extent possible. The tier-up of this expense is allocated to the loss shares of S stock transferred by members in the transaction in the same manner as provided in paragraph (c)(1)(ii)(A)(*1*) of this section, and thereafter the tier-up of that expense is included in the remaining adjustment (see paragraph (c)(1)(iii) of this section).

(*3*) *Example*. The following example illustrates the rules of this paragraph (c)(1)(ii)(A).

Example. Assume P owns M1, P and M1 own M2, M2 owns S, M1 and S own S1, and M1 and S1 own S2. If S sells a portion of the S1 shares at a gain and M2 sells all of the S stock at a net loss (after adjusting the basis for the gain recognized by S on the sale of the S1 shares), and P elects under §1.1502–36(d)(6) to reattribute attributes of S2, the resulting noncapital, nondeductible expense is allocated entirely to the S2 shares held by S1 with positive basis in a manner that reduces the disparity in those bases to the greatest extent possible. The tier-up of this amount is allocated entirely to the S1 shares held by S (excluding the S1 shares sold) with positive basis in a manner that reduces the disparity in those bases to the greatest extent possible. The tier-up of this amount is allocated to the loss shares of S stock sold by M2 in proportion to the loss in those shares. The tier-up of this amount is then included in the remaining adjustment and tiers up from M2 to M1 and P, and from M1 to P under the general rules of this section.

(B) *Tier-up of reallocated investment adjustments subject to prior use limitation.* If the reallocation of an investment adjustment under §1.1502–36(b)(2) is subject to the prior use limitation in §1.1502–36(b)(2)(iii)(B)(*2*), no amount of the tier-up of such reallocated investment adjustment shall be allocated to any share whose prior use resulted in the application of the limitation. Thereafter, the tier-up of this amount is included in the remaining adjustment (see paragraph (c)(1)(iii) of this section).

(iii) *Remaining adjustment.* The *remaining adjustment* is the adjustment that consists of the items described in paragraphs (b)(2)(i) through (b)(2)(iii) of this section (adjustments for taxable income or loss, tax-exempt income, and noncapital, nondeductible expenses), including adjustments to lower-tier stock basis that tier up under paragraph (a)(3)(iii) of this section, but only to the extent not specially allocated under paragraph (c)(1)(ii) of this section. The remaining adjustment is allocated among the shares of S stock as provided in paragraphs (c)(2) through (c)(4) of this section. If the remaining adjustment is positive, it is allocated first to any preferred stock as provided in paragraph (c)(3) of this section, and then to the common stock as provided in paragraph (c)(2) of this section. If the remaining adjustment is negative, it is allocated only to common stock as provided in paragraph (c)(2) of this section.

(iv) *Nonmember shares.* No adjustment under this section that is allocated to a share for the period it is owned by a nonmember affects the basis of the share.

(v) *Cross-references.* See paragraph (c)(4) of this section for the reallocation of adjustments, and paragraph (d) of this section for definitions. See §1.1502–19(d) for special allocations of basis determined or adjusted under the Internal Revenue Code (Code) with respect to excess loss accounts.

(2) *Common stock*—(i) *Allocation within a class.* The remaining adjustment described in paragraph (c)(1)(iii) of this section that is allocable to a class of common stock is generally allocated equally to each share within the class. However, if a member has an excess loss account in a share of a class of common stock at the time a positive remaining adjustment is to be allocated, the portion of the positive remaining adjustment allocable to the member with respect to the class is allocated first to equalize and then eliminate that member's excess loss accounts. It is then allocated equally among the members' shares in that class. Similarly, the portion of any negative remaining adjustment allocable to the member with respect to the class is allocated equally to the member's shares with positive bases, eliminating all positive basis in shares of the class before creating or increasing any excess loss accounts. After positive basis is eliminated, any remaining portion of the negative remaining adjustment is allocated to equalize the member's excess loss accounts in the shares of that class to the greatest extent possible. Distributions and any adjustments or determinations under the Internal Revenue Code (for example, under section 358, including any modifications under §1.1502–19(d)) are taken into account before the allocation is made under this paragraph (c)(2)(i).

(ii) *Allocation among classes*—(A) *General rule.* If S has more than one class of common stock, the extent to which the remaining adjustment described in paragraph (c)(1)(iii) of this section is allocated to each class is determined, based on consistently applied assumptions, by taking into account the terms of each class and all other facts and circumstances relating to the overall economic arrangement. The allocation generally must reflect the manner in which the classes participate in the economic benefit or burden (if any) corresponding to the items of income, gain, deduction, or loss allocated. In determining participation, any differences in voting rights are not taken into account, and the following factors are among those to be considered—

(*1*) The interest of each share in economic profits and losses (if different from the interest in taxable income);

(*2*) The interest of each share in cash flow and other non-liquidating distributions; and

(*3*) The interest of each share in distributions in liquidation.

(B) *Distributions and Code adjustments.* Distributions and any adjustments or determinations under the Internal Revenue Code are taken into account before the allocation is made under this paragraph (c)(2)(ii).

(3) *Preferred stock.* If the remaining adjustment described in paragraph (c)(1)(iii) of this section is positive, it is allocated to preferred stock to the extent required (when aggregated with prior allocations to the preferred stock during the period that S is a member of the consolidated group) to reflect distributions described in section 301 (and all other distributions treated as dividends) to which the preferred stock becomes entitled, and arrearages arising, during the period that S is a member of the consolidated group. If the amount of distributions and arrearages exceeds the positive amount (when aggregated with prior allocations), the positive amount is first allocated among classes of preferred stock to reflect their relative priorities, and the amount allocated to each class is then allocated pro rata within the class. An allocation to a share with respect to arrearages and distributions for the period the share is owned by a nonmember is not reflected in the basis of the share under paragraph (b) of this section. However, if M and S cease to be members of one consolidated group and remain affiliated as members of another consolidated group, M's ownership of S's stock during consolidated return years of the prior group is treated for this purpose as ownership by a member to the extent that the adjustments during the prior consolidated return years are still reflected in the basis of the preferred stock.

(4) *Cumulative redetermination*—(i) *General rule.* A member's basis in each share of S preferred and common stock must be redetermined whenever necessary to determine the tax liability of any person. See paragraph (b)(1) of this section. The redetermination is made by reallocating S's adjustments described in paragraphs (c)(1)(ii)(B) (specially allocated adjustments for tier-up of reallocated investment adjustments subject to prior use limitation) and (c)(1)(iii) (remaining adjustments) of this section for each consolidated return year (or other applicable period) of the group by taking into account all of the facts and circumstances affecting allocations under this paragraph (c) as of the redetermination date with respect to all of the S shares. For this purpose:

(A) Amounts may be reallocated from one class of S's stock to another class, but not from one share of a class to another share of the same class.

(B) If there is a change in the equity structure of S (e.g., as the result of S's issuance, redemption, or recapitalization of shares), a cumulative redetermination is made for the period before the change. If a reallocation is required by another redetermination after a change, amounts arising after the change are reallocated before amounts arising before the change.

(C) If S becomes a nonmember as a result of a change in its equity structure, any reallocation is made only among the shares of S's stock immediately before the change. For example, if S issues stock to a nonmember creditor in exchange for its debt, and the exchange results in S becoming a nonmember, any reallocation is only among the shares of S's stock immediately before the exchange.

(D) Any reallocation is treated for all purposes after it is made (including subsequent redeterminations) as the original allocation of an amount under this paragraph (c), but the reallocation does not affect any prior period.

(ii) *Prior use of allocations*. An amount may not be reallocated under paragraph (c)(4)(i) of this section to the extent that the amount has been used before the reallocation. For this purpose, an amount has been used to the extent it has been taken into account, directly or indirectly, by any member in determining income, gain, deduction, or loss, or in determining the basis of any property that is not subject to this section (e.g., stock of a corporation that has become a nonmember). For example, if M sells a share of S stock, an amount previously allocated to the share cannot be reallocated to another share of S stock, but an amount allocated to another share of S stock can still be reallocated to the sold share because the reallocated amount has not been taken into account; however, any adjustment reallocated to the sold share may effectively be eliminated, because the reallocation was not in effect when the share was previously sold and M's gain or loss from the sale is not redetermined. If, however, M sells the share of S stock to another member, the amount is not used until M's gain or loss is taken into account under §1.1502–13.

(5) *Examples*. The principles of this paragraph (c) are illustrated by the following examples.

Example 1. Ownership of less than all the stock. (a) *Facts*. M owns 80% of S's only class of stock with an $800 basis. For Year 1, S has $100 of taxable income.

(b) *Analysis*. Under paragraph (c)(1) of this section, the $100 positive adjustment under paragraph (b) of this section for S's taxable income is allocated among the shares of S's stock, including shares owned by nonmembers. Under paragraph (c)(2)(i) of this section, the adjustment is allocated equally to each share of S's stock. Thus, M increases its basis in S's stock under paragraph (b) of this section as of the close of Year 1 by $80. (The basis of the 20% of S's stock owned by nonmembers is not adjusted under this section.)

(c) *Varying interest*. The facts are the same as in paragraph (a) of this *Example 1*, except that M buys the remaining 20% of S's stock at the close of business on June 30 of Year 1 for $208. Under paragraph (b)(1) of this section and the principles of §1.1502–76(b), S's $100 of taxable income is allocable $40 to the period from January 1 to June 30 and $60 to the period from July 1 to December 31. Thus, for the period ending June 30, M is treated as having a $32 adjustment with respect to the S stock that M has owned since January 1 (80% of $40) and, under paragraph (c)(2)(i) of this section, the adjustment is allocated equally among those shares. For the period ending December 31, M is treated as having a $60 adjustment (100% of $60) that is also allocated equally among M's shares of S's stock owned after June 30. M's basis in the shares owned as of the beginning of the year therefore increases by $80 (the sum of 80% of $40 and 80% of $60), from $800 to $880, and M's basis in the shares purchased on June 30 increases by $12 (20% of $60), from $208 to $220. Thus, M's aggregate basis in S's stock as of the end of Year 1 is $1,100.

(d) *Tax liability*. The facts are the same as in paragraph (a) of this *Example 1*, except that M pays S's $34 share of the group's consolidated tax liability resulting from S's taxable income, and S does not reimburse M. S's $100 of taxable income results in a positive adjustment under paragraph (b)(3)(i) of this section, and S's $34 of tax liability results in a negative adjustment under paragraph (b)(3)(iv)(D) of this section and the principles of section 1552. Because S does not make any payment in recognition of the additional tax liability, by analogy to the treatment under §1.1552–1(b)(2), S is treated as having made a $34 payment that is described in paragraph (b)(3)(iii) of this section (noncapital, nondeductible expenses) and as having received an equal amount from M as a capital contribution. Thus, M increases its basis in its S stock by $52.80 (80% of the $100 of taxable income, less 80% of the $34 tax payment). In addition, M increases its basis in S's stock by $34 under the Internal Revenue Code and paragraph (a)(2) of this section to reflect the capital contribution. In the aggregate, M increases its basis in S's stock by $86.80. (If, as in paragraph (c) of this *Example 1*, M buys the remaining 20% of S's stock at the close of business on June 30, M increases its basis in S's stock by another $7.90 for the additional 20% interest in S's income after June 30 ($60 multiplied by 20%, less 20% of the $20.40 tax payment on $60); the $34 capital contribution by M is reflected in all of its S shares (not just the original 80%), and M's aggregate basis adjustment under this section is $94.70 ($86.80 plus $7.90).)

Example 2. Preferred stock. (a) *Facts*. M owns all of S's common stock with an $800 basis, and nonmembers own all of S's preferred stock. The preferred stock was issued for $200, has a $20 annual, cumulative preference as to dividends, and has an initial liquidation preference of $200. For Year 1, S has $50 of taxable income and no distributions are declared or made.

(b) *Analysis of arrearages*. Under paragraphs (c) (1) and (3) of this section, $20 of the $50 positive adjustment under paragraph (b) of this section is allocated first to the preferred stock to reflect the dividend arrearage arising in Year 1. The remaining $30 of the positive adjustment is allocated to the common stock, increasing M's basis from $800 to $830 as of the close of Year 1. (The basis of the preferred stock owned by nonmembers is not adjusted under this section.)

(c) *Current distribution.* The facts are the same as in paragraph (a) of this *Example 2*, except that S declares and makes a $20 distribution with respect to the preferred stock during Year 1 in satisfaction of its preference. The results are the same as in paragraph (b) of this *Example 2*.

(d) *Varying interest.* The facts are the same as in paragraph (a) of this *Example 2*, except that S has no income or loss for Years 1 and 2, M purchases all of S's preferred stock at the beginning of Year 3 for $240, and S has $70 of taxable income for Year 3. Under paragraph (c)(3) of this section, $60 of the $70 positive adjustment under paragraph (b) of this section is allocated to the preferred stock to reflect the dividends arrearages for Years 1 through 3, but only the $20 for Year 3 is reflected in the basis of the preferred stock under paragraph (b) of this section. (The remaining $40 is not reflected because the preferred stock was owned by nonmembers during Years 1 and 2.) Thus, M increases its basis in S's preferred stock from $240 to $260, and its basis in S's common stock from $800 to $810, as of the close of Year 3. (If M had acquired all of S's preferred stock in a transaction to which section 351 applies, and M's initial basis in S's preferred stock was $200 under section 362, M's basis in S's preferred stock would increase from $200 to $220.)

(e) *Varying interest with current distributions.* The facts are the same as in paragraph (d) of this *Example 2*, except that S declares and makes a $20 distribution with respect to the preferred stock in each of Years 1 and 2 in satisfaction of its preference, and M purchases all of S's preferred stock at the beginning of Year 3 for $200. Under paragraph (c)(3) of this section, $40 of the $70 positive adjustment under paragraph (b) of this section is allocated to the preferred stock to reflect the distributions in Years 1 and 2, and $20 of the $70 is allocated to the preferred stock to reflect the arrearage for Year 3. However, as in paragraph (d) of this *Example 2*, only the $20 attributable to Year 3 is reflected in the basis of the preferred stock under paragraph (b) of this section. Thus, M increases its basis in S's preferred stock from $200 to $220, and M increases its basis in S's common stock from $800 to $810.

Example 3. Cumulative redetermination. (a) *Facts.* M owns all of S's common and preferred stock. The preferred stock has a $100 annual, cumulative preference as to dividends. For Year 1, S has $200 of taxable income, the first $100 of which is allocated to the preferred stock and the remaining $100 of which is allocated to the common stock. For Year 2, S has no adjustment under paragraph (b) of this section, and M sells all of S's common stock at the close of Year 2.

(b) *Analysis.* Under paragraph (c)(4) of this section, M's basis in S's common stock must be redetermined as of the sale of the stock. The redetermination is made by reallocating the $200 positive adjustment under paragraph (b) of this section for Year 1 by taking into account all of the facts and circumstances affecting allocations as of the sale. Thus, the $200 positive adjustment for Year 1 is reallocated entirely to the preferred stock to reflect the dividend arrearages for Years 1 and 2. The reallocation away from the common stock reflects the fact that, because of the additional amount of arrearage in Year 2, the common stock is not entitled to any part of the $200 of taxable income from Year 1. Thus, the common stock has no positive or negative adjustment, and the preferred stock has a $200 positive adjustment. These reallocations are treated as the original allocations for Years 1 and 2. (The results for the common stock would be the same if the common and preferred stock were not owned by the same member, or the preferred stock were owned by nonmembers.)

(c) *Preferred stock issued after adjustment arises.* The facts are the same as in paragraph (a) of this *Example 3*, except that S does not issue its preferred stock until the beginning of Year 2, S has no further adjustment under paragraph (b) of this section for Years 2 and 3, and M sells S's common stock at the close of Year 3. Under paragraphs (c) (1) and (2) of this section, the $200 positive adjustment for Year 1 is initially allocated entirely to the common stock. Under paragraph (c)(4) of this section, the $200 adjustment is reallocated to the preferred stock to reflect the arrearages for Years 2 and 3. Thus, the common stock has no positive or negative adjustment.

(d) *Common stock issued after adjustment arises.* The facts are the same as in paragraph (a) of this *Example 3*, except that S has no preferred stock, S issues additional common stock of the same class at the beginning of Year 2, S has no further adjustment under paragraph (b) of this section in Years 2 and 3, and M sells its S common stock at the close of Year 3. Under paragraphs (c) (1) and (2) of this section, the $200 positive adjustment for Year 1 is initially allocated entirely to the original common stock. Under paragraph (c)(4)(i)(A) of this section, the $200 adjustment is not reallocated among the original common stock and the additional stock. Unlike the preferred stock in paragraph (c) of this *Example 3*, the additional common stock is of the same class as the original stock, and there is no reallocation between shares of the same class.

(e) *Positive and negative adjustments.* The facts are the same as in paragraph (a) of this *Example 3*, except that S has a $200 loss for Year 2 that results in a negative adjustment to the common stock before any redetermination. For purposes of the basis redetermination under paragraph (c)(4) of this section, the Year 1 and 2 adjustments under paragraph (b) of this section are not netted. Thus, as in paragraph (b) of this *Example 3*, the redetermination is made by reallocating the $200 positive adjustment for Year 1 entirely to the preferred stock. The $200 negative adjustment for Year 2 is allocated entirely to the common stock. Consequently, the preferred stock has a $200 positive cumulative adjustment, and the common stock has a $200 negative cumulative adjustment. (The results would be the same if there were no other adjustments described in paragraph (b) of this section, M sells S's common stock at the close of Year 3 rather than Year 2, and an additional $100 arrearage arises in Year 3; only adjustments under paragraph (b) of this section may be reallocated, and there is no additional adjustment for Year 3.)

(f) *Current distributions.* The facts are the same as in paragraph (a) of this *Example 3*, except that, during Year 1, S declares and makes a distribution to M of $100 as a dividend on the preferred stock and $100 as a dividend on the common stock. The taxable income and distributions result in no Year 1 adjustment under paragraph (b) of this section for either the common or preferred stock. For example, if T merges into S, S is treated, as the context may require, as a successor to T and as becoming a member of the group. However, as in paragraph (b) of this *Example 3*, the redetermination under paragraph (c)(4) of this section is made by reallocating a $200 positive adjustment for Year 1 (S's net adjustment described in paragraph (b) of this section, determined without taking distributions into account) to the preferred stock. Consequently, the preferred stock has a $100 positive cumulative adjustment ($200 of taxable income, less a $100 distribution with respect to the preferred stock) and the common stock has a $100 negative cumulative adjustment (for the distribution).

(g) *Convertible preferred stock.* The facts are the same as in paragraph (a) of this *Example 3*, except that the preferred stock is convertible into common stock that is identical to the common stock already outstanding, the holders of the preferred stock convert the stock at the close of Year 2, and no stock is sold until the close of Year 5. Under paragraph (c)(4) of this section, the $200 positive adjustment for Year 1 is reallocated entirely to the preferred stock immediately before the conversion. The newly issued common stock is treated as a second class of S common stock, and adjustments under paragraph (b) of this section are allocated between the original and the new common stock under paragraph (c)(2)(ii) of this section. Although the preferred stock is converted to common stock, the $200 adjustment to the preferred stock is not subsequently reallocated between the original and the new common stock. Because the original and the new stock are equivalent, adjustments under paragraph (b) of this section for subsequent periods are allocated equally to each share.

(h) *Prior use of allocations.* The facts are the same as in paragraph (a) of this *Example 3*, except that M sells 10% of S's common stock at the close of Year 1, and the remaining 90% at the close of Year 2. M's basis in the common stock sold in Year 1 reflects $10 of the adjustment allocated to the common stock for Year 1. Under paragraph (c)(4)(ii) of this section, because $10 of the Year 1 adjustment was used in determining M's gain or loss, only $90 is reallocated to the preferred stock, and $10 remains allocated to the common stock sold.

(i) *Lower-tier members.* The facts are the same as in paragraph (a) of this *Example 3*, except that M owns only S's common stock, and M is also a subsidiary. If there is a redetermination under paragraph (c)(4) of this section by a member owning M's stock, a redetermination with respect to S's stock must be made first, and the effect of that redetermination on M's adjustments is taken into account under paragraph (b) of this section. However, as in paragraph (h) of this *Example 3*, to the extent an amount of the initial adjustments with respect to S's common stock have already been tiered up and used by a member owning M's stock, that amount remains with S's common stock (and the higher-tier member using the adjustment with respect to M's stock), and may not be reallocated to S's preferred stock.

Example 4. Allocation to preferred stock between groups. (a) *Facts.* M owns all of S's only class of stock, and S owns all of T's common and preferred stock. The preferred stock has a $100 annual, cumulative preference as to dividends. For Year 1, T has $200 of taxable income, the first $100 of which is allocated to the preferred stock and the remaining $100 of which is allocated to the common stock, and S has no adjustments other than the amounts tiered up from T. S and T have no adjustments under paragraph (b) of this section for Years 2 and 3. X, the common parent of another consolidated group, purchases all of S's stock at the close of Year 3, and S and T become members of the X group. For Year 4, T has $200 of taxable income, and S has no adjustments other than the amounts tiered up from T.

(b) *Analysis for Years 1 through 3.* Under paragraph (c)(4) of this section, the allocation of S's adjustments under paragraph (b) of this section (determined without taking distributions into account) must be redetermined as of the time M sells S's stock. As a result of this redetermination, T's common stock has no positive or negative adjustment and the preferred stock has a $200 positive adjustment.

(c) *Analysis for Year 4.* Under paragraph (c)(3) of this section, the allocation of T's $200 positive adjustment in Year 4 to T's preferred stock with respect to arrearages is made by taking into account the consolidated return years of both the M group and the X group. Thus, the allocation of the $200 positive adjustment for Year 4 to T's preferred stock is not treated as an allocation for a period for which the preferred stock is owned by a nonmember. Thus, the $200 adjustment is reflected in S's basis in T's preferred stock under paragraph (b) of this section.

(d) *Definitions.* For purposes of this section—

(1) *Class.* The shares of a member having the same material terms (without taking into account voting rights) are treated as a single class of stock.

(2) *Preferred stock.* Preferred stock is stock that is limited and preferred as to dividends and has a liquidation preference. A class of stock that is not described in section 1504(a)(4), however, is not treated as preferred stock for purposes of paragraph (c) of this section if members own less than 80% of each class of common stock (determined without taking this paragraph (d)(2) into account).

(3) *Common stock.* Common stock is stock that is not preferred stock.

(4) *Becoming a nonmember.* A member is treated as becoming a nonmember if it has a separate return year (including another group's consolidated return year). For example, S may become a nonmember if it issues additional stock to nonmembers, but S does not become a nonmember as a result of its complete liquidation.

(e) *Anti-avoidance rule*—(1) *General rule.* If any person acts with a principal purpose contrary to the purposes of this section, to avoid the effect of the rules of this section or apply the rules of this section to avoid the effect of any other provision of the consolidated return regulations, adjustments must be made as necessary to carry out the purposes of this section.

(2) *Examples.* The principles of this paragraph (e) are illustrated by the following examples.

Example 1. Preferred stock treated as common stock. (a) *Facts.* S has 100 shares of common stock and 100 shares of preferred stock described in section 1504(a)(4). M owns 80 shares of S's common stock and all of S's preferred stock. The shareholders expect that S will have negative adjustments under paragraph (b) of this section for Years 1 and 2 (all of which will be allocable to S's common stock), the negative adjustments will have no significant effect on the value of S's stock, and S will have offsetting positive adjustments thereafter. When the preferred stock was issued, M intended to cause S to recapitalize the preferred stock into additional common stock at the end of Year 2 in a transaction described in section 368(a)(1)(E). M's temporary ownership of the preferred stock is with a principal purpose to limit M's basis reductions under paragraph (b) of this section to 80% of the anticipated negative adjustments. The recapitalization is intended to cause significantly more than 80% of the anticipated positive adjustments to increase M's basis in S's stock because of M's increased ownership of S's common stock immediately after the recapitalization.

(b) *Analysis.* S has established a transitory capital structure with a principal purpose to enhance M's basis in S's stock under this section. Under paragraph (e)(1) of this section, all of S's common and preferred stock is treated as a single class of common stock in Years 1 and 2 for purposes of this section. Thus, S's items are allocated under the principles of paragraph (c)(2)(ii) of this section, and M decreases its basis in both the common and preferred stock accordingly.

Example 2. Contribution of appreciated property. (a) *Facts.* M owns all of the stock of S and T, and S and T each own 50% of the stock of U. M's S stock has a $150 basis and $200 value, and M's T stock has a $200 basis and $200 value. With a principal purpose to eliminate M's gain from an anticipated sale of S's stock, T contributes to U an asset with a $100 value and $0 basis, and S contributes $100 cash. U sells T's asset and recognizes a $100 gain that results in a $100 positive adjustment under paragraph (b) of this section.

(b) *Analysis.* Under paragraph (c)(2) of this section, U's adjustment ordinarily would be allocated equally to each share of U's stock. If so allocated, M's basis in S's stock would increase from $150 to $200 and M would recognize no gain from the sale of S's stock for $200. Under paragraph (e)(1) of this section, however, because T transferred an appreciated asset to U with a principal purpose to shift a portion of the stock basis increase from M's stock in T to M's stock in S, the allocation of the $100 positive adjustment under paragraph (c) of this section between the shares of U's stock must take into account the contribution. Consequently, all $100 of the positive adjustment is allocated to the U stock owned by T, rather than $50 to the U stock owned by S and $50 to the U stock owned by T. M's basis in S's stock remains $150, and its basis in T's stock increases to $300. Thus, M recognizes a $50 gain from its sale of S's stock for $200.

Example 3. Reorganizations. (a) *Facts.* M forms S with an $800 contribution, $200 of which is in exchange for S's preferred stock described in section 1504(a)(4) and the balance of which is for S's common stock. For Years 1 through 3, S has a total of $160 of ordinary income, $60 of which is distributed with respect to the preferred stock in satisfaction of its $20 annual preference as to dividends. Under this section, M's basis in S's preferred stock is unchanged, and its basis in S's common stock is increased from $600 to $700. To reduce its gain from an anticipated sale of S's preferred stock, M forms T at the close of Year 3 with a contribution of all of S's stock in exchange for corresponding common and preferred stock of T in a transaction to which section 351 applies. At the time of the contribution, the fair market value of the common stock is $700 and the fair market value of the preferred stock is $300 (due to a decrease in prevailing market interest rates). M subsequently sells T's preferred stock for $300.

(b) *Analysis.* Under section 358(b), M ordinarily has a $630 basis in T's common stock (70% of the $900 aggregate stock basis) and a $270 basis in T's preferred stock (30% of the $900 aggregate stock basis). However, because M transferred S's stock to T with a principal purpose to shift the allocation of basis adjustments under this section, adjustments are made under paragraph (e)(1) of this section to preserve the allocation under this section. Thus, M has a $700 basis in T's common stock and a $200 basis in T's preferred stock. Consequently, M recognizes a $100 gain from the sale of T's preferred stock.

Example 4. Post-deconsolidation basis adjustments. (a) *Facts.* For Year 1, the M group has $40 of taxable income when determined by including only S's items of income, gain, deduction, and loss taken into account, and M increases its basis in S's stock by $40 under paragraph (b) of this section. M anticipates that S will have a $40 ordinary loss for Year 2 that will be carried back and offset S's income in Year 1 and result in a $40 reduction to M's basis in S's stock for Year 2 under paragraph (b) of this section. With a principal purpose to avoid the reduction, M causes S to issue voting preferred stock that results in S becoming a nonmember at the beginning of Year 2. As anticipated, S has a $40 loss for Year 2, which is carried back to Year 1 and offsets S's income from Year 1.

(b) *Analysis.* Under paragraph (e)(1) of this section, because M caused S to become a nonmember with a principal purpose to absorb S's loss but avoid the corresponding negative adjustment under this section, and M bears a substantial portion of the loss because of its continued ownership of S common stock, the basis of M's common stock in S is decreased by $40 for Year 2. (If M has less than a $40 basis in the retained S stock, M must recognize income for Year 2 to the extent of the excess.) Section 1504(a)(3) limits the ability of S to subsequently rejoin the M group's consolidated return.

(c) *Carryback to pre-consolidation year.* The facts are the same as in paragraph (a) of this *Example 4*, except that M anticipates that S's loss will be carried back and absorbed in a separate return year of S before Year 1 (rather than to the M group's consolidated return for Year 1). Although M causes S to become a nonmember with a principal purpose to avoid the negative adjustment under this section, and M bears a substantial portion of the loss because of its continued ownership of S common stock, both S's income and loss are taken into account under the separate return rules. Consequently, no one has acted with a principal purpose contrary to the purposes of this section, and no adjustments are necessary to carry out the purposes of this section.

Example 5. Pre-consolidation basis adjustments. (a) *Facts.* M forms S with a $100 contribution, and S becomes a member of the M affiliated group which does not file consolidated returns. For Years 1 through 3, S earns $300. M anticipates that it will elect under section 1501 for the M group to begin filing consolidated returns in Year 5. In anticipation of filing consolidated returns, and to avoid the negative stock basis adjustment that would result under paragraph (b) of this section from distributing S's earnings after Year 5, M causes S to distribute $300 during Year 4 as a qualifying dividend within the meaning of section 243(b). There is no plan or intention to recontribute the funds to S after the distribution.

(b) *Analysis.* Although S's distribution of $300 is with a principal purpose to avoid a corresponding negative adjustment under this section, the $300 was both earned and distributed entirely under the separate return rules. Consequently, M and S have not acted with a principal purpose contrary to the purposes of this section, and no adjustments are necessary to carry out the purposes of this section.

(f) *Predecessors and successors.* For purposes of this section, any reference to a corporation or to a share of stock includes a reference to a successor or predecessor as the context may require. A corporation is a successor if the basis of its assets is determined, directly or indirectly, in whole or in part, by reference to the basis of another corporation (the predecessor). For example, if T merges into S, S is treated, as the context may require, as a successor to T and as becoming a member of the group. A share is a successor if its basis is determined, directly or indirectly, in whole or in part, by reference to the basis of another share (the predecessor).

(g) *Recordkeeping.* Adjustments under this section must be reflected annually on permanent records (including work papers). See also section 6001, requiring records to be maintained. The group must be able to identify from these permanent records the amount and allocation of adjustments, including the nature of any tax-exempt income and noncapital, nondeductible expenses, so as to permit the application of the rules of this section for each year.

(h) *Effective/applicability date*—(1) *General rule.* Except as provided in paragraph (h)(8) of this section, this section applies with respect to determinations of the basis of the stock of a subsidiary (e.g., for determining gain or loss from a disposition of stock), in consolidated return years beginning on or after January 1, 1995. If this section applies, basis must be determined or redetermined as if this section were in effect for all years (including, for example, the consolidated return years of another consolidated group to the extent adjustments from those years are still reflected). For example, if the portion of a consolidated net operating loss carryover attributable to S expired in 1990 and is treated as a noncapital, nondeductible expense under paragraph (b) of this section, it is taken into account in tax years beginning on or after January 1, 1995 as a negative adjustment for 1990. Any such determination or redetermination does not, however, affect any prior period. Thus, the negative adjustment for S's noncapital, nondeductible expense is not taken into account for tax years beginning before January 1, 1995.

(2) *Dispositions of stock before effective date*—(i) *In general.* If M disposes of stock of S in a consolidated return year beginning before January 1, 1995, the amount of M's income, gain, deduction, or loss, and the basis reflected in that amount, are not redetermined under this section. See §1.1502–19 as contained in the 26 CFR part 1 edition revised as of April 1, 1994 for the definition of disposition, and paragraph (h)(5) of this section for the rules applicable to such dispositions.

(ii) *Lower-tier members.* Although M disposes of S's stock in a tax year beginning before January 1, 1995, S's determinations or adjustments with respect to the stock of a lower-tier member with which it continues to file a consolidated return are redetermined in accordance with the rules of this section (even if they were previously taken into account by M and reflected in income, gain, deduction, or loss from the disposition of S's stock). For example, assume that M owns all of S's stock, S owns all of T's stock, and T owns all of U's stock. If S sells 80% of T's stock in a tax year beginning before January 1, 1995 (the effective date), the amount of S's income, gain, deduction, or loss from the sale, and the stock basis adjustments reflected in that amount, are not redetermined if M sells S's stock after the effective date. If S sells the remaining 20% of T's stock after the effective date, S's stock basis adjustments with respect to that T stock are also not redetermined because T became a nonmember before the effective date. However, if T and U continue to file a consolidated return with each other and T sells U's stock after the effective date, T's stock basis adjustments with respect to U's stock are redetermined (even though some of those adjustments may have been taken into account by S in its prior sale of T's stock before the effective date).

(iii) *Deferred amounts.* For purposes of this paragraph (h)(2), a disposition does not include a transaction to which §1.1502–13, §1.1502–13T, §1.1502–14, or §1.1502–14T applies. Instead, the transaction is deemed to occur as the income, gain, deduction, or loss (if any) is taken into account.

(3) *Distributions*—(i) *Deemed dividend elections.* If there is a deemed distribution and recontribution pursuant to §1.1502–32(f)(2) as contained in the 26 CFR part 1 edition revised as of April 1, 1994 in a consolidated return year beginning before January 1, 1995, the deemed distribution and recontribution under the election are treated as an actual distribution by S and recontribution by M as provided under the election.

(ii) *Affiliated earnings and profits.* This section does not apply to reduce the basis in S's stock as a result of a distribution of earnings and profits accumulated in separate return years, if the distribution is made in a consolidated return year beginning before January 1, 1995, and the distribution does not cause a negative adjustment under the investment adjustment rules in effect at the time of the distribution. See paragraph (h)(5) of this section for the rules in effect with respect to the distribution.

(4) *Expiring loss carryovers.* If S became a member of a consolidated group in a consolidated return year beginning before January 1, 1995, and S had a loss carryover from a separate return limitation year at that time, the group does not treat any expiration of the loss carryover (even if in a tax year beginning on or after January 1, 1995) as a noncapital, nondeductible expense resulting in a negative adjustment under this section. If S becomes a member of a consolidated group in a consolidated return year beginning on or after January 1, 1995, and S has a loss carryover from a separate return limitation year at that time, adjustments with respect to the expiration are determined under this section.

(5) *Prior law*—(i) *In general.* For prior determinations, see prior regulations under section 1502 as in effect with respect to the determination. See, e.g., §§1.1502–32 and 1.1502–32T as contained in the 26 CFR part 1 edition revised as of April 1, 1994.

(ii) *Continuing basis reductions for certain deconsolidated subsidiaries.* If a subsidiary ceases to be a member of a group in a consolidated return year beginning before January 1, 1995, and its basis was subject to reduction under §1.1502–32T or §1.1502–32(g) as contained in the 26 CFR part 1 edition revised as of April 1, 1994, its basis remains subject to reduction under those principles. For example, if S ceased to be a member in 1990, and M's basis in any retained S stock was subject to a basis reduction account, the basis remains subject to reduction. Similarly, if an election could be made to apply §1.1502–32T instead of §1.1502–32(g), the election remains available. However, §§1.1502–32T and 1.1502–32(g) do not apply as a result of a subsidiary ceasing to be a member in tax years beginning on or after January 1, 1995.

(6) *Loss suspended under §1.1502–35(c) or disallowed under §1.1502–35(g)(3)(iii).* Paragraphs (a)(2), (b)(3)(iii)(C), (b)(3)(iii)(D), and (b)(4)(vi) of this section are applicable on and after March 10, 2006. For rules applicable before March 10, 2006, see §1.1502–32T(h)(6) as contained in 26 CFR part 1 in effect on January 1, 2006.

(7) *Rules related to discharge of indebtedness income excluded from gross income.* Paragraphs (b)(1)(ii), (b)(3)(ii)(C)(*1*), (b)(3)(iii)(A), and (b)(5)(ii), *Example 4,* paragraphs (a), (b), and (c) of this section apply with respect to determinations of the basis of the stock of a subsidiary in consolidated return years the original return for which is due (without regard to extensions) after March 21, 2005. However, groups may apply those provisions with respect to determinations of the basis of the stock of a subsidiary in consolidated return years the original return for which is due (without regard to extensions) on or before March 21, 2005, and after August 29, 2003. For determinations of the basis of the stock of a subsidiary in consolidated return years the original return for which is due (without regard to extensions) on or before March 21, 2005, and after August 29, 2003, with respect to which a group chooses not to apply paragraphs (b)(1)(ii), (b)(3)(ii)(C)(*1*), (b)(3)(iii)(A), and (b)(5)(ii), *Example 4,* paragraphs (a), (b), and (c) of this section, see §1.1502–32T(b)(3)(ii)(C)(*1*), (b)(3)(iii)(A), and (b)(5)(ii), *Example 4,* paragraphs (a), (b), and (c) as contained in 26 CFR part 1 revised as of April 1, 2004.

(8) *Determination of stock basis in reorganization with boot.* Paragraph (b)(5)(ii) *Example 6* of this section applies only with respect to determinations of the basis of the stock of a subsidiary on or after January 23, 2006. For determinations of the basis of the stock of a subsidiary before January 23, 2006, see §1.1502–32(b)(5)(ii) *Example 6* as contained in the 26 CFR part 1 edition revised as of April 1, 2005.

(9) *Allocations of investment adjustments, including adjustments attributable to certain loss transfers; certain conforming amendments.* Paragraphs (a)(2),

(b)(3)(ii)(C)(*2*), (c)(1), (c)(2)(i), (c)(2)(ii)(A), (c)(3), and (c)(4)(i) of this section are applicable for determinations of the basis of stock of a subsidiary on or after September 17, 2008.

(i) [Reserved]. For further guidance, see § 1.1502–32T(i) through (j)(1).

(j) *Effective/applicability date*. Paragraph (b)(4)(iv) of this section applies to any original consolidated Federal income tax return due (without extensions) after June 14, 2007. For original consolidated Federal income tax returns due (without extensions) after May 30, 2006, and on or before June 14, 2007, see § 1.1502–32T as contained in 26 CFR part 1 in effect on April 1, 2007. For original consolidated Federal income tax returns due (without extensions) on or before May 30, 2006, see § 1.1502–32 as contained in 26 CFR part 1 in effect on April 1, 2006.

(k) [Reserved]. For further guidance, see § 1.1502–32T(k).

[T.D. 8560, 59 FR 41685, Aug. 15, 1994]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 1.1502–32, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at *www.fdsys.gov*.

§ 1.1502–33 Earnings and profits.

(a) *In general*—(1) *Purpose*. This section provides rules for adjusting the earnings and profits of a subsidiary (S) and any member (P) owning S's stock. These rules modify the determination of P's earnings and profits under applicable rules of law, including section 312, by adjusting P's earnings and profits to reflect S's earnings and profits for the period that S is a member of the consolidated group. The purpose for modifying the determination of earnings and profits is to treat P and S as a single entity by reflecting the earnings and profits of lower-tier members in the earnings and profits of higher-tier members and consolidating the group's earnings and profits in the common parent. References in this section to earnings and profits include deficits in earnings and profits.

(2) *Application of other rules of law, duplicative adjustments*. See § 1.1502–80(a) regarding the general applicability of other rules of law and a limitation on duplicative adjustments. The rules of this section are in addition to other rules of law. For example, the allowance for depreciation is determined in accordance with section 312(k). P's earnings and profits must not be adjusted under this section and other rules of law in a manner that has the effect of duplicating an adjustment. For example, if S's earnings and profits are reflected in P's earnings and profits under paragraph (b) of this section, and S transfers its assets to P in a liquidation to which section 332 applies, S's earnings and profits that P succeeds to under section 381 must be adjusted to prevent duplication.

(b) *Tiering up earnings and profits*—(1) *General rule*. P's earnings and profits are adjusted under this section to reflect changes in S's earnings and profits in accordance with the applicable principles of § 1.1502–32, consistently applied, and an adjustment to P's earnings and profits for a tax year under this paragraph (b)(1) is treated as earnings and profits of P for the tax year in which the adjustment arises. Under these principles, for example, the adjustments are made as of the close of each consolidated return year, and as of any other time if a determination at that time is necessary to determine the earnings and profits of any person. Similarly, S's earnings and profits are allocated under the principles of § 1.1502–32(c), and the adjustments are applied in the order of the tiers, from the lowest to the highest. However, modifications to the principles include:

(i) The amount of P's adjustment is determined by reference to S's earnings and profits, rather than S's taxable and tax-exempt items (and therefore, for example, the deferral of a negative adjustment for S's unabsorbed losses does not apply).

(ii) The tax sharing rules under paragraph (d) of this section apply rather than those of § 1.1502–32(b)(3)(iv)(D).

(2) *Affiliated earnings and profits*. The reduction in S's earnings and profits under section 312 from a distribution of earnings and profits accumulated in separate return years of S that are not separate return limitation years does not tier up to P's earnings and profits. Thus, the increase in P's earnings and profits under section 312 from receipt of the distribution is not offset by a corresponding reduction.

(3) *Examples*—(i) *In general.* For purposes of the examples in this section, unless otherwise stated, P owns all of the only class of S's stock, the stock is owned for the entire year, S owns no stock of lower-tier members, the tax year of all persons is the calendar year, all persons use the accrual method of accounting, the facts set forth the only corporate activity, preferred stock is described in section 1504(a)(4), all transactions are between unrelated persons, and tax liabilities are disregarded.

(ii) *Tiering up earnings and profits.* The principles of this paragraph (b) are illustrated by the following examples.

Example 1. Tier-up and distribution of earnings and profits. (a) *Facts.* P forms S in Year 1 with a $100 contribution. S has $100 of earnings and profits for Year 1 and no earnings and profits for Year 2. During Year 2, S declares and distributes a $50 dividend to P.

(b) *Analysis.* Under paragraph (b)(1) of this section, S's $100 of earnings and profits for Year 1 increases P's earnings and profits for Year 1. P has no additional earnings and profits for Year 2 as a result of the $50 distribution in Year 2, because there is a $50 increase in P's earnings and profits as a result of the receipt of the dividend and a corresponding $50 decrease in S's earnings and profits under section 312(a) that is reflected in P's earnings and profits under paragraph (b)(1) of this section.

(c) *Distribution of current earnings and profits.* The facts are the same as in paragraph (a) of this *Example 1,* except that S distributes the $50 dividend at the end of Year 1 rather than during Year 2. Under paragraph (b)(1) of this section, P's earnings and profits are increased by $100 (S's $50 of undistributed earnings and profits, plus P's receipt of the $50 distribution). Thus, S's earnings and profits increase by $50 and P's earnings and profits increase by $100.

(d) *Affiliated earnings and profits.* The facts are the same as in paragraph (a) of this *Example 1,* except that P and S do not begin filing consolidated returns until Year 2. Because P and S file separate returns for Year 1, P's basis in S's stock remains $100 under §1.1502–32 and this section, S has $100 of earnings and profits, and none of S's earnings and profits is reflected in P's earnings and profits under paragraph (b) of this section. S's distribution in Year 2 ordinarily would reduce S's earnings and profits but not increase P's earnings and profits. (P's $50 of earnings and profits from the dividend would be offset by S's $50 reduction in earnings and profits that tiers up under paragraph (b) of this section.) However, under paragraph (b)(2) of this section, the negative adjustment for S's distribution to P does not apply. Thus, S's distribution reduces its earnings and profits by $50 but increases P's earnings and profits by $50. (If S's earnings and profits had been accumulated in a separate return limitation year, paragraph (b)(2) of this section would not apply and the distribution would reduce S's earnings and profits but not increase P's earnings and profits.)

(e) *Earnings and profits deficit.* Assume instead that after P forms S in Year 1 with a $100 contribution, S borrows additional funds and has a $150 deficit in earnings and profits for Year 1. The corresponding loss for tax purposes is not absorbed in Year 1, and is included in the group's consolidated net operating loss carried forward to Year 2. Under paragraph (b)(1) of this section, however, S's $150 deficit in earnings and profits decreases P's earnings and profits for Year 1 by $150. (Absorption of the loss in a later tax year has no effect on the earnings and profits of P and S.)

Example 2. Section 355 distribution. (a) *Facts.* P owns all of S's stock and S owns all of T's stock. For Year 1, T has $100 of earnings and profits. Under paragraph (b)(1) of this section, the earnings and profits of T tier up to S and to P. S and P have no other earnings and profits for Year 1. S distributes T's stock to P at the end of Year 1 in a distribution to which section 355 applies.

(b) *Analysis.* Because S's distribution of T's stock is a distribution to which section 355 applies, the applicable principles of §1.1502–32(b)(2)(iv) do not require P's earnings and profits to be adjusted by reason of the distribution. In addition, although S's earnings and profits may be reduced under section 312(h) as a result of the distribution, the applicable principles of §1.1502–32(b)(3)(iii) do not require P's earnings and profits to be adjusted to reflect this reduction in S's earnings and profits.

Example 3. Allocating earnings and profits among shares. P owns 80% of S's stock throughout Year 1. For Year 1, S has $100 of earnings and profits. Under paragraph (b)(1) of this section, $80 of S's earnings and profits is allocated to P based on P's ownership of S's stock. Accordingly, $80 of S's earnings and profits for Year 1 is reflected in P's earnings and profits for Year 1.

(c) *Special rules.* For purposes of this section—

(1) *Stock of members.* For purposes of determining P's earnings and profits from the disposition of S's stock, P's basis in S's stock is adjusted to reflect S's earnings and profits determined under paragraph (b) of this section, rather than under §1.1502–32. For example, P's basis in S's stock is increased by positive earnings and profits and decreased by deficits in earnings and

profits. Similarly, P's basis in S's stock is not reduced for distributions to which paragraph (b)(2) of this section applies (affiliated earnings and profits). P may have an excess loss account in S's stock for earnings and profits purposes (whether or not there is an excess loss account under § 1.1502–32), and the excess loss account is determined, adjusted, and taken into account in accordance with the principles of §§ 1.1502–19 and 1.1502–32.

(2) *Intercompany transactions.* Intercompany items and corresponding items are not reflected in earnings and profits before they are taken into account under § 1.1502–13. See § 1.1502–13 for the applicable rules and definitions.

(3) *Example.* The principles of this paragraph (c) are illustrated by the following example.

Example. Adjustments to stock basis. (a) *Facts.* P forms S in Year 1 with a $100 contribution. For Year 1, S has $75 of taxable income and $100 of earnings and profits. For Year 2, S has no taxable income or earnings and profits, and S declares and distributes a $50 dividend to P. P sells all of S's stock for $150 at the end of Year 2.

(b) *Analysis.* Under paragraph (c)(1) of this section, P's basis in S's stock for earnings and profits purposes immediately before the sale is $150 (the $100 initial basis, plus S's $100 of earnings and profits for Year 1, minus the $50 distribution of earnings and profits in Year 2). Thus, P recognizes no gain or loss from the sale of S's stock for earnings and profits purposes.

(c) *Earnings and profits deficit.* Assume instead that S has a $100 tax loss and earnings and profits deficit for Year 1. The tax loss is not absorbed in Year 1 and is included in the group's consolidated net operating loss carried forward to Year 2. Under paragraph (b) of this section, S's $100 deficit in earnings and profits decreases P's earnings and profits for Year 1. Under paragraph (c) of this section, P decreases its basis in S's stock for purposes of determining earnings and profits from $100 to $0. (If S had borrowed an additional $50 that it also lost in Year 1, P would have decreased its earnings and profits for Year 1 by the additional $50, and P would have had a $50 excess loss account in S's stock for earnings and profits purposes, which would be taken into account in determining P's earnings and profits from its sale of S's stock.)

(d) *Affiliated earnings and profits.* Assume instead that P and S do not begin filing consolidated returns until Year 2. Under paragraph (b) of this section, the negative adjustment under § 1.1502–32(b) for distributions does not apply to S's distribution of earnings and profits accumulated in a separate return year that is a not separate return limitation year. Thus, P's basis in S's stock for earnings and profits purposes remains $100, and P has $50 of earnings and profits from the sale of S's stock.

(d) *Federal income tax liability*—(1) *In general*—(i) *Extension of tax allocations.* Section 1552 allocates the tax liability of a consolidated group among its members for purposes of determining the amounts by which their earnings and profits are reduced for taxes. Section 1552 does not reflect the absorption by one member of another member's tax attributes (e.g., losses, deductions and credits). For example, if P's $100 of income is offset by S's $100 of deductions, consolidated tax liability is $0 and no amount is allocated under section 1552. However, the group may elect under this paragraph (d) to allocate additional amounts to reflect the absorption by one member of the tax attributes of another member. Permissible methods are set forth in paragraphs (d)(2) through (4) of this section, and election procedures are provided in paragraph (d)(5) of this section. Allocations under this paragraph (d) must be reflected annually on permanent records (including work papers). Any computations of separate return tax liability are subject to the principles of section 1561.

(ii) *Effect of extended tax allocations.* The amounts allocated under this paragraph (d) are treated as allocations of tax liability for purposes of § 1.1552–1(b)(2). For example, if P's taxable income is offset by S's loss, and tax liability is allocated under the percentage method of paragraph (d)(3) of this section, P's earnings and profits are reduced as if its income were subject to tax, P is treated as liable to S for the amount of the tax, and corresponding adjustments are made to S's earnings and profits. If the liability of one member to another is not paid, the amount not paid generally is treated as a distribution, contribution, or both, depending on the relationship between the members.

(2) *Wait-and-see method.* The wait-and-see method under this paragraph (d)(2) is derived from Securities and Exchange Commission procedures. In the year that a member's tax attribute

is absorbed, the group's consolidated tax liability is allocated in accordance with the group's method under section 1552. When, in effect, the member with the tax attribute could have absorbed the attribute on a separate return basis in a later year, a portion of the group's consolidated tax liability for the later year that is otherwise allocated to members under section 1552 is reallocated. The reallocation takes into account all consolidated return years to which this paragraph (d) applies (the computation period), and is determined by comparing the tax allocated to a member during the computation period with the member's tax liability determined as if it had filed separate returns during the computation period.

(i) *Cap on allocation under section 1552.* A member's allocation under section 1552 for a tax year may not exceed the excess, if any, of—

(A) The total of the tax liabilities of the member for the computation period (including the current year), determined as if the member had filed separate returns; over

(B) The total amount allocated to the member under section 1552 and this paragraph (d) for the computation period (except the current year).

(ii) *Reallocation of capped amounts.* To the extent that the amount allocated to a member under section 1552 exceeds the limitation under paragraph (d)(2)(i) of this section, the excess is allocated among the remaining members in proportion to (but not to exceed the amount of) each member's excess, if any, of—

(A) The total of the tax liabilities of the member for the computation period (including the current year), determined as if the member had filed separate returns; over

(B) The total amount allocated to the member under section 1552 and this paragraph (d) for the computation period (including for the current year only the amount allocated under section 1552).

(iii) *Reallocation of excess capped amounts.* If the reductions under paragraph (d)(2)(i) of this section exceed the amounts allocable under paragraph (d)(2)(ii) of this section, the excess is allocated among the members in accordance with the group's method under section 1552 without taking this paragraph (d)(2) into account.

(3) *Percentage method.* The percentage method under this paragraph (d)(3) allocates tax liability based on the absorption of tax attributes, without taking into account the ability of any member to subsequently absorb its own tax attributes. The allocation under this method is in addition to the allocation under section 1552.

(i) *Decreased earnings and profits.* A member's allocation under section 1552 for any year is increased, thereby decreasing its earnings and profits, by a fixed percentage (not to exceed 100%) of the excess, if any, of—

(A) The member's separate return tax liability for the consolidated return year as determined under §1.1552–1(a)(2)(ii); over

(B) The amount allocated to the member under section 1552.

(ii) *Increased earnings and profits.* An amount equal to the total decrease in earnings and profits under paragraph (d)(3)(i) of this section (including amounts allocated as a result of a carryback) increases the earnings and profits of the members whose attributes are absorbed, and is allocated among them in a manner that reasonably reflects the absorption of the tax attributes.

(4) *Additional methods.* The absorption by one member of the tax attributes of another member may be reflected under any other method approved in writing by the Commissioner.

(5) *Election of allocation method*—(i) *In general.* Tax liability may be allocated under this paragraph (d) only if an election is filed with the group's first return. The election must—

(A) Be made in a separate statement entitled ''ELECTION TO ALLOCATE TAX LIABILITY UNDER §1.1502–33(d)'';

(B) State the allocation method elected under §1.1502–33(d) and under section 1552;

(C) If the percentage method is elected, state the percentage (not to exceed 100%) to be used; and

(D) If a method is permitted under paragraph (d)(4) of this section, provide the date and control number of the private letter ruling issued by the Internal Revenue Service approving such method.

(ii) *Consent*—(A) *Electing or changing methods*. An election for a later year, or an election to change methods, may be made only with the written consent of the Commissioner.

(B) *Prior law elections*. An election in effect for the last tax year beginning before January 1, 1995, remains in effect under this section. However, a group may elect to conform its earnings and profits computations to the method described in §1.1502–32(b)(3)(iv)(D) (the percentage method, using a 100% allocation), whether or not it has previously made an election for earnings and profits purposes. If a conforming election is made, the group must make all adjustments necessary to prevent amounts from being duplicated or omitted. The conforming election is made by attaching a statement entitled ''ELECTION TO CONFORM TAX ALLOCATIONS UNDER §§1.1502–32 and 1.1502–33(d)'' to the consolidated group's return for its first tax year beginning on or after January 1, 1995. The statement must be signed by the common parent, and must specify whether the method is conformed only for years beginning on or after January 1, 1995 or as if the method were in effect for all prior years. The statement must also describe the adjustments made by reason of the change (e.g., to reflect prior use of earnings and profits).

(6) *Examples*. The principles of this paragraph (d) are illustrated by the following examples.

Example 1. Wait-and-see method. (a) *Facts*. P owns all of the stock of S1 and S2. The P group uses the wait-and-see method of allocation under paragraph (d)(2) of this section in conjunction with §1.1552–1(a)(1). For Year 1, each member's taxable income, both for purposes of §1.1552–1(a)(1) and redetermined as if the member had filed separate returns, is as follows: P $0, S1 $2,000, and S2 ($1,000). Thus, the P group's consolidated tax liability for Year 1 is $340 (assuming a 34% tax rate).

(b) *Analysis*. Under §1.1552–1(a)(1)(i), the tax liability of the P group is allocated among the members in accordance with the portion of the consolidated taxable income attributable to each member having taxable income. Thus, all of the P group's $340 consolidated tax liability is allocated to S1. As a result, S1 decreases its earnings and profits under section 1552 by $340 (even if S1 does not pay the tax liability). No further allocations are made under paragraph (d)(2) of this section because S2 cannot yet absorb its loss on a separate return basis.

(c) *Payment of tax liability*. If S1 pays the $340 tax liability, there is no further effect on the income, earnings and profits, or stock basis of any member. If P pays the $340 tax liability (and the payment is not a loan from P to S1), P is treated as making a $340 contribution to the capital of S1; if S2 pays the $340 tax liability (and the payment is not a loan from S2 to S1), S2 is treated as making a $340 distribution to P with respect to its stock, and P is treated as making a $340 contribution to the capital of S1. See §1.1552–1(b)(2).

(d) *Year 2*. For Year 2, each member's taxable income, under §1.1552–1(a)(1)(ii) and redetermined as if the member had filed separate returns, without taking into account any carryover from Year 1, is as follows: P $0, S1 $1,000, and S2 $3,000. Thus, the P group's consolidated tax liability for Year 2 is $1,360 (assuming a 34% tax rate). Of this amount, section 1552 would allocate $340 to S1 and $1,020 to S2. However, under paragraph (d)(2)(i) of this section, no more than $680 may be allocated to S2. This is because S2 would have had an aggregate tax liability of $680 if it had filed separate returns for Years 1 and 2 (a $0 tax liability for Year 1, and a $680 tax liability for Year 2, taking into account a $1,000 net operating loss carryover from Year 1). Under paragraph (d)(2)(ii) of this section, the entire excess of $340 which would otherwise be allocated to S2 under §1.1552–1(a)(1) is allocated to S1. This is because S1 would have had an additional $340 of aggregate tax liability if it had filed separate returns for Years 1 and 2 (a $680 tax liability for Year 1, and a $340 tax liability for Year 2, not taking into account S2's $1,000 net operating loss for Year 1). The effect of the allocation of $680 to S1 and $680 to S2 is determined under §1.1552–1(b)(2).

Example 2. Percentage method. (a) *Facts*. The facts are the same as in *Example 1*, but the P group uses the percentage method of allocation under paragraph (d)(3) of this section, with a percentage of 100%. In addition, the taxable incomes and losses of the members are the same if computed as provided in §1.1552–1(a)(2)(ii).

(b) *Analysis*. Under §1.1552–1(a)(2)(ii), $340 of tax liability is allocated to S1 for Year 1. Under paragraph (d)(3)(i) of this section, S1 is allocated another $340 of tax liability because S1 would have had a $680 tax liability if it had filed separate returns but only $340 is allocated to S1 under section 1552. Thus, S1's earnings and profits are decreased by the $680 total. Under paragraph (d)(3)(ii) of this section, S2's earnings and profits are increased by $340 because the additional $340 allocated to S1 under paragraph (d)(3)(i) of this section is attributable to the absorption of S2's losses.

(c) *Payment of tax liability.* If S1 pays the $340 tax liability of the P group and pays $340 to S2, the Year 1 tax liability results in no further adjustments to the income, earnings and profits, or basis of any member's stock. If S1 pays the $340 tax liability of the P group and pays the other $340 to P instead of S2 because, for example, of an agreement among the members, S2 is treated as distributing $340 to P with respect to its stock in the year that S1 makes the payment to P. See §1.1552–1(b)(2).

(d) *Year 2.* For Year 2, $340 is allocated to S1 and $1,020 is allocated to S2 under section 1552. No additional amounts are allocated under paragraph (d)(3) of this section.

(e) *Deconsolidations*—(1) *In general.* Immediately before it becomes a nonmember, S's earnings and profits are eliminated to the extent they were taken into account by any member under this section. If S's earnings and profits are eliminated under this paragraph (e)(1), no corresponding adjustment is made to the earnings and profits of P (or any other member) under paragraph (b) of this section or to any basis in a member's stock under paragraph (c) of this section. For this purpose, S is treated as becoming a nonmember on the first day of its first separate return year (including another group's consolidated return year).

(2) *Acquisition of group*—(i) *Application.* This paragraph (e)(2) applies only if a consolidated group (the terminating group) ceases to exist as a result of—

(A) The acquisition of either the assets of the common parent of the terminating group in a reorganization described in section 381(a)(2), or the stock of the common parent of the terminating group; or

(B) The application of the principles of §1.1502–75(d)(2) or (d)(3).

(ii) *General rule.* Paragraph (e)(1) of this section does not apply solely by reason of the termination of a group because it is acquired, if there is a surviving group that is, immediately thereafter, a consolidated group. Instead, the surviving group is treated as the terminating group for purposes of applying this paragraph (e) to the terminating group. This treatment does not apply, however, to members of the terminating group that are not members of the surviving consolidated group immediately after the terminating group ceases to exist (e.g., under section 1504(a)(3) relating to reconsolidation, or section 1504(c) relating to includible insurance companies).

(3) *Certain corporate separations and reorganizations.* The adjustments under paragraph (e)(1) of this section must be modified to the extent necessary to effectuate the principles of section 312(h). Thus, P's earnings and profits rather than S's earnings and profits may be eliminated immediately before S becomes a nonmember. P's earnings and profits are eliminated to the extent that its earnings and profits reflect S's earnings and profits after applying section 312(h) immediately after S becomes a nonmember (determined without taking this paragraph (e) into account).

(4) *Special uses of earnings and profits.* Paragraph (e)(1) of this section does not apply for purposes of determining—

(i) The extent to which a distribution is charged to reserve accounts under section 593(e);

(ii) The extent to which a distribution is taxable to the recipient under sections 805(a)(4) and 832; and

(iii) Any other special use identified in guidance published in the Internal Revenue Bulletin.

(5) *Example.* The principles of this paragraph (e) are illustrated by the following example.

Example. (a) *Facts.* Individuals A and B own all of P's stock, and P owns all of the stock of S and T, each with a $500 basis. For Year 1, S has $100 of earnings and profits and T has $50 of earnings and profits. Under paragraph (b)(1) of this section, the earnings and profits of S and T tier up to P, and P has $150 of earnings and profits for Year 1. P sells all of S's stock for $600 at the close of Year 1.

(b) *Analysis.* Under paragraph (e)(1) of this section, S's $100 of earnings and profits is eliminated immediately before S becomes a nonmember because the earnings and profits are taken into account under paragraph (b) of this section in P's earnings and profits. However, no corresponding adjustment is made to P's earnings and profits or to P's basis in S's stock for purposes of earnings and profits. P's earnings and profits for Year 1 remain $150 following the sale of S's stock.

(c) *Forward merger.* The facts are the same as in paragraph (a) of this *Example*, except that, rather than P selling S's stock, S merges into a nonmember in a transaction described in section 368(a)(2)(D). Under paragraph (h) of this section, the nonmember is treated as a successor to S. Thus, as in paragraph (b) of this *Example,* S's $100 of earnings and profits is eliminated immediately before S ceases to be a member.

(d) *Acquisition of entire group.* The facts are the same as in paragraph (a) of this *Example,* except that X, the common parent of another consolidated group, purchases all of P's stock at the close of Year 1, and P sells S's stock during Year 3. Under paragraph (e)(2) of this section, the earnings and profits of S and T are not eliminated as a result of X purchasing P's stock. However, S's earnings and profits from consolidated return years of both the P group and the X group are eliminated immediately before S becomes a nonmember of the X group.

(e) *Earnings and profits deficit.* The facts are the same as in paragraph (d) of this *Example,* except that S has a $550 deficit in earnings and profits for Year 1. The effect of paragraph (e)(1) of this section is the same. Under paragraph (c)(1) of this section, P would have an excess loss account in S's stock for earnings and profits purposes under the principles of §§1.1502–19 and 1.1502–32, and, under the principles of §1.1502–19(c)(2), the excess loss account is not taken into account as a result of X's purchase of P's stock. Under paragraph (e)(2) of this section, S's deficit is not eliminated under paragraph (e)(1) of this section immediately before X's purchase of P's stock. However, S's earnings and profits (or deficit) is eliminated immediately before S becomes a nonmember of the X group.

(f) *Section 355 distribution.* The facts are the same as in paragraph (a) of this *Example,* except that, rather than selling S's stock, P distributes S's stock to A at the close of Year 1 in a distribution to which section 355 applies. Under paragraph (e)(3) of this section, P's earnings and profits may be reduced under section 312(h) as a result of the distribution. To the extent that P's earnings and profits are reduced, S's earnings and profits are not eliminated under paragraph (e)(1) of this section.

(f) *Changes in the structure of the group*—(1) *Changes in the common parent*—(i) *General rule.* If P succeeds another corporation under the principles of §1.1502–75(d) (2) or (3) as the common parent of a consolidated group (a group structure change), the earnings and profits of P are adjusted immediately after P becomes the new common parent to reflect the earnings and profits of the former common parent immediately before the former common parent ceases to be the common parent. The adjustment is made as if P succeeds to the earnings and profits of the former common parent in a transaction described in section 381(a). See §1.1502–31 for the basis of the stock of members following a group structure change.

(ii) *Minority shareholders.* If the former common parent's stock is not wholly owned by members of the consolidated group immediately after the former common parent ceases to be the common parent, appropriate adjustments must be made to reflect in the new common parent only an allocable part of the former common parent's earnings and profits.

(iii) *Higher-tier members.* To the extent that earnings and profits are adjusted under this paragraph (f)(1), and the former common parent is owned by members other than P, the earnings and profits of the intermediate subsidiaries must be adjusted in accordance with the principles of this section.

(iv) *Example.* The principles of this paragraph (f)(1) are illustrated by the following example.

Example. (a) *Facts.* X is the common parent of a consolidated group with $100 of earnings and profits, and P is the common parent of another consolidated group with $20 of earnings and profits. P acquires all of X's stock at the close of Year 1 in exchange for 70% of P's stock. The exchange is a reverse acquisition under §1.1502–75(d)(3), and the X group is treated as remaining in existence with P as its new common parent.

(b) *Adjustments for X group earnings and profits.* Under paragraph (f)(1) of this section, P's earnings and profits are adjusted immediately after P becomes the new common parent, to reflect X's $100 of earnings and profits immediately before X ceases to be the common parent. The adjustment is made as if P succeeds to X's earnings and profits in a transaction described in section 381(a). Thus, immediately after the acquisition, P has $120 of accumulated earnings and profits and X continues to have $100 of accumulated earnings and profits.

(c) *Adjustments for P group earnings and profits.* Although the P group terminates on P's acquisition of X's stock, under paragraph (e)(2) of this section, no adjustments are made to the earnings and profits of any subsidiaries in the terminating P group.

(d) *Acquisition of separate return corporation.* The facts are the same as in paragraph (a) of this *Example,* except that, immediately before the acquisition of its stock by P, X is not affiliated with any other corporation. The exchange is a reverse acquisition under §1.1502–75(d)(3), and P is treated as the common parent of the X group. Consequently, the results are the same as in paragraphs (b) and (c) of this *Example*.

(2) *Change in the location of subsidiaries*. If the location of a member within a group changes, appropriate adjustments must be made to the earnings and profits of the members to prevent the earnings and profits from being eliminated. For example, if P transfers all of S's stock to another member in a transaction to which section 351 and §1.1502–13 apply, the transferee's earnings and profits are adjusted immediately after the transfer to reflect S's earnings and profits immediately before the transfer from consolidated return years. On the other hand, if the transferee purchases S's stock from P, the transferee's earnings and profits are not adjusted.

(g) *Anti-avoidance rule*. If any person acts with a principal purpose contrary to the purposes of this section, to avoid the effect of the rules of this section or apply the rules of this section to avoid the effect of any other provision of the consolidated return regulations, adjustments must be made as necessary to carry out the purposes of this section.

(h) *Predecessors and successors*. For purposes of this section, any reference to a corporation or to a share includes a reference to a successor or predecessor as the context may require. A corporation is a successor if its earnings and profits are determined, directly or indirectly, in whole or in part, by reference to the earnings and profits of another corporation (the predecessor). A share is a successor if its basis is determined, directly or indirectly, in whole or in part, by reference to the basis of another share (the predecessor).

(i) [Reserved]

(j) *Effective/applicability date*—(1) *General rule*. This section applies with respect to determinations of the earnings and profits of a member (e.g., for purposes of a characterizing a distribution to which section 301 applies) in consolidated return years beginning on or after January 1, 1995. If this section applies, earnings and profits must be determined or redetermined as if this section were in effect for all years (including, for example, the consolidated return years of another consolidated group to the extent the earnings and profits from those years are still reflected). For example, if a distribution by P to a nonmember shareholder in 1990 was a dividend because of an unabsorbed loss carryover attributable to S, P's earnings and profits in tax years beginning after January 1, 1995 are redetermined by taking into account a negative adjustment in the tax year S's loss arose and in 1990 for P's distribution, and any subsequent absorption of the loss has no effect on earnings and profits. Any such determination or redetermination does not, however, affect any prior period. Thus, the shareholder's treatment in 1990 of the distribution as a dividend (and the effect of the distribution on stock basis) is not redetermined under this section. Paragraphs (a)(2) and (e)(2)(i)(A) of this section apply with respect to determinations of the earnings and profits of a member in consolidated return years beginning on or after September 17, 2008. However, taxpayers may apply paragraph (e)(2)(i)(A) of this section with respect to determinations of the earnings and profits of a member in consolidated return years beginning prior to September 17, 2008.

(2) *Dispositions of stock before effective date*—(i) *In general*. If P disposes of stock of S in a consolidated return year beginning before January 1, 1995, the amount of P's earnings and profits with respect to S are not redetermined under paragraph (j)(1) of this section. See §1.1502–19 as contained in the 26 CFR part 1 edition revised as of April 1, 1994 for the definition of disposition, and paragraph (j)(5) of this section for the rules applicable to such dispositions.

(ii) *Lower-tier members*. Although P disposes of S's stock in a tax year beginning before January 1, 1995, S's determinations or adjustments with respect to lower-tier members with which it continues to file a consolidated return are redetermined in accordance with the rules of this section (even if S's earnings and profits were previously taken into account by P). For example, assume that P owns all of S's stock, S owns all of T's stock, and T owns all of U's stock. If S sells 80%

of T's stock in a tax year beginning before January 1, 1995 (the effective date), the amount of S's earnings and profits from the sale, and the adjustments to stock basis for earnings and profits purposes that are reflected in that amount, are not redetermined if P sells S's stock after the effective date. If S sells the remaining 20% of T's stock after the effective date, S's stock basis adjustments with respect to that T stock are also not redetermined because T became a nonmember before the effective date. However, if T and U continue to file a consolidated return with each other, paragraph (e)(1) of this section did not apply, and T sells U's stock after the effective date, T's earnings and profits with respect to U are redetermined (even though some of the earnings and profits may have been taken into account by S in its prior sale of T's stock before the effective date).

(iii) *Deferred amounts.* For purposes of this paragraph (j)(2), a disposition does not include a transaction to which §1.1502–13, §1.1502–13T, §1.1502–14, or §1.1502–14T applies. Instead, the transaction is deemed to occur as the earnings and profits (if any) are taken into account.

(3) *Deconsolidations and group structure changes*—(i) *In general.* Paragraphs (e) and (f) of this section apply with respect to deconsolidations and group structure changes occurring in consolidated return years beginning on or after January 1, 1995.

(ii) *Prior period group structure changes.* If there was a group structure change in a consolidated return year beginning before January 1, 1995, and earnings and profits were not determined under §1.1502–33T(a) as contained in the 26 CFR part 1 edition revised as of April 1, 1994, a distribution in a tax year ending after September 7, 1988, of earnings and profits that are not reflected in the earnings and profits of the distributee member, but would have been so reflected if §1.1502–33T(a) as contained in the 26 CFR part 1 edition revised as of April 1, 1994 had applied, the negative adjustment under paragraph (b) of this section for distributions does not apply (and there is therefore no offset to the increase in the earnings and profits of the distributee).

(4) *Deemed dividend elections.* If there is a deemed distribution and recontribution pursuant to §1.1502–32(f)(2) as contained in the 26 CFR part 1 edition revised as of April 1, 1994 in a consolidated return year beginning before January 1, 1995, the deemed distribution and recontribution under the election are treated as an actual distribution by S and recontribution by P as provided under the election.

(5) *Prior law.* For prior determinations, see prior regulations under section 1502 as in effect with respect to the determination. See, e.g., §§1.1502–33 and 1.1502–33T as contained in the 26 CFR part 1 edition revised as of April 1, 1994.

(k) *Effective/applicability date.* Paragraph (d)(5)(i)(D) of this section applies to any original consolidated Federal income tax return due (without extensions) after June 14, 2007. For original consolidated Federal income tax returns due (without extensions) after May 30, 2006, and on or before June 14, 2007, see §1.1502–33T as contained in 26 CFR part 1 in effect on April 1, 2007. For original consolidated Federal income tax returns due (without extensions) on or before May 30, 2006, see §1.1502–33 as contained in 26 CFR part 1 in effect on April 1, 2006.

[T.D. 8560, 59 FR 41695, Aug. 15, 1994, as amended by T.D. 8597, 60 FR 36710, July 18, 1995; T.D. 9264, 71 FR 30603, May 30, 2006; T.D. 9329, 72 FR 32805, June 14, 2007; T.D. 9424, 73 FR 53951, Sept. 17, 2008; 73 FR 62204, Oct. 20, 2008]

§ 1.1502–34 Special aggregate stock ownership rules.

For purposes of §§1.1502–1 through 1.1502–80, in determining the stock ownership of a member of a group in another corporation (the ''issuing corporation'') for purposes of determining the application of section 165(g)(3)(A), 332(b)(1), 333(b), 351(a), 732(f), or 904(f), in a consolidated return year, there shall be included stock owned by all other members of the group in the issuing corporation. Thus, assume that members A, B, and C each own 33⅓ percent of the stock issued by D. In such case, A, B, and C shall each be treated as meeting the 80-percent stock ownership requirement for purposes of section 332, and no member can elect to have section 333 apply. Furthermore, the special rule for minority shareholders in section 337(d) cannot apply with respect to amounts received by A, B, or C in liquidation of D.

[T.D. 6894, 31 FR 11794, Sept. 8, 1966, as amended by T.D. 8949, 66 FR 32902, June 19, 2001]

§ 1.1502–35 Transfers of subsidiary stock and deconsolidations of subsidiaries.

(a) *In general*—(1) *Purpose*. The purpose of this section is to prevent a group from obtaining more than one tax benefit from a single economic loss. The provisions of this section shall be construed in a manner that is consistent with that purpose and in a manner that reasonably carries out that purpose.

(2) *Dates of applicability*. This section applies if—

(i) On or after March 7, 2002, a member recognizes a loss on the disposition of a share of stock of a subsidiary (or, on or after April 10, 2007, a share of stock of a former subsidiary) or a carryover basis asset (subject to paragraph (c)(6) of this section),

(ii) The member's loss on the share of subsidiary stock or the carryover basis asset is allowed on or before the date that is ten years after the disposition of the share or carryover basis asset, and

(iii) If the disposition is of a share of subsidiary stock, it is not a transfer to which § 1.1502–36 applies.

(b) *Redetermination of basis on certain nondeconsolidating transfers of subsidiary stock and on certain deconsolidations of subsidiaries*—(1) *Redetermination of basis on certain nondeconsolidating transfers of subsidiary stock*. Except as provided in paragraph (b)(3)(i) of this section, if, immediately after a transfer of stock of a subsidiary that has a basis that exceeds its value, the subsidiary remains a member of the group, then the basis in each share of subsidiary stock owned by each member of the group shall be redetermined in accordance with the provisions of this paragraph (b)(1) immediately before such transfer. All of the members' bases in the shares of subsidiary stock immediately before such transfer shall be aggregated. Such aggregated basis shall be allocated first to the shares of the subsidiary's preferred stock that are owned by the members of the group immediately before such transfer, in proportion to, but not in excess of, the value of those shares at such time. After allocation of the aggregated basis to all shares of the preferred stock of the subsidiary pursuant to the preceding sentence, any remaining basis shall be allocated among all common shares of subsidiary stock held by members of the group immediately before the transfer, in proportion to the value of such shares at such time.

(2) *Redetermination of basis on certain deconsolidations of subsidiaries*—(i) *Allocation of reallocable basis amount*. Except as provided in paragraph (b)(3)(ii) of this section, if, immediately before a deconsolidation of a subsidiary, any share of stock of such subsidiary owned by a member of the group has a basis that exceeds its value, then the basis in each share of the subsidiary's stock owned by each member of the group shall be redetermined in accordance with the provisions of this paragraph (b)(2) immediately before such deconsolidation. The basis in each share of the subsidiary's stock held by members of the group immediately before the deconsolidation that has a basis in excess of value at such time shall be reduced, but not below such share's value, in a manner that, to the greatest extent possible, causes the ratio of the basis to the value of each such share to be the same; provided, however, that the aggregate amount of such reduction shall not exceed the reallocable basis amount (as computed pursuant to paragraph (b)(2)(ii) of this section). Then, to the extent of the reallocable basis amount, the basis of each share of the preferred stock of the subsidiary that are held by members of the group immediately before the deconsolidation shall be increased, but not above such share's value, in a manner that, to the greatest extent possible, causes the ratio of the basis to the value of each such share to be the

same. Then, to the extent that the reallocable basis amount does not increase the basis of shares of preferred stock of the subsidiary pursuant to the third sentence of this paragraph (b)(2)(i), such amount shall increase the basis of all common shares of the subsidiary's stock held by members of the group immediately before the deconsolidation in a manner that, to the greatest extent possible, causes the ratio of the basis to the value of each such share to be the same.

(ii) *Calculation of reallocable basis amount*. The reallocable basis amount shall equal the lesser of—

(A) The aggregate of all amounts by which, immediately before the deconsolidation, the basis exceeds the value of a share of subsidiary stock owned by any member of the group at such time; and

(B) The total of the subsidiary's (and any predecessor's) items of deduction and loss, and the subsidiary's (and any predecessor's) allocable share of items of deduction and loss of all lower-tier subsidiaries, that were taken into account in computing the adjustment under §1.1502–32 to the bases of shares of stock of the subsidiary (and any predecessor) held by members of the group immediately before the deconsolidation, other than shares that have bases in excess of value immediately before the deconsolidation.

(3) *Exceptions to application of redetermination rules*. (i) Paragraph (b)(1) of this section shall not apply to a transfer of subsidiary stock if—

(A) During the taxable year of such transfer, in one or more fully taxable transactions, the members of the group dispose of all of the shares of the subsidiary stock that they own immediately before the transfer, other than the shares the transfer of which would otherwise trigger the application of paragraph (b)(1) of this section, to a person or persons that are not members of the group;

(B) During the taxable year of such transfer, the members of the group are allowed a worthless stock loss under section 165(g) (taking into account the provisions of §1.1502–80(c)) with respect to all of the shares of subsidiary stock that they own immediately before the transfer, other than the shares the transfer of which would otherwise trigger the application of paragraph (b)(1) of this section; or

(C) Such transfer is to a member of the group and section 332 (provided the stock is transferred to an 80-percent distributee), section 351, section 354, or section 361 applies to such transfer.

(ii) Paragraph (b)(2) of this section shall not apply to a deconsolidation of a subsidiary if—

(A) During the taxable year of such deconsolidation, in one or more fully taxable transactions, the members of the group dispose of all of the shares of the subsidiary stock that they own immediately before the deconsolidation to a person or persons that are not members of the group;

(B) Such deconsolidation results from a fully taxable disposition, to a person or persons that are not members of the group, of some of the shares of the subsidiary, and, during the taxable year of such deconsolidation, the members of the group are allowed a worthless stock loss under section 165(g) with respect to all of the shares of the subsidiary stock that they own immediately after the deconsolidation;

(C) The members of the group are allowed a worthless stock loss under section 165(g) with respect to all of the shares of the subsidiary stock that they own immediately before the deconsolidation;

(D) The deconsolidation of the subsidiary results from the deconsolidation of a higher-tier subsidiary and, immediately after the deconsolidation of the subsidiary, none of the stock of the subsidiary is owned by a group member; or

(E) The deconsolidation of the subsidiary results from a termination of the group.

(4) *Special rule for lower-tier subsidiaries*. If, immediately after a transfer of subsidiary stock or a deconsolidation of a subsidiary, a lower-tier subsidiary some of the stock of which is owned by the subsidiary is a member of the group, then, for purposes of applying this paragraph (b), the subsidiary shall be treated as having transferred its stock of the lower-tier subsidiary. This principle shall apply to stock of subsidiaries that are owned by such lower-tier subsidiary.

(5) *Stock basis adjustments for higher-tier stock.* The basis adjustments required under this paragraph (b) result in basis adjustments to higher-tier member stock. The adjustments are applied in the order of the tiers, from the lowest to highest. For example, if a common parent owns stock of a subsidiary that owns stock of a lower-tier subsidiary and the subsidiary recognizes a loss on the disposition of a portion of its shares of the lower-tier subsidiary stock, the common parent must adjust its basis in its subsidiary stock under the principles of §1.1502–32 to reflect the adjustments that the subsidiary must make to its basis in its stock of the lower-tier subsidiary.

(6) *Ordering rules.* (i) The rules of this paragraph (b) apply after the rules of §1.1502–32 are applied.

(ii) The rules of this paragraph (b) apply before the rules of §1.337(d)–2 and paragraphs (c) and (f) of this section are applied.

(iii) This paragraph (b) (and any resulting basis adjustments to higher-tier member stock made pursuant to paragraph (b)(5) of this section) applies to redetermine the basis of stock of a lower-tier subsidiary before this paragraph (b) applies to a higher-tier member of such lower-tier subsidiary.

(c) *Loss suspension*—(1) *General rule.* Any loss recognized by a member of a consolidated group with respect to the disposition of a share of subsidiary stock shall be suspended to the extent of the duplicated loss with respect to such share of stock if, immediately after the disposition, the subsidiary is a member of the consolidated group of which it was a member immediately prior to the disposition (or any successor group).

(2) *Special rule for lower-tier subsidiaries.* This paragraph (c)(2) applies if neither paragraph (c)(1) nor (f) of this section applies to a member's disposition of a share of stock of a subsidiary (the departing member), a loss is recognized on the disposition of such share, and the departing member owns stock of one or more other subsidiaries (a remaining member) that is a member of such group immediately after the disposition. In that case, such loss shall be suspended to the extent the duplicated loss with respect to the departing member stock disposed of is attributable to the remaining member or members.

(3) *Treatment of suspended loss*—(i) *General rule.* For purposes of the rules of §1.1502–32, any loss suspended pursuant to paragraph (c)(1) or (c)(2) of this section is treated as a noncapital, nondeductible expense of the member that disposes of subsidiary stock, incurred during the taxable year that includes the date of the disposition of stock to which paragraph (c)(1) or (c)(2) of this section applies. See §1.1502–32(b)(3)(iii)(C). Consequently, the basis of a higher-tier member's stock of the member that disposes of subsidiary stock is reduced by the suspended loss in the year it is suspended.

(ii) *Location of suspended loss following deconsolidation of selling member.* If a member recognizes a loss that is suspended under this paragraph (c) but that member ceases to be a member of the group before the loss is allowable, the common parent is treated as succeeding to the loss in a transaction to which section 381(a) applies.

(4) *Reduction of suspended loss*—(i) *General rule.* The amount of any loss suspended pursuant to paragraph (c)(1) or (c)(2) of §1.1502–35 shall be reduced, but not below zero, by the subsidiary's (and any successor's) items of deduction and loss, and the subsidiary's (and any successor's) allocable share of items of deduction and loss of all lower-tier subsidiaries, that are allocable to the period beginning on the date of the disposition that gave rise to the suspended loss and ending on the day before the first date on which the subsidiary (and any successor) is not a member of the group of which it was a member immediately prior to the disposition (or any successor group), and that are taken into account in determining consolidated taxable income (or loss) of such group for any taxable year that includes any date on or after the date of the disposition and before the first date on which the subsidiary (and any successor) is not a member of such group; provided, however, that such reduction shall not exceed the excess of the amount of such items over the amount of such items that are taken into account in determining the basis adjustments made under §1.1502–32 to

stock of the subsidiary (or any successor) owned by members of the group. The preceding sentence shall not apply to items of deduction and loss to the extent that the group can establish that all or a portion of such items was not reflected in the computation of the duplicated loss with respect to the subsidiary on the date of the disposition of stock that gave rise to the suspended loss.

(ii) *Operating rules*—(A) *Year in which deduction or loss is taken into account*. For purposes of paragraph (c)(4)(i) of this section, a subsidiary's (or any successor's) deductions and losses are treated as taken into account when and to the extent they are absorbed by the subsidiary (or any successor) or any other member. To the extent that the subsidiary's (or any successor's) deduction or loss is absorbed in the year it arises or is carried forward and absorbed in a subsequent year (e.g., under section 172, 465, or 1212), the deduction is treated as taken into account in the year in which it is absorbed. To the extent that a subsidiary's (or any successor's) deduction or loss is carried back and absorbed in a prior year (whether consolidated or separate), the deduction or loss is treated as taken into account in the year in which it arises and not in the year in which it is absorbed.

(B) *Determination of items that are allocable to the post-disposition, pre-deconsolidation period*. For purposes of paragraph (c)(4)(i) of this section, the determination of whether a subsidiary's (or any successor's) items of deduction and loss and allocable share of items of deduction and loss of all lower-tier subsidiaries are allocable to the period beginning on the date of the disposition of subsidiary stock that gave rise to the suspended loss and ending on the day before the first date on which the subsidiary (or any successor) is not a member of the consolidated group of which it was a member immediately prior to the disposition (or any successor group) is determined pursuant to the rules of §1.1502–76(b)(2), without regard to §1.1502–76(b)(2)(ii)(D), as if the subsidiary ceased to be a member of the group at the end of the day before the disposition and filed separate returns for the period beginning on the date of the disposition and ending on the day before the first date on which it is not a member of such group.

(5) *Allowable loss*—(i) *General rule*. To the extent not reduced under paragraph (c)(4) of this section, any loss suspended pursuant to paragraph (c)(1) or (c)(2) of this section shall be allowed, to the extent otherwise allowable under applicable provisions of the Internal Revenue Code and regulations, on a return filed by the group of which the subsidiary was a member on the date of the disposition of subsidiary stock that gave rise to the suspended loss (or any successor group) for the taxable year that includes the earlier of—

(A) The day before the first date on which the subsidiary (and any successor) is not a member of such group or the date the group is allowed a worthless stock loss under section 165 (taking into account the provisions of §1.1502–80(c)) with respect to all of the subsidiary stock owned by members and;

(B) The date that is ten years after the date of the disposition of subsidiary stock that gave rise to the suspended loss.

(ii) *No tiering up of certain adjustments*. No adjustments shall be made to a member's basis of stock of a subsidiary (or any successor) for a suspended loss that is taken into account under paragraph (c)(5)(i) of this section. See §1.1502–32(a)(2).

(iii) *Statement of allowed loss*. Paragraph (c)(5)(i) of this section applies only if the separate statement required under this paragraph (c)(5)(iii) is filed with, or as part of, the taxpayer's return for the year in which the loss is allowable. The statement must be entitled ''ALLOWED LOSS UNDER §1.1502–35(c)(5)'' and must contain the name and employer identification number of the subsidiary the stock of which gave rise to the loss.

(6) *Special rule for dispositions of certain carryover basis assets*. If—

(i) A member of a group recognizes a loss on the disposition of an asset other than stock of a subsidiary;

(ii) Such member's basis in the asset disposed of was determined, directly or indirectly, in whole or in part, by reference to the basis of stock of a subsidiary and, at the time of the determination of the member's basis in the asset disposed of, there was a duplicated loss with respect to such stock of the subsidiary; and

(iii) Immediately after the disposition, the subsidiary is a member of such group, then such loss shall be suspended pursuant to the principles of paragraphs (c)(1) and (c)(2) of this section to the extent of the duplicated loss with respect to such stock at the time of the determination of basis of the asset disposed of. Principles similar to those set forth in paragraphs (c)(3), (c)(4), and (c)(5) of this section shall apply to a loss suspended pursuant to this paragraph (c)(6).

(7) *Coordination with loss deferral, loss disallowance, and other rules*—(i) *In general.* Loss recognized on the disposition of subsidiary stock or another asset is subject to redetermination, deferral, or disallowance under other applicable provisions of the Internal Revenue Code and regulations thereunder, including sections 267(f) and 482. Paragraphs (c)(1), (c)(2), and (c)(6) of this section do not apply to a loss that is disallowed under any other provision. If loss is deferred under any other provision, paragraphs (c)(1), (c)(2), and (c)(6) of this section apply when the loss would otherwise be taken into account under such other provision. However, if an overriding event described in paragraph (c)(7)(ii) of this section occurs before the deferred loss is taken into account, paragraphs (c)(1), (c)(2), and (c)(6) of this section apply to the loss immediately before the event occurs, even though the loss may not be taken into account until a later time.

(ii) *Overriding events.* For purposes of paragraph (c)(7)(i) of this section, the following are overriding events—

(A) The stock ceases to be owned by a member of the consolidated group;

(B) The stock is canceled or redeemed (regardless of whether it is retired or held as treasury stock); or

(C) The stock is treated as disposed of under §1.1502–19(c)(1)(ii)(B) or (c)(1)(iii).

(8) *No elimination of economic loss.* This paragraph (c) shall not be applied in a manner that permanently disallows a deduction for an economic loss, provided that such deduction is otherwise allowable. If the application of any provision of this paragraph (c) results in such a disallowance, proper adjustment may be made to prevent such a disallowance. Whether a provision of this paragraph (c) has resulted in such a disallowance is determined on the date on which the subsidiary (or any successor) the disposition of the stock of which gave rise to a suspended stock loss is not a member of the group or the date the group is allowed a worthless stock loss under section 165(g) (taking into account the provisions of §1.1502–80(c)) with respect to all of such subsidiary stock owned by members. Proper adjustment in such cases shall be made by restoring the suspended stock loss immediately before the subsidiary ceases to be a member of the group or the group is allowed a worthless stock loss under section 165(g) (taking into account the provisions of §1.1502–80(c)) with respect to all of such subsidiary stock owned by members, to the extent that its reduction pursuant to paragraph (c)(4) of this section had the result of permanently disallowing a deduction for an economic loss.

(9) *Ordering rule.* The rules of this paragraph (c) apply after the rules of paragraph (b) of this section and §1.337(d)–2 are applied.

(d) *Definitions*—(1) *Disposition* means any event in which gain or loss is recognized, in whole or in part.

(2) *Deconsolidation* means any event that causes a subsidiary to no longer be a member of the consolidated group.

(3) *Value* means fair market value.

(4) *Duplicated loss*—(i) *In general.* Duplicated loss is determined immediately after a disposition and equals the excess, if any, of—

(A) The sum of—

(*1*) The aggregate adjusted basis of the subsidiary's assets other than any stock that subsidiary owns in another subsidiary;

(*2*) Any losses attributable to the subsidiary and carried to the subsidiary's first taxable year following the disposition; and

(*3*) Any deductions of the subsidiary that have been recognized but are deferred under a provision of the Internal

Revenue Code (such as deductions deferred under section 469); over

(B) The sum of—

(*1*) The value of the subsidiary's stock; and

(*2*) Any liabilities of the subsidiary that have been taken into account for tax purposes.

(ii) *Special rules.* (A) The amounts determined under paragraph (d)(4)(i) (other than amounts described in paragraph (d)(4)(i)(B)(1)) of this section with respect to a subsidiary include its allocable share of corresponding amounts with respect to all lower-tier subsidiaries. If 80 percent or more in value of the stock of a subsidiary is acquired by purchase in a single transaction (or in a series of related transactions during any 12-month period), the value of the subsidiary's stock may not exceed the purchase price of the stock divided by the percentage of the stock (by value) so purchased. For this purpose, stock is acquired by purchase if the transferee is not related to the transferor within the meaning of sections 267(b) and 707(b)(1), using the language ''10 percent'' instead of ''50 percent'' each place that it appears, and the transferee's basis in the stock is determined wholly by reference to the consideration paid for such stock.

(B) The amounts determined under paragraph (d)(4)(i) of this section are not applied more than once to suspend a loss under this section.

(5) *Predecessor and successor.* A predecessor is a transferor of assets to a transferee (the successor) in a transaction—

(i) To which section 381(a) applies;

(ii) In which substantially all of the assets of the transferor are transferred to members in a complete liquidation;

(iii) In which the successor's basis in assets is determined (directly or indirectly, in whole or in part) by reference to the transferor's basis in such assets, but the transferee is a successor only with respect to the assets the basis of which is so determined; or

(iv) Which is an intercompany transaction, but only with respect to assets that are being accounted for by the transferor in a prior intercompany transaction.

(6) *Successor group.* A surviving group is treated as a successor group of a consolidated group (the terminating group) that ceases to exist as a result of—

(i) The acquisition by a member of another consolidated group of either the assets of the common parent of the terminating group in a reorganization described in section 381(a)(2), or the stock of the common parent of the terminating group; or

(ii) The application of the principles of § 1.1502–75(d)(2) or (3).

(7) *Preferred stock, common stock.* Preferred stock and common stock shall have the meanings set forth in § 1.1502–32(d)(2) and (3), respectively.

(8) *Higher-tier.* A subsidiary is higher-tier with respect to a member if or to the extent investment adjustments under § 1.1502–32 with respect to the stock of the latter member would affect investment adjustments with respect to the stock of the former member.

(9) *Lower-tier.* A subsidiary is lower-tier with respect to a member if or to the extent investment basis adjustments under § 1.1502–32 with respect to the stock of the former member would affect investment adjustments with respect to the stock of the latter member.

(e) *Examples.* For purposes of the examples in this section, unless otherwise stated, all groups file consolidated returns on a calendar-year basis, the facts set forth the only corporate activity, all transactions are between unrelated persons, and tax liabilities are disregarded. In addition, all transactions described in section 362(a) are completed before October 22, 2004, and therefore are not subject to section 362(e)(2). The principles of paragraphs (a) through (d) of this section are illustrated by the following examples:

Example 1. Nondeconsolidating sale of preferred stock of lower-tier subsidiary. (i) *Facts.* P owns 100 percent of the common stock of each of S1 and S2. S1 and S2 each have only one class of stock outstanding. P's basis in the stock of S1 is $100 and the value of such stock is $130. P's basis in the stock of S2 is $120 and the value of such stock is $90. P, S1, and S2 are all members of the P group. S1 and S2 form S3. In Year 1, in transfers to which section 351 applies, S1 contributes $100 to S3 in exchange for all of the common stock of S3 and S2 contributes an asset with a basis of $50 and a value of $20 to S3 in exchange for all of the preferred stock of S3. S3 becomes a member of the P group. In Year 3, in a transaction that is not part of the plan that includes the contributions to S3, S2 sells the preferred stock of S3 for $20. Immediately after the sale, S3 is a member of the P group.

(ii) *Application of basis redetermination rule.* Because S2's basis in the preferred stock of S3 exceeds its value immediately prior to the sale and S3 is a member of the P group immediately after the sale, all of the P group members' bases in the stock of S3 is redetermined pursuant to paragraph (b)(1) of this section. Of the group members' total basis of $150 in the S3 stock, $20 is allocated to the preferred stock, the fair market value of the preferred stock on the date of the sale, and $130 is allocated to the common stock. S2's sale of the preferred stock results in the recognition of $0 of gain/loss. Pursuant to paragraph (b)(5) of this section, the redetermination of S1's and S2's bases in the stock of S3 results in adjustments to P's basis in the stock of S1 and S2. In particular, P's basis in the stock of S1 is increased by $30 to $130 and its basis in the stock of S2 is decreased by $30 to $90.

Example 2. Deconsolidating sale of common stock. (i) *Facts.* In Year 1, in a transfer to which section 351 applies, P contributes Asset A with a basis of $900 and a value of $200 to S in exchange for one share of S common stock (CS1). In Years 2 and 3, in successive but unrelated transfers to which section 351 applies, P transfers $200 to S in exchange for one share of S common stock (CS2), Asset B with a basis of $300 and a value of $200 in exchange for one share of S common stock (CS3), and Asset C with a basis of $1000 and a value of $200 in exchange for one share of S common stock (CS4). In Year 4, S sells Asset A for $200, recognizing $700 of loss that is used to offset income of P recognized during Year 4. As a result of the sale of Asset A, the basis of each of P's four shares of S common stock is reduced by $175. Therefore, the basis of CS1 is $725. The basis of CS2 is $25. The basis of CS3 is $125, and the basis of CS4 is $825. In Year 5 in a transaction that is not part of a plan that includes the Year 1 contribution, P sells CS4 for $200. Immediately after the sale of CS4, S is not a member of the P group.

(ii) *Application of basis redetermination rule.* Because P's basis in each of CS1 and CS4 exceeds its value immediately prior to the deconsolidation of S, P's basis in its shares of S common stock is redetermined pursuant to paragraph (b)(2) of this section. Pursuant to paragraph (b)(2)(ii) of this section, the reallocable basis amount is $350 (the lesser of $1150, the gross loss inherent in the stock of S owned by P immediately before the sale, and $350, the aggregate amount of S's items of deduction and loss that were previously taken into account in the computation of the adjustment to the basis of the stock of S that P did not hold at a loss immediately before the deconsolidation). Pursuant to paragraph (b)(2)(i) of this section, first, P's basis in CS1 is reduced from $725 to $600 and P's basis in CS4 is reduced from $825 to $600. Then, the reallocable basis amount increases P's basis in CS2 from $25 to $250 and P's basis in CS3 from $125 to $250. P recognizes $400 of loss on the sale of CS4. The loss suspension rule does not apply because S is no longer a member of the P group. Thus, the loss is allowable at that time.

Example 3. Nondeconsolidating sale of common stock. (i) *Facts.* In Year 1, P forms S with a contribution of $80 in exchange for 80 shares of the common stock of S, which at that time represents all of the outstanding stock of S. S becomes a member of the P group. In Year 2, P contributes Asset A with a basis of $50 and a value of $20 in exchange for 20 shares of the common stock of S in a transfer to which section 351 applies. In Year 4, in a transaction that is not part of the plan that includes the Year 2 contribution, P sells the 20 shares of the common stock of S that it acquired in Year 2 for $20. Immediately after the Year 4 stock sale, S is a member of the P group. At the time of the Year 4 stock sale, S has $80 and Asset A. In Year 5, S sells Asset A, the basis and value of which have not changed since its contribution to S. On the sale of Asset A for $20, S recognizes a $30 loss. The P group cannot establish that all or a portion of the $30 loss was not reflected in the calculation of the duplicated loss of S on the date of the Year 4 stock sale. The $30 loss is used on the P group return to offset income of P. In Year 6, P sells its remaining S common stock for $80.

(ii) *Application of basis redetermination and loss suspension rules.* Because P's basis in the common stock sold exceeds its value immediately prior to the sale and S is a member of the P group immediately after the sale, P's basis in all of the stock of S is redetermined pursuant to paragraph (b)(1) of this section. Of P's total basis of $130 in the S common stock, a proportionate amount is allocated to each of the 100 shares of S common stock. Accordingly, $26 is allocated to the common stock of S that is sold and $104 is allocated to the common stock of S that is retained. On P's sale of the 20 shares of the common stock of S for $20, P recognizes a loss of $6. Because the sale of the 20 shares of common stock of S does not result in the deconsolidation of S, under paragraph (c)(1) of this section, that loss is suspended to the extent of the duplicated loss with respect to the shares sold. The duplicated loss with respect to the shares sold is $6. Therefore, the entire $6 loss is suspended.

(iii) *Effect of subsequent asset sale on stock basis.* Of the $30 loss recognized on the sale of

Asset A, $24 is taken into account in determining the basis adjustments made under §1.1502–32 to the stock of S owned by P. Accordingly, P's basis in its S stock is reduced by $24 from $104 to $80.

(iv) *Effect of subsequent asset sale on suspended loss.* Because P cannot establish that all or a portion of the loss recognized on the sale of Asset A was not reflected in the calculation of the duplicated loss of S on the date of the Year 4 stock sale and such loss is allocable to the period beginning on the date of the Year 4 disposition of the S stock and ending on the day before the first date on which S is not a member of the P group and is taken into account in determining consolidated taxable income (or loss) of the P group for a taxable year that includes a date on or after the date of the Year 4 disposition and before the first date on which S is not a member of the P group, such asset loss reduces the suspended loss pursuant to paragraph (c)(4) of this section. The amount of such reduction, however, cannot exceed $6, the excess of the amount of such loss, $30, over the amount of such loss that is taken into account in determining the basis adjustment made to the stock of S owned by P, $24. Therefore, the suspended loss is reduced to zero.

(v) *Effect of subsequent stock sale.* P recognizes $0 gain/loss on the Year 6 sale of its remaining S common stock. No amount of suspended loss remains to be allowed under paragraph (c)(5) of this section.

Example 4. Nondeconsolidating sale of common stock of lower-tier subsidiary. (i) *Facts.* In Year 1, P forms S1 with a contribution of $200 in exchange for all of the common stock of S1, which represents all of the outstanding stock of S1. In the same year, S1 forms S2 with a contribution of $80 in exchange for 80 shares of the common stock of S2, which at that time represents all of the outstanding stock of S2. S1 and S2 become members of the P group. In the same year, S2 purchases Asset A for $80. In Year 2, S1 contributes Asset B with a basis of $50 and a value of $20 in exchange for 20 shares of the common stock of S2 in a transfer to which section 351 applies. In Year 4, S1 sells the 20 shares of the common stock of S2 that it acquired in Year 2 for $20. Immediately after the Year 4 stock sale, S2 is a member of the P group. At the time of the Year 4 stock sale, the bases and values of Asset A and Asset B are unchanged. In Year 5, S2 sells Asset B for $45, recognizing a $5 loss. The P group cannot establish that all or a portion of the $5 loss was not reflected in the calculation of the duplicated loss of S2 on the date of the Year 4 stock sale. The $5 loss is used on the P group return to offset income of P. In Year 6, S1 sells its remaining S2 common stock for $100.

(ii) *Application of basis redetermination and loss suspension rules.* Because S1's basis in the S2 common stock sold exceeds its value immediately prior to the sale and S2 is a member of the P group immediately after the sale, S1's basis in all of the stock of S2 is redetermined pursuant to paragraph (b)(1) of this section. Of S1's total basis of $130 in the S2 common stock, a proportionate amount is allocated to each of the 100 shares of S2 common stock. Accordingly, a total of $26 is allocated to the common stock of S2 that is sold and $104 is allocated to the common stock of S2 that is retained. On S1's sale of the 20 shares of the common stock of S2 for $20, S1 recognizes a loss of $6. Because the sale of the 20 shares of common stock of S2 does not result in the deconsolidation of S2, under paragraph (c)(1) of this section, that loss is suspended to the extent of the duplicated loss with respect to the shares sold. The duplicated loss with respect to the shares sold is $6. Therefore, the entire $6 loss is suspended. Pursuant to paragraph (c)(3) of this section and §1.1502–32(b)(3)(iii)(C), the suspended loss is treated as a noncapital, nondeductible expense incurred by S1 during the tax year that includes the date of the disposition of stock to which paragraph (c)(1) of this section applies. Accordingly, P's basis in its S1 stock is reduced from $200 to $194.

(iii) *Effect of subsequent asset sale on stock basis.* Of the $5 loss recognized on the sale of Asset B, $4 is taken into account in determining the basis adjustments made under §1.1502–32 to the stock of S2 owned by S1. Accordingly, S1's basis in its S2 stock is reduced by $4 from $104 to $100 and P's basis in its S1 stock is reduced by $4 from $194 to $190.

(iv) *Effect of subsequent asset sale on suspended loss.* Because P cannot establish that all or a portion of the loss recognized on the sale of Asset B was not reflected in the calculation of the duplicated loss of S2 on the date of the Year 4 stock sale and such loss is allocable to the period beginning on the date of the Year 4 disposition of the S2 stock and ending on the day before the first date on which S2 is not a member of the P group and is taken into account in determining consolidated taxable income (or loss) of the P group for a taxable year that includes a date on or after the date of the Year 4 disposition and before the first date on which S2 is not a member of the P group, such asset loss reduces the suspended loss pursuant to paragraph (c)(4) of this section. The amount of such reduction, however, cannot exceed $1, the excess of the amount of such loss, $5, over the amount of such loss that is taken into account in determining the basis adjustment made to the stock of S2 owned by members of the P group, $4. Therefore, the suspended loss is reduced to $5.

(v) *Effect of subsequent stock sale.* In year 6, when S1 sells its remaining S2 stock for $100, it recognizes $0 gain/loss. Pursuant to paragraph (c)(5) of this section, the remaining $5 of the suspended loss is allowed on the P group's return for Year 6 when S1 sells its remaining S2 stock.

Example 5. Deconsolidating sale of subsidiary owning stock of another subsidiary that remains in group. (i) *Facts.* In Year 1, P forms S1 with a contribution of Asset A with a basis of $50 and a value of $20 in exchange for 100 shares of common stock of S1 in a transfer to which section 351 applies. Also in Year 1, P and S1 form S2. P contributes $80 to S2 in exchange for 80 shares of common stock of S2. S1 contributes Asset A to S2 in exchange for 20 shares of common stock of S2 in a transfer to which section 351 applies. In Year 3, in a transaction that is not part of a plan that includes the Year 1 contributions, P sells its 100 shares of S1 common stock for $20. Immediately after the Year 3 stock sale, S2 is a member of the P group. At the time of the Year 3 stock sale, S1 owns 20 shares of common stock of S2, and S2 has $80 and Asset A. In Year 4, S2 sells Asset A, the basis and value of which have not changed since its contribution to S2. On the sale of Asset A for $20, S2 recognizes a $30 loss. That $30 loss is used on the P group return to offset income of P. In Year 5, P sells its S2 common stock for $80.

(ii) *Application of basis redetermination and loss suspension rules.* Pursuant to paragraph (b)(4) of this section, because immediately before P's transfer of S1 stock S1 owns stock of S2 (another subsidiary of the same group) that has a basis that exceeds its value, paragraph (b) of this section applies as if S1 had transferred its stock of S2. Because S2 is a member of the group immediately after the transfer of the S1 stock, the group member's basis in the S2 stock is redetermined pursuant to paragraph (b)(1) of this section immediately prior to the sale of the S1 stock. Of the group members' total basis of $130 in the S2 stock, $26 is allocated to S1's 20 shares of S2 common stock and $104 is allocated to P's 80 shares of S2 common stock. Pursuant to paragraph (b)(5) of this section, the redetermination of S1's basis in the stock of S2 results in an adjustment to P's basis in the stock of S1. In particular, P's basis in the stock of S1 is decreased by $24 to $26. On P's sale of its 100 shares of S1 common stock for $20, P recognizes a loss of $6. Because S1 is not a member of the P group immediately after P's sale of the S1 stock, paragraph (c)(1) of this section does not apply to suspend such loss. However, because P recognizes a loss with respect to the disposition of the S1 stock and S1 owns stock of S2 (which is a member of the P group immediately after the disposition), paragraph (c)(2) of this section does apply to suspend up to $6 of that loss, an amount equal to the amount by which the duplicated loss with respect to the stock of S1 sold is attributable to S2's adjusted basis in its assets, loss carryforwards, and deferred deductions.

(iii) *Effect of subsequent asset sale on stock basis.* Of the $30 loss recognized on the sale of Asset A, $24 is taken into account in determining the basis adjustments made under §1.1502–32 to the stock of S2 owned by P. Accordingly, P's basis in its S2 stock is reduced by $24 from $104 to $80.

(iv) *Effect of subsequent asset sale on suspended loss.* Because P cannot establish that all or a portion of the loss recognized on the sale of Asset A was not reflected in the calculation of the duplicated loss of S2 on the date of the Year 3 stock sale and such loss is allocable to the period beginning on the date of the Year 3 deemed disposition of the S2 stock and ending on the day before the first date on which S2 is not a member of the P group and is taken into account in determining consolidated taxable income (or loss) of the P group for a taxable year that includes a date on or after the date of the Year 3 deemed disposition and before the first date on which S2 is not a member of the P group, such asset loss reduces the suspended loss pursuant to paragraph (c)(4) of this section. The amount of such reduction, however, cannot exceed $6, the excess of the amount of such loss, $30, over the amount of such loss that is taken into account in determining the basis adjustment made to the stock of S2 owned by P, $24. Therefore, the suspended loss is reduced to zero.

(v) *Effect of subsequent stock sale.* P recognizes $0 gain/loss on the Year 5 sale of its remaining S2 common stock. No amount of suspended loss remains to be allowed under paragraph (c)(5) of this section.

Example 6. Loss recognized on asset with basis determined by reference to stock basis of subsidiary. (i) *Facts.* In Year 1. P forms S with a contribution of $80 in exchange for 80 shares of common stock of S which at that time represents all of the outstanding stock of S. S becomes a member of the P group. In Year 2, P contributes Asset A with a basis of $50 and a value of $20 in exchange for 20 shares of common stock of S in a transfer to which section 351 applies. In Year 4, in a transaction that is not part of a plan that includes the Year 1 and Year 2 contributions, P contributes the 20 shares of S common stock it acquired in Year 2 to PS, a partnership, in exchange for a 20 percent capital and profits interest in a transaction described in section 721. Immediately after the contribution to PS, S is a member of the P group. In Year 5, P sells its interest in PS for $20.

(ii) *Application of basis redetermination rule upon nonrecognition transfer.* Because P's basis in the S common stock contributed to PS exceeds its value immediately prior to the transfer and S is a member of the P group immediately after the transfer, P's basis in all of the S stock is redetermined pursuant to paragraph (b)(1) of this section. Of P's total basis of $130 in the common stock of S, a proportionate amount is allocated to each share of S common stock. Accordingly, $26 is allocated to the S common stock that is contributed to PS and, under section 722, P's basis in its interest in PS is $26.

(iii) *Application of loss suspension rule on disposition of asset with basis determined by reference to stock basis of subsidiary.* P recognizes a $6 loss on its disposition of its interest in PS. Because P's basis in its interest in PS was determined by reference to the basis of S stock and at the time of the determination of P's basis in its interest in PS such S stock had a duplicated loss of $6, and, immediately after the disposition, S is a member of the P group, such loss is suspended to the extent of such duplicated loss. Principles similar to those of paragraphs (c)(3), (c)(4), and (c)(5) of this section shall apply to such suspended loss.

(f) *Worthlessness not followed by separate return years.* Notwithstanding any other provision in the regulations under section 1502, if a member of a group (the claiming group) treats stock of a subsidiary as worthless under section 165 (taking into account the provisions of §1.1502–80(c)) and, on the day following the last day of the claiming group's taxable year in which the worthless stock deduction is claimed, the subsidiary (or its successor, determined without regard to paragraphs (d)(5)(iii) and (iv) of this section) is a member of a group that includes any corporation that, during that taxable year, was a member of the claiming group (other than a lower-tier subsidiary of the subsidiary) or is a successor (determined without regard to paragraphs (d)(5)(iii) and (iv) of this section) of such a member, then all losses treated as attributable to the subsidiary under the principles of §1.1502–21(b)(2)(iv) shall be treated as expired as of the beginning of the day following the last day of the claiming group's taxable year in which the worthless stock deduction is claimed. In addition, notwithstanding any other provision in the regulations under section 1502, if a member recognizes a loss with respect to subsidiary 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 under the principles of §1.1502–21(b)(2)(iv) shall be treated as expired as of the beginning of the day following the last day of the group's taxable year in which the stock loss is claimed. For purposes of this paragraph (f), the determination of the losses attributable to the subsidiary shall be made after computing the taxable income of the group for the taxable year in which the group treats the stock of the subsidiary as worthless or the subsidiary liquidates and after computing the taxable income for any taxable year to which such losses may be carried back. The loss treated as expired under this paragraph (f) shall not be treated as a noncapital, nondeductible expense under §1.1502–32(b)(2)(iii). This paragraph (f) applies to worthlessness determinations and liquidations that occur on or after March 10, 2006. For rules applicable to worthless determinations and liquidations before March 10, 2006, see §1.1502–35T(f)(1) and (2) as contained in 26 CFR part 1 in effect on January 1, 2006.

(g) *Anti-avoidance rules*—(1) *Transfer of share without a loss in avoidance.* If a share of subsidiary stock has a basis that does not exceed its value and the share is transferred with a view to avoiding application of the rules of paragraph (b) of this section prior to the transfer of a share of subsidiary stock that has a basis that does exceed its value or a deconsolidation of a subsidiary, the rules of paragraph (b) of this section shall apply immediately prior to the transfer of stock that has a basis that does not exceed its value.

(2) *Transfers of loss property in avoidance.* If a member of a consolidated group contributes an asset with a basis that exceeds its value to a partnership in a transaction described in section 721 or a corporation that is not a member of such group in a transfer described in section 351, such partnership or corporation contributes such asset to a subsidiary in a transfer described in section 351, and such contributions are undertaken with a view to avoiding the rules of paragraph (b) or (c) of this section, adjustments must be made to carry out the purposes of this section.

(3) *Anti-loss reimportation rule*—(i) *Conditions for application.* This paragraph (g)(3) applies when—

(A) A member of a group (selling group) recognized and was allowed a loss with respect to a share of stock of

S, a subsidiary or former subsidiary of the selling group;

(B) That stock loss was duplicated (in whole or in part) in S's attributes (duplicating items) at the earlier of the time that the loss was recognized or that S ceased to be a member; and

(C) Within ten years of the date that S ceased to be a member, there is a reimportation event. For this purpose, a reimportation event is any event after which a duplicating item is a reimported item. A reimported item is any duplicating item that is reflected in the attributes of any member of the selling group, including S, or, if not reflected in the attributes, would be properly taken into account by any member of the selling group (for example as the result of a carryback).

(ii) *Effect of application.* Immediately before the time that a reimported item (or any portion of a reimported item) would be properly taken into account (but for the application of this paragraph (g)(3)), such item (or such portion of the item) is reduced to zero and no deduction or loss is allowed, directly or indirectly, with respect to that item.

(iii) *Operating rules.* For purposes of this paragraph (g)(3)—

(A) The terms *member, subsidiary,* and *group* include their predecessors and successors to the extent necessary to effectuate the purposes of this section; and

(B) The reduction of a reimported item (other than duplicating items that are carried back to a consolidated return year of the selling group) is a noncapital, nondeductible expense within the meaning of §1.1502–32(b)(3)(iii).

(4) *Avoidance of recognition of gain.* (i) 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 the application of paragraph (b)(1) of this section to redetermine the basis of stock of a subsidiary, and the stock loss that gives rise to the application of paragraph (b)(1) of this section is not significant, paragraphs (b) and (c) of this section shall not apply.

(ii) 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 the application of paragraph (b)(2) of this section to redetermine the basis of stock of a subsidiary, and the duplicated loss of the subsidiary that is reflected in stock of the subsidiary owned by members of the group immediately before the deconsolidation is not significant, paragraphs (b) and (c) of this section shall not apply.

(5) *Examples.* For purposes of the examples in this section, all transactions described in section 362(a) are completed before October 22, 2004, and therefore are not subject to section 362(e)(2). The principles of this paragraph (g) are illustrated by the following examples:

Example 1. Transfers of property in the avoidance of basis redetermination rule. (i) *Facts.* In Year 1, P forms S with a contribution of $100 in exchange for 100 shares of common stock of S which at that time represents all of the outstanding stock of S. S becomes a member of the P group. In Year 2, P contributes 20 shares of common stock of S to PS, a partnership, in exchange for a 20 percent capital and profits interest in a transaction described in section 721. In Year 3, P contributes Asset A with a basis of $50 and a value of $20 to PS in exchange for an additional capital and profits interest in PS in a transaction described in section 721. Also in Year 3, PS contributes Asset A to S and P contributes an additional $80 to S in transfers to which section 351 applies. In Year 4, S sells Asset A for $20, recognizing a loss of $30. The P group uses that loss to offset income of P. In Year 5, P sells its entire interest in PS for $40.

(ii) *Analysis.* Pursuant to paragraph (g)(2) of this section, if P's contributions of S stock and Asset A to PS were undertaken with a view to avoiding the application of the basis redetermination or the loss suspension rule, adjustments must be made such that the group does not obtain more than one tax benefit from the $30 loss inherent in Asset A.

Example 2. Transfers effecting a reimportation of loss. (i) *Facts.* In Year 1, P forms S with a contribution of Asset A with a value of $100 and a basis of $120, Asset B with a value of $50 and a basis of $70, and Asset C with a value of $90 and a basis of $100 in exchange for all of the common stock of S and S becomes a member of the P group. In Year 2, in a transaction that is not part of a plan that includes the contribution, P sells the stock of S for $240, recognizing a loss of $50. At such time, the bases and values of Assets A, B, and C have not changed since their contribution to S. In Year 3, S sells Asset A, recognizing a $20 loss. In Year 3, S merges into

M in a reorganization described in section 368(a)(1)(A). In Year 8, P purchases all of the stock of M for $300. At that time, M has a $10 net operating loss. In addition, M owns Asset D, which was acquired in an exchange described in section 1031 in connection with the surrender of Asset B. Asset C has a value of $80 and a basis of $100. Asset D has a value of $60 and a basis of $70. In Year 9, P has operating income of $100 and M recognizes $20 of loss on the sale of Asset C. In Year 10, P has operating income of $50 and M recognizes $50 of loss on the sale of Asset D.

(ii) *Analysis*. P's $50 loss on the sale of S stock is entirely attributable to duplicated loss. Therefore, pursuant to paragraph (g)(3) of this section, assuming the P group cannot establish otherwise, M's $10 net operating loss is treated as attributable to assets that were owned by S on the date of the disposition and that had bases in excess of value on such date. Without regard to any other limitations on the group's use of M's net operating loss, the P group cannot use M's $10 net operating loss pursuant to paragraph (g)(3)(iii)(D) of this section. Pursuant to paragraph (g)(3)(iv) of this section and §1.1502–32(b)(3)(iii)(D), such loss is treated as a noncapital, nondeductible expense of M incurred during the taxable year that it would otherwise be absorbed, namely in Year 9. In addition, the P group is denied the use of $10 of the loss recognized on the sale of Asset C. Finally, the P group is denied the use of $10 of the loss recognized on the sale of Asset D. Pursuant to paragraph (g)(3)(iv) of this section and §1.1502–32(b)(3)(iii)(D), each such disallowed loss is treated as a noncapital, nondeductible expense of M incurred during the taxable year that includes the date of the disposition of the asset with respect to which such loss was recognized.

Example 3. Transfers to avoid recognition of gain. (i) *Facts*. P 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 S3 common stock with a basis of $150. 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. 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. Immediately after the sale of the S2 stock, S3 is a member of the P group.

(ii) *Analysis*. Pursuant to paragraph (b)(4) of this section, because S2 owns stock of S3 (another subsidiary of the same group) and, immediately after the sale of the S2 stock, S3 is a member of the group, then for purposes of applying paragraph (b) of this section, S2 is deemed to have transferred its S3 stock. Because S3 is a member of the group immediately after the transfer of the S2 stock and the S3 stock deemed transferred has a basis in excess of value, the group in the S3 stock is redetermined pursuant to paragraph (b)(1) of this section immediately prior to the sale of the S2 stock. Accordingly, P would recognize only $1 of gain on the sale of its S2 stock. However, because the recapitalization of the S3 was structured with a view to, and has the effect of, avoiding the recognition of gain on a disposition of stock by invoking the application of paragraph (b) of this section, paragraph (g)(4)(i) of this section applies. Accordingly, paragraph (b) of this section does not apply upon P's disposition of the S2 stock and P recognizes $100 gain on the disposition of the S2 stock.

(6) *General anti-avoidance rule*. If a taxpayer acts with a view to avoid the purposes of this section, appropriate adjustments will be made to carry out the purposes of this section.

(h) *Application of other rules of law*. See §1.1502–80(a) regarding the general applicability of other rules of law.

(i) [Reserved]

(j) *Effective/applicability dates*. This section applies after September 16, 2008. For prior law, see §§1.1502–35 and 1.1502–35T as contained in 26 CFR part 1 in effect on April 1, 2008.

[T.D. 9254, 71 FR 13010, Mar. 14, 2006, as amended by T.D. 9264, 71 FR 30603, 30607, May 30, 2006; T.D. 9254, 71 FR 48473, Aug. 21, 2006; T.D. 9322, 72 FR 17805, Apr. 10, 2007; T.D. 9342, 72 FR 39736, July 20, 2007; T.D. 9424, 73 FR 53951, Sept. 17, 2008; 75 FR 10172, Mar. 5, 2010]

§ 1.1502–36 Unified loss rule.

(a) *In general*—(1) *Scope*. This section provides rules for adjusting members' bases in stock of a subsidiary (S) and for reducing S's attributes when a member (M) transfers a loss share of S stock. See paragraph (f) of this section for definitions of the terms used in this section, including *transfer* and *value*.

(2) *Purpose*. The rules in this section have two principal purposes. The first is to prevent the consolidated return provisions from reducing a group's consolidated taxable income through the creation and recognition of noneconomic loss on S stock. The second is to prevent members (including former members) of the group from collectively obtaining more than one tax benefit from a single economic loss. Additional purposes are set forth in

other paragraphs of this section. The rules of this section must be interpreted and applied in a manner that is consistent with and reasonably carries out the purposes of this section.

(3) *Overview*—(i) *General application of section*. This section applies when M transfers a share of S stock and, after taking into account the effects of all applicable rules of law (even if the adjustments required by such provisions are not deemed effective until after the transfer, such as certain adjustments required under sections 108 and 1017 and §1.1502–28), the share is a loss share. When this section applies, paragraph (b) of this section applies first and may redetermine members' bases in their shares of S stock. If the transferred share is a loss share after any basis redetermination under paragraph (b) of this section, paragraph (c) of this section applies and may reduce M's basis in the transferred loss share. If the transferred share is a loss share after any basis reduction required by paragraph (c) of this section, paragraph (d) of this section applies and may reduce attributes of S and subsidiaries that are lower-tier to S. Although the determination of whether there is a transfer of a loss share is made as of the transfer, this section applies, and any adjustments it requires are given effect, immediately before the transfer. Paragraphs (e), (f), and (g) of this section provide general operating rules (including rules for transfers of S stock between members), definitions, and an anti-abuse rule, respectively.

(ii) *Stock of multiple subsidiaries transferred in the transaction*—(A) *Initial application of section to transferred shares in lowest tier*. If shares of stock of more than one subsidiary are transferred in a transaction, the application of this section begins at the lowest tier. If no transferred shares of stock of the lowest-tier subsidiary (S2) are loss shares, any gain recognized with respect to the S2 shares immediately tiers up and adjusts members' bases in subsidiary stock under §1.1502–32. However, if any of the transferred S2 shares are loss shares, paragraph (b) of this section applies with respect to those shares. If, after the application of paragraph (b) of this section, any transferred S2 shares are still loss shares, paragraph (c) of this section applies with respect to those shares. If, after the application of paragraph (c) of this section, any transferred S2 shares are still loss shares and P makes an election under paragraph (d)(6) of this section with respect to those S2 shares, then paragraph (d) of this section applies with respect to those shares, but only to the extent necessary to give effect to the election. After taking into account the effects of any adjustments required by this initial application of this section, recognized gain or loss is computed on all transferred S2 shares. Any adjustments under paragraph (b) or (c) of this section, the effect of any election under paragraph (d)(6) of this section, any gain or loss recognized on the transferred S2 shares (whether allowed or disallowed), and any other related or resulting adjustments then tier-up and apply to adjust members' bases in subsidiary stock under §1.1502–32.

(B) *Initial application of section to transferred shares in higher tiers*. After taking into account the effects of any adjustments described in paragraph (a)(3)(ii)(A) of this section, transferred shares in the next higher tier, and then in each next higher tier successively, other than the transferred loss shares at the highest tier, are treated in the manner described in paragraph (a)(3)(ii)(A) of this section.

(C) *Application of section to transferred shares in highest tier*. After paragraphs (b) and (c) of this section, and, to the extent necessary to give effect to any election under paragraph (d)(6) of this section, paragraph (d) of this section, have been applied to or with respect to all lower-tier transferred loss shares, and after all lower-tier adjustments have been taken into account (whether resulting from the application of paragraph (b) or (c) of this section, an election under paragraph (d)(6) of this section, the recognition of gain or loss on a transfer, or otherwise), paragraphs (b), then (c), and then (d) of this section apply with respect to the highest-tier shares that are transferred loss shares.

(D) *Final application of section to transferred shares in lower tiers*. After paragraph (d) of this section has been applied with respect to transferred loss shares in the highest tier, it is applied with respect to transferred shares in each next lower tier, successively, to the extent such shares are loss shares after the application of paragraph (d) of this section.

(4) *Other rules of law and coordination with deferral and disallowance provisions.* In general, this section applies and has effect immediately upon the transfer of a loss share even if the loss is deferred, disallowed, or otherwise not taken into account under any other applicable rules of law. However, see paragraph (e)(3) of this section for special rules applicable to shares of S stock transferred in an intercompany transaction. See section §1.1502–80(a) for the general applicability of other rules of law and a limitation on duplicative adjustments.

(5) *Nomenclature, factual assumptions adopted in this section.* Unless otherwise stated, for purposes of this section, the following nomenclature and assumptions are adopted. P is the common parent of a consolidated group of which S, M, and M1 are members. X is not a member of the P group. If a corporation has preferred stock outstanding, it is stock described in section 1504(a)(4). The examples set forth the only facts, elections, and activities relevant to the example. All transactions are between unrelated persons and are independent of each other. Tax liabilities and their effect, and the application of any other loss disallowance or deferral provisions of the Internal Revenue Code (Code) or regulations, including but not limited to section 267, are disregarded. All persons report on a calendar year basis and use the accrual method of accounting. All parties comply with filing and other requirements of this section and all other provisions of the Code and regulations.

(b) *Basis redetermination to reduce disparity*—(1) *In general*—(i) *Purpose and scope.* The rules of this paragraph (b) reduce the extent to which there is disparity in members' bases in shares of S stock. These rules supplement the operation of the investment adjustment system; their purpose is to prevent the realization of noneconomic loss and facilitate the elimination of duplicated loss when members hold S shares with disparate bases. The rules of this paragraph (b) only reallocate investment adjustments previously applied to members' bases in shares of S stock, thus they do not alter the aggregate amount of basis in shares of S stock held by members or the aggregate amount of investment adjustments applied to shares of S stock.

(ii) *Special rules for applicability of redetermination rule.* Notwithstanding the general rule in paragraph (b)(2) of this section, members' bases in shares of S stock are not redetermined under this paragraph (b) if—

(A) There is no disparity among members' bases in shares of S common stock and no member owns a share of S preferred stock with respect to which there is unrecognized gain or loss; or

(B) All the shares of S stock held by members are transferred to one or more nonmembers, become worthless under section 165 (taking into account the provisions of §1.1502–80(c)), or a combination thereof, in one fully taxable transaction. However, in such a case, P may elect to redetermine such bases under this paragraph (b). Such an election is made in the manner provided in paragraph (e)(5) of this section. If stock of more than one subsidiary is transferred in the transaction, the election may be made with respect to one or more of such subsidiaries.

(iii) *Investment adjustment.* For purposes of this paragraph (b), the term *investment adjustment* includes adjustments specially allocated under §1.1502–32(c)(1)(ii)(B) and remaining adjustments described in §1.1502–32(c)(1)(iii). In applying any provision of this section, the term includes all such adjustments reflected in the basis of the share as of the application of the provision, whether originally allocated under §1.1502–32 or otherwise. The term therefore includes adjustments previously reallocated to the share, and it does not include adjustments previously reallocated from the share, whether pursuant to this section or any other provision of law. It also includes the proportionate amount of adjustments reflected in the exchanged basis of a share, such as the basis determined under section 358 in connection with a reorganization or a transaction qualifying under section 355.

(2) *Basis redetermination rule.* If M transfers a loss share of S stock, all

members' bases in all their shares of S stock are subject to redetermination under this paragraph (b). The determination of whether a share is a loss share is made as of the transfer, taking into account the effects of all applicable rules of law. The redeterminations are made immediately before applying paragraph (c) of this section and in accordance with the following:

(i) *Decreasing the bases of transferred loss shares*—(A) *Removing positive investment adjustments from transferred loss shares of common stock.* M's basis in each of its transferred loss shares of S common stock is first reduced, but not below value, by removing positive investment adjustments previously applied to the basis of the share. The positive investment adjustments removed from transferred loss shares of S common stock are reallocated under paragraph (b)(2)(ii) of this section after negative investment adjustments are reallocated under paragraph (b)(2)(i)(B) of this section.

(B) *Reallocating negative investment adjustments from shares of S common stock.* If a transferred share is still a loss share after applying paragraph (b)(2)(i)(A) of this section, M's basis in the share is reduced, but not below value, by reallocating negative investment adjustments to the transferred loss share (whether common or preferred stock) from members' shares of S common stock that are not transferred loss shares. The adjustments reallocated under this paragraph (b)(2)(i)(B) are reallocated and applied first to M's bases in transferred loss shares of S preferred stock and then to M's bases in transferred loss shares of S common stock. Reallocations under this paragraph (b)(2)(i)(B) are made in a manner that, to the greatest extent possible, reduces the disparity among members' bases in all transferred loss shares of S preferred stock, and reduces the disparity among members' bases in all shares of S common stock.

(ii) *Increasing the bases of gain preferred and all common shares*—(A) *Preferred stock.* After the application of paragraph (b)(2)(i) of this section, the positive investment adjustments removed from transferred loss shares of S common stock under paragraph (b)(2)(i)(A) of this section are reallocated and applied to increase, but not above value, members' bases in shares of S preferred stock (without regard to whether such shares are transferred in the transaction). Reallocations under this paragraph (b)(2)(ii)(A) are made in a manner that, to the greatest extent possible, reduces the disparity among members' bases in all shares of S preferred stock.

(B) *Common stock.* Any positive investment adjustments removed from transferred loss shares of S common stock under paragraph (b)(2)(i)(A) of this section and not reallocated and applied to S preferred shares are reallocated and applied to increase members' bases in shares of S common stock. Reallocations are made to shares of S common stock without regard to whether a particular share is a loss share or a transferred share, and without regard to the share's value. Reallocations under this paragraph (b)(2)(ii)(B) are made in a manner that, to the greatest extent possible, reduces the disparity among members' bases in all shares of S common stock.

(iii) *Operating rules*—(A) *Method.* In general, reallocations should be made first with respect to the earliest available adjustments. However, the overall application of this paragraph (b) to a transaction must be made in a manner that, to the greatest extent possible, reduces basis disparity (as provided in paragraphs (b)(2)(i)(B) and (b)(2)(ii) of this section). The specific reallocation of an investment adjustment under this paragraph (b) may be made using any reasonable method or formula that is consistent with the provisions of this paragraph (b)(2) and furthers the purposes of this section.

(B) *Limits on reallocation*—(*1*) *Restriction to members' outstanding shares.* Investment adjustments can only be reallocated to shares that were held by members at the time the adjustment was originally applied.

(*2*) *Limitation by prior use*—(*i*) *In general.* In order to prevent the reallocation of investment adjustments from either increasing or decreasing members' aggregate bases in subsidiary stock, no investment adjustment (positive or negative) may be reallocated under this paragraph (b)(2) to the extent that it was (or would have been) used prior to the time that it would otherwise be reallocated under this paragraph (b)(2). For this purpose, an investment adjustment was used (or would have been used) to the extent that it was reflected in (or would have been reflected in) the basis of a share of subsidiary stock and the basis of that share has already been taken into account, directly or indirectly, in determining income, gain, deduction, or loss (including by affecting the application of this section to a prior transfer of subsidiary stock) or in determining the basis of any property that is not subject to §1.1502–32. However, if the prior use was in an intercompany transaction, an investment adjustment may be reallocated to the extent that §1.1502–13 has prevented the gain or loss on the transaction from being taken into account. (In that case, appropriate adjustments must be made to the intercompany item from the prior intercompany transaction that has not yet been taken into account.) Further, if an investment adjustment was reflected in (or would have been reflected in) the basis of a share that has been taken into account, the limitation on reallocation under this paragraph (b)(2)(iii)(B)(*2*) does not apply to the extent the basis of that share would not change as a result of the reallocation (for example, because the reallocation is between shares that are both lower-tier to the share with the previously used basis). See §1.1502–32(c)(1)(ii)(B) regarding special allocations applicable to the tier-up of the reallocated investment adjustment if the reallocation is limited under this paragraph (b)(2)(iii)(B)(*2*) due to prior use at a higher tier.

(*ii*) *Example.* The application of this paragraph (b)(2)(iii)(B)(*2*) is illustrated by the following example:

Example. (i) *Facts.* P owns all 20 shares of M stock, and 10 shares of S stock. M owns the remaining 10 shares of S stock. In year 1, S recognizes $200 of income that results in a $10 positive investment adjustment being allocated to each share of S stock. The group does not recognize any other items. The $100 positive adjustment to M's basis in the S stock tiers up, and results in a $5 positive adjustment to each share of M stock. In year 2, P sells one share of M stock and recognizes a gain. In year 3, M sells one loss share of S stock, and this paragraph (b) applies and requires a reallocation of the year 1 positive investment adjustment applied to the basis of the transferred S share.

(ii) *Application of limitation by prior use.* M's basis in the transferred loss share of S stock reflects a $10 positive investment adjustment attributable to S's year 1 income. Under the general rule of this paragraph (b), that $10 would be subject to reallocation to reduce basis disparity. However, that $10 adjustment had originally tiered up to adjust P's basis in its M shares and, as a result, $.50 of that adjustment was reflected in P's basis in each share of M stock. When P sold the share of M stock, the basis of that share (which included the tiered-up $.50) was used in determining the gain on the sale. Thus, $.50 of the $10 investment adjustment originally allocated to the transferred S share that tiered-up to the sold M share was previously used and, as such, cannot be reallocated in a manner that would (if it were the original allocation) affect the basis of the sold M share. Accordingly, no more than $9.50 of the adjustment to M's transferred S share could be reallocated to P's shares of S stock. If so, under the special allocation rule in §1.1502–32(c)(1)(ii)(B), the tier-up of this $9.50 would only be allocated among P's remaining 19 shares of M stock. Alternatively, all $10 of the investment adjustment could be reallocated to M's other S shares (because the tier-up to P's M shares would have been the same regardless which of M's shares of S stock were adjusted).

(iii) *Application of limitation where adjustment would have been used.* The facts are the same as in paragraph (i) of this *Example* except that M does not sell any shares of S stock and, in year 3, P sells a loss share of S stock. As in paragraph (i) of this *Example*, when P sold the share of M stock, the basis of that share was used in determining the gain on the share. When P sells the loss share of S stock, the $10 positive investment adjustment from S's year 1 income cannot be reallocated in a manner that would (if it were the original adjustment) affect the basis of the sold M share. If this $10 positive investment adjustment had originally been allocated to the S shares held by M, $.50 of the $10 investment adjustment would have tiered up to the M share that P sold, would have been reflected in P's basis in that M share, and would have been used in determining P's gain or loss on the sale. Accordingly, up to $9.50 of the $10 investment adjustment applied to the basis of P's transferred S share could be reallocated to M's shares of S stock. If so, under the special allocation rule in §1.1502–32(c)(1)(ii)(B), the tier-up of this $9.50 would only be allocated among P's remaining 19 shares of M stock. Alternatively, all $10 of the investment adjustment could be reallocated to P's other S shares.

(3) *Examples.* The general application of this paragraph (b) is illustrated by the following examples:

Example 1. Transfer of stock received in section 351 exchange. (i) *Redetermination to prevent noneconomic loss.* (A) *Facts.* For many years, M has owned two assets, Asset 1 and Asset 2. On January 1, year 1, M receives the only four outstanding shares of S common stock (Block 1 shares) in exchange for Asset 1, which has a basis and value of $80. Section 351 applies to the exchange and, therefore, under section 358, M's aggregate basis in the Block 1 shares is $80 ($20 per share). On July 1, year 2, M receives another share of S common stock (Block 2 share) in exchange for Asset 2, which has a basis of $0 and value of $20. Section 351 applies to this exchange and, under section 358, M's basis in the Block 2 share is $0. On October 1, year 3, S sells Asset 2 for $20, recognizing a $20 gain. On December 31, year 3, M sells one of its Block 1 shares to X for $20. After taking into account the effects of all applicable rules of law, M's basis in each Block 1 share is $24 (M's original $20 basis increased under §1.1502–32 by $4, the share's allocable portion of the $20 gain recognized on the sale of Asset 2). In addition, M's basis in its Block 2 share is $4 (M's original $0 basis increased under §1.1502–32 by $4 (the share's allocable portion of the $20 gain recognized on the sale of Asset 2)). M's sale of the Block 1 share is a transfer of a loss share and therefore subject to this section.

(B) *Basis redetermination under this paragraph (b).* Under this paragraph (b), M's bases in all its shares of S stock are subject to redetermination. First, paragraph (b)(2)(i)(A) of this section applies to reduce M's basis in the transferred loss share, but not below value, by removing positive investment adjustments applied to the basis of the share. Accordingly, M's basis in the transferred Block 1 share is reduced by $4 (the amount of the positive investment adjustment applied to the share), from $24 to $20. Even if there were negative investment adjustments applied to adjust the bases of nontransferred common shares, no further reduction to the basis of the share would be required under this paragraph (b) because the basis of the transferred share is then equal to the share's value. Under paragraph (b)(2)(ii)(B) of this section, the positive investment adjustment removed from the transferred loss share is reallocated and applied to increase M's bases in its S common shares in a manner that reduces disparity in M's bases in all the S common shares, to the greatest extent possible. Accordingly, the $4 positive investment adjustment removed from the Block 1 share is reallocated and applied to the basis of the Block 2 share, increasing it from $4 to $8.

(C) *Application of paragraphs (c) and (d) of this section.* Because M's sale of the Block 1 share is not a transfer of a loss share after the application of this paragraph (b), neither paragraph (c) of this section nor paragraph (d) of this section applies to the transfer.

(ii) *Redetermination to eliminate duplicated loss.* (A) *Facts.* The facts are the same as in paragraph (i)(A) of this *Example 1*, except that, at the time of the second contribution, the value of Asset 1 had declined to $20 and so, instead of contributing Asset 2, M contributed Asset 3 to S in exchange for the Block 2 share. At the time of that exchange, Asset 3 had a basis and value of $5. On October 1, year 3, S sells Asset 1 for $20, recognizing a $60 loss that is absorbed by the group. On December 31, year 3, M sells one of its Block 1 shares to X for $5. After taking into account the effects of all applicable rules of law, M's basis in each Block 1 share is $8 (M's original $20 basis decreased under §1.1502–32 by $12 (the share's allocable portion of the $60 loss recognized on the sale of Asset 1)). M's basis in its Block 2 share is an excess loss account of $7 (M's original basis of $5 reduced under §1.1502–32 by $12, the share's allocable portion of the loss recognized on the sale of Asset 1). M's sale of the Block 1 share is a transfer of a loss share and therefore subject to this section.

(B) *Basis redetermination under this paragraph (b).* Under this paragraph (b), M's bases in all its shares of S stock are subject to redetermination. There are no positive investment adjustments and so there is no adjustment under paragraph (b)(2)(i)(A) of this section. However, under paragraph (b)(2)(i)(B) of this section, M's basis in the transferred Block 1 share is reduced, but not below value, by reallocating negative investment adjustments from common shares that are not transferred loss shares. In total, there were $48 of negative investment adjustments applied to common shares that are not transferred loss shares. Accordingly, M's basis in the Block 1 share is reduced by $3, from $8 to its value of $5. Under paragraph (b)(2)(i)(B) of this section, the negative investment adjustments applied to the transferred share are reallocated from (and therefore cause an increase in the basis of) S common shares that are not transferred loss shares in a manner that reduces disparity among members' bases in all S common shares to the greatest extent possible. Accordingly, the $3 negative investment adjustment reallocated and applied to the transferred Block 1 share is reallocated entirely from the Block 2 share, increasing the basis in the Block 2 share from an excess loss account of $7 to an excess loss account of $4.

(C) *Application of paragraphs (c) and (d) of this section.* Because M's sale of the Block 1 share is not a transfer of a loss share after the application of this paragraph (b), neither paragraph (c) of this section nor paragraph (d) of this section applies to the transfer.

(iii) *Nonapplicability of redetermination rule to sale of entire interest.* The facts are the same as in paragraph (ii)(A) of this *Example 1*, except that, on December 31, year 3, M sells all its shares of S stock to X for $25. M's sale of the S stock to X is a transfer of all of the shares of S stock held by members to one or more nonmembers in one fully taxable transaction and, therefore, basis is not redetermined under this paragraph (b). Accordingly, the sale of the Block 1 shares remains a transfer of loss shares and, as such, subject to paragraphs (c) and (d) of this section. However, paragraphs (c)(7) and (d)(3)(i)(A) of this section apply netting principles to prevent adjustments under either paragraph (c) or paragraph (d) of this section, respectively. Alternatively, the group could elect to apply this paragraph (b). In that case, the $12 negative adjustment applied to the Block 2 shares would be reallocated to the Block 1 shares with the result that there would be no loss (or gain) on any of the transferred shares following the application of this paragraph (b). In that case, there would be no further application of this section to the transfer.

(iv) *Transfer of entire interest, partially taxable*. The facts are the same as in paragraph (iii) of this *Example 1*, except that, instead of selling the Block 2 share to X, M contributes the share to a nonmember in a section 351 exchange that is part of the same transaction. Although all the S shares held by members are transferred in the transaction, not all the shares are transferred to one or more nonmembers in one fully taxable transaction. Therefore, paragraph (b)(1)(ii)(B) of this section does not apply and M must redetermine its bases in its shares of S stock under this paragraph (b). In total, there were $12 of negative investment adjustments applied to common shares that are not transferred loss shares (the Block 2 share, a gain share). Accordingly, M's basis in each of the Block 1 shares is reduced by $3, from $8 to its value of $5. Under paragraph (b)(2)(i)(B) of this section, the negative investment adjustments applied to the transferred shares are reallocated from (and therefore cause an increase in the basis of) S shares that are not transferred loss shares in a manner that reduces disparity among members' bases in all S common shares to the greatest extent possible. Accordingly, the $12 negative investment adjustment reallocated and applied to the transferred Block 1 shares is reallocated entirely from the Block 2 share, increasing the basis in the Block 2 share from an excess loss account of $7 to a basis of $5. Because M's transfer is not a transfer of loss shares after the application of this paragraph (b), neither paragraph (c) of this section nor paragraph (d) of this section applies to the transfer.

Example 2. Redetermination increases basis of transferred loss share. (i) *Facts*. On January 1, year 1, M owns all 10 outstanding shares of S common stock. Five of the shares have a basis of $20 per share (Block 1 shares) and five of the shares have a basis of $10 per share (Block 2 shares). S's only asset, Asset 1, has a basis of $50. S has no other attributes. On October 1, year 1, S sells Asset 1 for $100, recognizing a $50 gain. On December 31, year 2, M sells one Block 1 share and one Block 2 share to X for $10 per share. After taking into account the effects of all applicable rules of law, M's basis in each Block 1 share is $25 (M's original $20 basis increased under §1.1502–32 by $5, the share's allocable portion of the $50 gain recognized on the sale of Asset 1), and M's basis in each Block 2 share is $15 (M's original $10 basis increased under §1.1502–32 by $5, the share's allocable portion of the $50 gain recognized on the sale of Asset 1). M's sale of the Block 1 and Block 2 shares is a transfer of loss shares and therefore subject to this section.

(ii) *Basis redetermination under this paragraph (b)*. Under this paragraph (b), M's bases in all its shares of S stock are subject to redetermination. First, paragraph (b)(2)(i)(A) of this section applies to reduce M's basis in the transferred Block 1 and Block 2 shares, but not below value, by removing the positive investment adjustments applied to the bases of the transferred loss shares. Accordingly, the basis of the transferred Block 1 share is reduced by $5, from $25 to $20. The basis of the transferred Block 2 share is also reduced by $5, from $15 to $10. (Although the transferred Block 1 share is still a loss share, there is no reduction to its basis under paragraph (b)(2)(i)(B) of this section because there were no negative investment adjustments applied to the bases of the S common shares that are not transferred loss shares.) Next, paragraph (b)(2)(ii)(B) of this section applies to reallocate and apply the $10 of positive investment adjustments removed from the transferred loss shares to increase M's bases in its S common shares in a manner that reduces the disparity in its bases in all S common shares to the greatest extent possible. Accordingly, of the $10 of positive investment adjustments to be reallocated, $6 is reallocated and applied to the basis of the transferred Block 2 share (increasing it from $10 to $16) and $4 is reallocated and applied equally to the basis of each of the four retained Block 2 shares (increasing the basis of each from $15 to $16). After giving effect to the reallocations under this paragraph (b), M's basis in each retained Block 1 share is $25, M's basis in the transferred Block 1 share is $20, and M's basis in each Block 2 share is $16.

(iii) *Application of paragraph (c) of this section*. After the application of this paragraph (b), M's sale of the Block 1 and Block 2 shares is still a transfer of loss shares and, accordingly, subject to paragraph (c) of this section. No adjustment is required to the basis of the transferred Block 1 share under paragraph (c) of this section because, after its basis is redetermined under this paragraph (b), the net positive adjustment to the basis of the share is $0. See paragraph (c)(3) of this section. However, under paragraph (c) of this section M's basis in the transferred Block 2 share is reduced by $6 (the lesser of its net positive adjustment, $6, and its disconformity amount, $6), from $16 to $10, its value. See paragraph (c)(2) of this section.

(iv) *Application of paragraph (d) of this section.* After the application of paragraph (c) of this section, M's sale of the Block 1 share is still a transfer of a loss share and, accordingly, subject to paragraph (d) of this section. No adjustment is required under paragraph (d) of this section because there is no aggregate inside loss. See paragraph (d)(3)(iii) of this section. Because M's sale of the Block 2 share is no longer a transfer of a loss share after the application of paragraph (c) of this section, paragraph (d) of this section does not apply to the transfer of the Block 2 share.

Example 3. Tiered subsidiaries. (i) *Transfer of all shares of common stock.* (A) *Facts.* P owns the sole outstanding share of S stock with a basis of $100, and the sole outstanding share of M stock with a basis of $300. M has $200 and owns an asset with a basis of $0. S owns one asset, Asset 1, with a basis of $100. At a time when Asset 1 has a value of $200, S issues a second share of common stock to M in exchange for $200. Later S sells Asset 1 for $200, recognizing a $100 gain. After taking into account the effects of all applicable rules of law, P's basis in its S stock is $150 (P's original $100 basis increased under §1.1502–32 by $50, the share's allocable portion of the $100 gain recognized on the sale of Asset 1), M's basis in its S stock is $250 (M's original $200 basis increased under §1.1502–32 by $50, the share's allocable portion of the $100 gain recognized on the sale of Asset 1), and P's basis in its M stock is $350 (P's original $300 basis increased under §1.1502–32 by $50, the tier-up of M's increase in its basis in its S stock). P then sells its M share and its S share to X for $300 and $200, respectively. M and S are not members of the same consolidated group immediately after the sale. Therefore, the M share and both of the S shares are transferred in the transaction. Regarding P's sale of its share of S stock and its share of M stock, see paragraph (f)(10)(i)(A) of this section (ceasing to own a share in a taxable transaction) and paragraph (f)(10)(i)(C) of this section (nonmember acquires share); regarding M's share of S stock, see paragraph (f)(10)(i)(B) of this section (ceasing to be members of the same group). The application of this section begins with respect to the stock of S, the subsidiary at the lowest tier in which there is a transfer of subsidiary stock. See paragraph (a)(3)(ii) of this section. Although both P and M transfer their S shares, only M's S share is a loss share. Thus, only M's transfer is a transfer of a loss share of S stock and only M's transfer is subject to this section.

(B) *Application of section to transferred S shares.* Although only M's transfer is subject to this section, all members' bases in their shares of S stock are subject to redetermination under this paragraph (b). First, paragraph (b)(2)(i)(A) of this section applies to reduce M's basis in its transferred S share, but not below value, by removing the positive investment adjustment applied to that share. Accordingly, the basis of M's S share is reduced by $50, from $250 to $200 (under §1.1502–32, that redetermination adjustment tiers up to reduce P's basis in its M stock by $50, from $350 to $300). Because there are no negative adjustments to reallocate under paragraph (b)(2)(i)(B) of this section, paragraph (b)(2)(ii)(B) of this section then applies to reallocate and apply the $50 positive investment adjustment removed from the transferred loss S share to increase P's basis in its S share in a manner that reduces disparity among members' bases in all S common shares to the greatest extent possible. Accordingly, all $50 of the positive investment adjustment is reallocated and applied to P's basis in its S share (increasing the basis from $150 to $200). Because M's transfer of its S share is not a transfer of a loss share after the application of this paragraph (b), neither paragraph (c) of this section nor paragraph (d) of this section applies to that transfer.

(C) *Application of section to transfers at next higher tier.* After the adjustments to M's share of S stock are given effect, P's transfer of its share of M stock is not a transfer of a loss share and so this section does not apply to that transfer.

(D) *Result of application of section.* After the application of this section, P recognizes no gain or loss on its sale of either the S share or the M share. In addition, the unrecognized (noneconomic) loss in M's basis in its S share is eliminated. The results would be the same if, in addition to the facts in paragraph (i)(A) of this *Example 3*, M transferred its S share to X in a fully taxable transaction and, as permitted under paragraph (b)(1)(ii)(B) of this section, P elected to redetermine basis under this paragraph (b).

(ii) *Transfer of less than all lower-tier shares of stock.* (A) *Facts.* The facts are the same as in paragraph (i)(A) of this *Example 1*, except that M and S are members of the same consolidated group immediately after the sale. Therefore, in this case, M's S share is not transferred and so this section has no application with respect to M's S share. P's transfer of its S share is not a transfer of a loss share and so is also not subject to this section. However, P's sale of its share of M stock is a transfer of a loss share and is subject to this section.

(B) *Basis redetermination under this paragraph (b).* Although P's transfer of its share of M stock is subject to this section, this paragraph (b) does not apply to the transfer because there is only one share of M stock outstanding (and so there can be no disparity among members' bases in common shares and there are no outstanding preferred shares with respect to which there can be unrecognized gain or loss). Accordingly, after the application of this paragraph (b), P's sale of its M share is still a transfer of a loss share and therefore subject to paragraph (c) of this section.

(C) *Application of paragraphs (c) and (d) of this section.* Under paragraph (c) of this section, P must reduce its basis in its M share by $50, the lesser of its net positive adjustment ($50, see paragraph (c)(3) of this section) and its disconformity amount ($150, see paragraphs (c)(4), (c)(5), and (c)(6) of this section). As a result, the share is no longer a loss share and the transfer is not subject to paragraph (d) of this section.

(D) *Result of application of section.* After the application of this section, P recognizes a $50 gain on its sale of the S share and no loss on its sale of the M share. Although there is unrecognized loss preserved in M's basis in its S share, if M later transfers the share when it is a loss share, that transfer will be subject to this section.

Example 4. Application to outstanding common and preferred shares. (i) *Facts.* P owns all the stock of M and all eight outstanding shares of S common stock. S also has two shares of nonvoting preferred stock outstanding; the preferred shares each have a $100 annual, cumulative preference as to dividends. M owns one of the preferred shares (PS1) and P owns the other (PS2). On January 1, year 1, the bases and values of the outstanding S shares are:

	Preferred		Common							
	PS1 (M)	PS2 (P)	CS1 (P)	CS2 (P)	CS3 (P)	CS4 (P)	CS5 (P)	CS6 (P)	CS7 (P)	CS8 (P)
Basis	1250	990	1025	710	550	400	375	250	215	100
Value	1000	1000	375	375	375	375	375	375	375	375

(A) As of January 1, year 1, there are no arrearages on the preferred stock. In year 1, S has a $1100 capital loss and $100 of ordinary income. The group absorbs the loss and the negative remaining adjustment of $1000 is allocable entirely to the common stock, equally to each common share ($125 per share). See §1.1502–32(c)(1)(iii) and (c)(2).

(B) In year 2, S has $700 of ordinary income and a $100 ordinary loss. Also, on October 1, year 2, S declares and makes a $200 dividend distribution with respect to the preferred stock ($100 per share). Under §1.1502–32(c)(1)(i), a negative adjustment of $100 is first allocated to each of the preferred shares to reflect the declaration of the dividend. The $600 positive remaining adjustment determined under §1.1502–32(c)(1)(iii) (reflecting S's net income reduced by the distribution) is then allocated to each of the preferred shares to the extent of its entitlement to dividends accruing in year 1 and year 2 ($200 per share). See §1.1502–32(c)(1)(iii) and (c)(3). The $200 of the positive remaining adjustment not allocated to the preferred shares is then allocated to the common stock, equally to each common share ($25 per share). See §1.1502–32(c)(1)(iii) and (c)(2). After taking into account the effects of all applicable rules of law, the adjusted bases and the values of the shares as of January 1, year 3, are:

	Preferred		Common							
	PS1 (M)	PS2 (P)	CS1 (P)	CS2 (P)	CS3 (P)	CS4 (P)	CS5 (P)	CS6 (P)	CS7 (P)	CS8 (P)
Basis	1250	990	1025	710	550	400	375	250	215	100
Year 1§1.1502–32 adjustments	N/A	N/A	−125	−125	−125	−125	−125	−125	−125	−125
Year 2§1.1502–32 adjustments	−100	−100	+25	+25	+25	+25	+25	+25	+25	+25
	+200	+200								
	+100	+100								
Adjusted basis	1350	1090	925	610	450	300	275	150	115	0
Value	1100	1100	275	275	275	275	275	275	275	275
Unrecognized gain/(loss)	(250)	10	(650)	(335)	(175)	(25)	0	125	160	275

(C) On January 1, year 3, M sells PS1 for $1100 and P sells CS2 for $275. The sales of PS1 and CS2 are transfers of loss shares and therefore subject to this section.

(ii) *Basis redetermination under this paragraph (b).* Under this paragraph (b), all members' bases in shares of S stock are subject to redetermination in accordance with the following:

(A) *Removing positive investment adjustments from transferred loss common shares*. First, paragraph (b)(2)(i)(A) of this section applies to reduce P's basis in CS2, but not below value, by removing the positive investment adjustment applied to the basis of the share. Accordingly, P's basis in CS2 is reduced by $25, from $610 to $585.

(B) *Reallocating negative investment adjustments from common shares that are not transferred loss shares*. Because the transferred shares remain loss shares after the removal of positive investment adjustments, their bases are further reduced under paragraph (b)(2)(i)(B) of this section, but not below value, by reallocating negative investment adjustments applied to common shares that are not transferred loss shares. Reallocations are made first to preferred shares and then to the common shares, in a manner that reduces disparity among members' bases in transferred loss preferred shares, and reduces disparity among members' bases in all common shares, to the greatest extent possible. The loss on PS1 is $250, the remaining loss on CS2 is $310, and the total amount of negative investment adjustments applied to shares that are not transferred loss shares is $875 (the sum of the negative adjustments applied to all common shares other than CS2). Thus, $250 of negative investment adjustments are reallocated and applied to the basis of PS1, reducing it to the share's value, $1100. The negative investment adjustments are reallocated from the common shares that are not transferred loss shares in a manner that reduces disparity among members' bases in all common shares to the greatest extent possible. The negative investment adjustments may be reallocated to PS1 from the common shares that are not transferred loss shares as follows: $125 from each of CS7 and CS8. Such reallocations increase the basis of CS7 by $125, from $115 to $240, and increase the basis of CS8 by $125, from $0 to $125. Negative investment adjustments are then reallocated to CS2 from the common shares that are not transferred loss shares in a manner that reduces disparity among members' bases in all common shares to the greatest extent possible. The negative investment adjustments may be reallocated to CS2 from the other common shares as follows: $80 from CS4, $105 from CS5, and $125 from CS6. Such reallocations reduce the basis of CS2 by $310, from $585 to $275, increase the basis of CS4 by $80, from $300 to $380, increase the basis of CS5 by $105, from $275 to $380, and increase the basis of CS6 by $125, from $150 to $275. However, there may be other reasonable reallocations.

(C) *Increasing basis by reallocated positive investment adjustments*. Under paragraph (b)(2)(ii)(A) of this section, the $25 positive investment adjustment removed from CS2 (the transferred loss common share) is then reallocated and applied to increase the basis of preferred shares, but not above value. Accordingly, $10 of that amount is reallocated to PS2, increasing its basis from $1090 to $1100, its value. Under paragraph (b)(2)(ii)(B) of this section, the remaining $15 is reallocated and applied to the common shares in a manner that reduces disparity among members' bases in all common shares to the greatest extent possible. The $15 positive investment adjustment that is reallocated to common shares may be reallocated entirely to CS8, increasing its basis from $125 to $140. However, there may be other reasonable reallocations.

(D) *Summary of the reallocation of adjustments*. The adjustments made under this paragraph (b) are:

	Preferred		Common							
	PS1 (M)	PS2 (P)	CS1 (P)	CS2 (P)	CS3 (P)	CS4 (P)	CS5 (P)	CS6 (P)	CS7 (P)	CS8 (P)
Adjusted basis before redetermination	1350	1090	925	610	450	300	275	150	115	0
Removing positive adjustments from transferred loss shares	....	....	....	−25						
Reallocating negative adjustments	−250	....	....	−310	....	+80	+105	+125	+125	+125
Applying positive adjustments removed from transferred loss shares	....	+10	....	....	....	....	....	....	....	+15
Basis after redetermination	1100	1100	925	275	450	380	380	275	240	140
Value	1100	1100	275	275	275	275	275	275	275	275
Gain/(loss)	0	0	(650)	0	(175)	(105)	(105)	0	35	135

(iii) *Application of paragraphs (c) and (d) of this section*. Because M's sale of PS1 and P's sale of CS2 are not transfers of loss shares after the application of this paragraph (b), paragraphs (c) and (d) of this section do not apply.

(iv) *Higher-tier effects*. The $250 reduction in the basis of PS1 under this paragraph (b) is a noncapital, nondeductible expense under §1.1502–32(b)(3)(iii)(B) that will be included in the year 3 investment adjustment to be applied to P's basis in its M stock.

(c) *Stock basis reduction to prevent noneconomic loss*—(1) *In general*. The rules of this paragraph (c) reduce M's basis in a transferred share of S stock to prevent noneconomic stock loss and thus promote the clear reflection of the group's income. These rules limit the reduction to M's basis in the S share to the amount of net unrealized appreciation reflected in the share's basis as of the transfer (the disconformity amount). These rules also limit the reduction to M's basis in the S share to the portion of the share's basis that is attributable to investment adjustments made pursuant to the consolidated return regulations.

(2) *Basis reduction rule.* This paragraph (c) applies if M transfers a share of S stock and, after taking into account the effects of all applicable rules of law, including any adjustments under paragraph (b) of this section, the share is a loss share. Under this paragraph (c), M's basis in the share is reduced, but not below value, by the lesser of—

(i) The share's net positive adjustment (as defined in paragraph (c)(3) of this section); and

(ii) The share's disconformity amount (as defined in paragraph (c)(4) of this section).

(3) *Net positive adjustment.* A share's *net positive adjustment* is the greater of—

(i) Zero; and

(ii) The sum of all investment adjustments reflected in the basis of the share. The term *investment adjustment* has the same meaning as in paragraph (b)(1)(iii) of this section, except that it includes all adjustments specially allocated under §1.1502–32(c)(1)(ii).

(4) *Disconformity amount.* A share's *disconformity amount* is the excess, if any, of—

(i) M's basis in the share; over

(ii) The share's allocable portion of S's net inside attribute amount (as defined in paragraph (c)(5) of this section).

(5) *Net inside attribute amount.* S's *net inside attribute amount* is determined as of the transfer, taking into account all applicable rules of law (even if the adjustments required by such rules are not deemed effective until after the transfer, such as certain adjustments required under sections 108 and 1017 and §1.1502–28). S's net inside attribute amount is the sum of S's net operating and capital loss carryovers, deferred deductions, money, and basis in assets other than money, reduced by the amount of S's liabilities. For this purpose, S's basis in any share of lower-tier subsidiary stock is generally S's basis in that share, adjusted to reflect any gain or loss recognized in the transaction with respect to the share and any other related or resulting adjustments to the basis of the share. However, see paragraph (c)(6) of this section for special rules regarding the computation of S's net inside attribute amount for purposes of this paragraph (c) if S holds stock of a subsidiary that is not transferred in the transaction. See paragraph (f) of this section for definitions of ''allocable portion,'' ''deferred deduction,'' ''liability,'' ''loss carryover,'' and other relevant terms.

(6) *Determination of S's net inside attribute amount if S owns stock of a lower-tier subsidiary*—(i) *Overview.* If a loss share of S stock is transferred when S holds a share of stock of another subsidiary (S1) and the S1 share is not transferred in the same transaction, S's net inside attribute amount is determined by treating S's basis in its S1 share as tentatively reduced under this paragraph (c)(6). The purpose of this rule is to reduce the extent to which S1's investment adjustments increase noneconomic loss on S stock (as a result of S1's recognition of items that are indirectly reflected in a member's basis in a share of S stock).

(ii) *General rule for nontransferred shares of lower-tier subsidiary stock.* For purposes of determining the disconformity amount of a share of S stock, S's basis in a nontransferred share of S1 stock is treated as reduced by the share's tentative reduction amount. The tentative reduction amount is the lesser of the S1 share's net positive adjustment and the S1 share's disconformity amount.

(iii) *Multiple tiers of nontransferred shares.* If S directly or indirectly owns nontransferred shares of stock of subsidiaries in multiple tiers, then, subject to the limitations in paragraph (c)(6)(iv) of this section (regarding nontransferred shares that are lower-tier to transferred shares), the rules of this paragraph (c)(6) first apply to determine the tentatively reduced basis of stock of the subsidiary at the lowest tier. These rules then apply to determine the tentatively reduced basis of nontransferred shares of stock of subsidiaries successively at each next higher tier that is lower-tier to S. The tentative reductions at each tier are treated as noncapital, nondeductible expenses that tier up under the principles of §1.1502–32, and, as such, result in a tentative reduction of basis and any net positive adjustment of subsidiary shares that are lower-tier to S.

(iv) *Nonapplicability of tentative basis reduction rule to transferred shares.* The tentative basis reduction rule in this paragraph (c)(6) does not apply to any share of stock of a lower-tier subsidiary (S1) that is transferred in the same transaction in which the S share is transferred. Further, for purposes of determining the S share's disconformity amount, the tentative basis reduction rule in this paragraph (c)(6) only applies with respect to stock of a lower-tier subsidiary if such stock is lower-tier to a nontransferred S1 share. The purpose of this rule is to prevent tentative adjustments to the bases of lower-tier shares if this paragraph (c) has already applied with respect to the shares, without regard to whether such application resulted in the reduction of the basis of any share.

(v) *Example.* The rules of this paragraph (c)(6) are illustrated by the following example:

Example. (i) *Facts.* M owns the sole outstanding share of S stock, S owns the sole outstanding share of S1 stock, S1 owns all five outstanding shares of S2 stock (the bases of which are equal), and S2 owns the sole outstanding share of S3 stock. The basis of each of the shares reflects its allocable portion of a $5 positive investment adjustment attributable to income recognized by S3. The basis of the S share exceeds its value by $10 and the basis of the S1 share exceeds its value by $5. The basis of each S2 share is $1 less than its value. In one transaction, M sells its S share to X, S1 issues new shares in an amount that prevents S and S1 from being members of the same group, and S1 sells one of its S2 shares to an unrelated individual. S1, S2, and S3 elect to file a consolidated return following the transaction.

(ii) *General applicability of section.* As a result of the transaction, there is a transfer of the S share and the S2 share that was sold (because both shares were sold to nonmembers) and of the S1 share (because S and S1 cease to be members of the same group as a result of the stock issuance). The transfer of the S2 share is not a transfer of a loss share, and so this section does not apply to that transfer. The transfers of the S and S1 shares are transfers of loss shares, and so this section applies to those transfers. The S3 share and the four retained S2 shares are not transferred in the transaction. Under paragraph (a)(3)(ii)(A) of this section, this section applies first to the transfer of the S1 share because it is the lowest-tier transferred loss share.

(iii) *Application of paragraph (b) of this section and this paragraph (c) to transfer of S1 stock.* First, the $1 gain recognized on the transfer of the S2 share tiers up to adjust the basis of each upper-tier share. The transferred S1 share is still a loss share (by $4) and is therefore subject to this section. Although the transfer is subject to paragraph (b) of this section, there is no basis redetermination under paragraph (b) of this section because there is only one share of S1 stock outstanding (and so there can be no disparity among members' bases in common shares and there are no outstanding preferred shares with respect to which there can be unrecognized gain or loss). See paragraph (b)(1)(ii)(A) of this section. Therefore, after the application of paragraph (b) of this section, the S1 share is still a loss share and, as such, subject to this paragraph (c). In determining the amount of any basis reduction under this paragraph (c), the disconformity amount of the S1 share is computed by comparing S's basis in its S1 share to S1's net inside attribute amount (because there is only one S1 share outstanding, the entire amount is allocable to that share). In determining S1's net inside attribute amount, the tentative reduction rule in this paragraph (c)(6) applies to nontransferred lower-tier shares (provided they are lower-tier to nontransferred shares). Thus, the rule applies to S1's four retained shares of S2 stock and to S2's share of S3 stock. The tentative reduction begins at the lowest level (S2's share of S3 stock) and any tentative reduction amount tiers up as a noncapital, nondeductible expense under the principles of §1.1502–32, tentatively reducing the bases of any upper tier nontransferred shares that are lower-tier to the transferred loss share (the S1 share). Accordingly, each of S1's nontransferred share of S2 stock is tentatively reduced by its portion of the tentative reduction to S2's share of S3 stock. S1 then applies the tentative reduction rule to its four nontransferred S2 shares. S1's net inside attribute amount is the sum of its basis in each of its nontransferred S2 shares, as tentatively reduced under this paragraph (c)(6) and S1's actual basis in the transferred S2 share, increased to reflect the gain recognized on the sale of that share. After the application of this paragraph (c) to the transfer of the S1 share, paragraph (b) of this section applies to M's transfer of the S share.

(iv) *Application of section to transfer of S stock.* Because the S share is still a loss share after applying paragraph (b) of this section and this paragraph (c) to the transfer of the S1 stock, this section applies to M's transfer of the S share. Although paragraph (b) of this section applies to the transfer, there is no basis redetermination under paragraph (b) of this section because there is only one share of S stock outstanding (and so there can be no disparity among members' bases in common shares and there are no outstanding preferred shares with respect to which there can be unrecognized gain or loss). See paragraph (b)(1)(ii)(A) of this section. Therefore, after the application of paragraph (b) of this section, the share is still a loss share and, as such, subject to this paragraph (c). In determining the disconformity amount of the S share, S's net inside attribute amount is determined using S's actual basis in the transferred S1 stock (after any reduction under this paragraph (c)), because the tentative reduction rule in this paragraph (c)(6) does not apply to shares that are transferred in the transaction. All other shares are lower-tier to the transferred S1 share and are therefore also not subject to tentative reduction for purposes of determining the disconformity amount of the S share. After the application of this paragraph (c) to the transfer of the S share, paragraph (d) of this section applies with respect to M's transfer of the S share. After the application of paragraph (d) of this section with respect to the transfer of the S share, if the S1 share is still a loss share, paragraph (d) of this section applies with respect to S's transfer of the S1 share.

(7) *Netting of gains and losses taken into account*—(i) *General rule.* Solely for purposes of computing the basis reduction required under this paragraph (c), the basis of each transferred loss share of S stock is treated as reduced proportionately (as to loss) by the amount of income or gain taken into account by members with respect to transferred shares of S stock, provided that—

(A) The shares are transferred in one transaction; and

(B) The gain is taken into account as of the transaction.

(ii) *Example.* The netting rule of this paragraph (c)(7) is illustrated by the following example:

Example. Disposition of gain and loss shares. (i) *Facts.* M owns the only three outstanding shares of S stock. Share A has a basis of $54, Share B has a basis of $100, and Share C has a basis of $80. In the same transaction, M sells all three S shares to X for $60 each. M realizes a gain of $6 on Share A, a loss of $40 on Share B, and a loss of $20 on Share C. M's sales of Share B and Share C are transfers of loss shares and therefore subject to this section. M's sale is a transfer of all of the shares of S stock held by members to one or more nonmembers in one fully taxable transaction and, therefore, basis is not redetermined under paragraph (b) of this section. See paragraph (b)(1)(ii)(B) of this section. The transfer is then subject to this paragraph (c). However, for this purpose, M treats its bases in Share B and Share C as reduced by the $6 gain taken into account on Share A. The gain is allocated to Share B and Share C proportionately based on the amount of loss in each share. Thus, $4 of gain ($40/$60 x $6) is treated as allocated to Share B and $2 of gain ($20/$60 x $6) is treated as allocated to Share C. Accordingly, M computes the basis reduction required under this paragraph (c) by treating its basis in Share B as $96 ($100 less $4) and its basis in Share C as $78 ($80 less $2). If, after the application of this paragraph (c), the sales of Share B and Share C are still transfers of loss shares, then the transfers are subject to paragraph (d) of this section. (Although the bases of Share B and Share C are not actually reduced by any portion of the gain, paragraph (d)(3)(i)(A) of this section applies netting principles to limit adjustments under paragraph (d) of this section.)

(ii) *Disposition of stock with deferred gain.* The facts are the same as in paragraph (i) of this *Example*, except that M sells the gain share to another member. Under §1.1502–13, M's gain recognized on Share A is not taken into account in the taxable year of the transfer and therefore cannot be treated as reducing M's loss recognized on Share B and Share C for purposes of this paragraph (c). The applicability of this section to the transfer of Share A is determined as of the time that the intercompany item (the gain on M's sale to the other member) is taken into account; see paragraph (e)(3) of this section. However, if Share B (instead of Share A) were sold to a member, the entire gain on Share A would be treated as reducing the loss on Share C for purposes of applying this paragraph (c); see paragraph (e)(3) of this section.

(8) *Examples.* The application of this paragraph (c) is illustrated by the following examples.

Example 1. Appreciation reflected in stock basis at acquisition. (i) *Appreciation recognized as gain.* (A) *Facts.* On January 1, year 1, M purchases the sole outstanding share of S stock for $100. At that time, S owns two assets, Asset 1 with a basis of $0 and a value of $40, and Asset 2 with a basis and value of $60. In year 1, S sells Asset 1 for $40, recognizing a $40 gain. On December 31, year 1, M sells its S share for $100. After taking into account the effects of all applicable rules of law, M's basis in the S share is $140 (M's original $100 basis increased under §1.1502–32 by $40, the share's allocable portion of the gain recognized on the sale of Asset 1). M's sale of the S share is a transfer of a loss share and therefore subject to this section.

(B) *Application of paragraph (b) of this section.* Although the transfer is subject to this section, there is no basis redetermination under paragraph (b) of this section because there is only one share of S stock outstanding (and so there can be no disparity among members' bases in common shares and there are no outstanding preferred shares with respect to which there can be unrecognized gain or loss). See paragraph (b)(1)(ii)(A) of this section. Therefore, after the application of paragraph (b) of this section, the share is still a loss share and, as such, subject to this paragraph (c).

(C) *Basis reduction under this paragraph (c).* Under this paragraph (c), M's basis in the S share, $140, is reduced, but not below value, $100, by the lesser of the share's net positive adjustment and disconformity amount. The share's net positive adjustment is the greater of zero and the sum of all investment adjustments (as defined in paragraph (b)(1)(iii) of this section) applied to the basis of the share. The only investment adjustment applied to the basis of the share is the $40 adjustment attributable to the gain recognized on the sale of Asset 1. Thus, the share's net positive adjustment is $40. The share's disconformity amount is the excess, if any, of its basis, $140, over its allocable portion of S's net inside attribute amount. S's net inside attribute amount is the sum of S's money ($40 from the sale of Asset 1) and S's basis in Asset 2, $60, or $100. The share is the only outstanding S share and so its allocable portion of the $100 net inside attribute amount is the entire $100. Thus, the share's disconformity amount is $40, the excess of $140 over $100. The lesser of the net positive adjustment, $40, and the share's disconformity amount, $40, is $40. Accordingly, immediately before the application of paragraph (d) of this section, M's basis in the share is reduced by $40, from $140 to $100.

(D) *Application of paragraph (d) of this section.* Because M's sale of the S share is not a transfer of a loss share after the application of this paragraph (c), paragraph (d) of this section does not apply to the transfer.

(ii) *Appreciation recognized as income earned in the consumption of built-in gain.* The facts are the same as in paragraph (i)(A) of this *Example 1*, except that, instead of selling Asset 1, the value of Asset 1 is consumed in the production of $40 of income in year 1 (reducing the value of Asset 1 to $0). Because the net positive adjustment includes items of income as well as items of gain, the results are the same as those described in paragraph (i) of this *Example 1*.

(iii) *Post-acquisition appreciation eliminates stock loss.* The facts are the same as in paragraph (i)(A) of this *Example 1* except that, in addition, the value of Asset 2 increases to $100 before the stock is sold. As a result, M sells the S share for $140. Because M's sale of the S share is not a transfer of a loss share, this section does not apply to the transfer, notwithstanding that P's basis in the S share was increased by the gain recognized on Asset 1.

(iv) *Distributions.* (A) *Facts.* The facts are the same as in paragraph (i)(A) of this *Example 1* except that, in addition, S declares and makes a $10 dividend distribution before the end of year 1. As a result, the value of the share decreases and M sells the share for $90. After taking into account the effects of all applicable rules of law, M's basis in the S share is $130 (M's original $100 basis increased under §1.1502–32 by $30, the $10 distribution on the share reduced by the share's allocable portion of the $40 gain recognized on the sale of Asset 1). M's sale of the S share is a transfer of a loss share and therefore subject to this section.

(B) *Application of paragraph (b) of this section.* Although the transfer is subject to this section, there is no basis redetermination under paragraph (b) of this section for the reasons set forth in paragraph (i)(B) of this *Example 1*. Therefore, after the application of paragraph (b) of this section, the share is still a loss share and, as such, subject to this paragraph (c).

(C) *Basis reduction under this paragraph (c).* Under this paragraph (c), M's basis in the S share, $130, is reduced, but not below value, $90, by the lesser of the share's net positive adjustment and disconformity amount. The share's net positive adjustment is $40 (the sum of all investment adjustments (as defined in paragraph (b)(1)(iii) of this section) applied to the basis of the share). The share's disconformity amount is the excess of its basis, $130, over its allocable portion of S's net inside attribute amount. S's net inside attribute amount is $90, the sum of S's money ($30, the $40 sale proceeds less the $10 distribution) and S's basis in Asset 2, $60. The share is the only outstanding S share and so its allocable portion of the $90 net inside attribute amount is the entire $90. The lesser of the share's net positive adjustment, $40, and its disconformity amount, $40, is $40. Accordingly, immediately before the application of paragraph (d) of this section, the basis in the share is reduced by $40, from $130 to $90.

(D) *Application of paragraph (d) of this section.* Because M's sale of the S share is not a transfer of a loss share after the application of this paragraph (c), paragraph (d) of this section does not apply to the transfer.

Example 2. Loss of appreciation reflected in basis. (i) *Facts.* On January 1, year 1, M purchases the sole outstanding share of S stock for $100. At that time, S owns two assets, Asset 1 with a basis of $0 and a value of $40, and Asset 2 with a basis and value of $60. The value of Asset 1 declines to $0 and M sells its S share for $60. After taking into account the effects of all applicable rules of law, M's basis in the S share is $100. M's sale of the S share is a transfer of a loss share and therefore subject to this section.

(ii) *Application of paragraph (b) of this section*. Although the transfer is subject to this section, there is no basis redetermination under paragraph (b) of this section because there is only one share of S stock outstanding (and so there can be no disparity among members' bases in common shares and there are no outstanding preferred shares with respect to which there can be unrecognized gain or loss). See paragraph (b)(1)(ii)(A) of this section. Therefore, after the application of paragraph (b) of this section, the share is still a loss share and, as such, subject to this paragraph (c).

(iii) *Basis reduction under this paragraph (c)*. Under this paragraph (c), M's $100 basis in the S share is reduced, but not below its $60 value by the lesser of the share's net positive adjustment and disconformity amount. There were no investment adjustments applied to M's basis in the share and so the share's net positive adjustment is $0. Thus, although the share's disconformity amount is $40 (the excess of M's $100 basis in the share over the share's $60 allocable portion of S's net inside attribute amount), no basis reduction is required under this paragraph (c).

(iv) *Application of paragraph (d) of this section*. After the application of this paragraph (c), M's sale of the S share is still a transfer of a loss share, and, accordingly, subject to paragraph (d) of this section. No adjustment is required under paragraph (d) of this section because there is no aggregate inside loss. See paragraph (d)(3)(iii) of this section.

Example 3. Items accruing after S becomes a member. (i) *Recognition of loss accruing after S becomes a member*. (A) *Facts*. On January 1, year 1, M purchases the sole outstanding share of S stock for $100. At that time, S owns two assets, Asset 1, with a basis of $0 and a value of $40, and Asset 2, with a basis and value of $60. In year 1, S sells Asset 1 for $40, recognizing a $40 gain. Also in year 1, the value of Asset 2 declines and S sells Asset 2 for $20, recognizing a $40 loss that is absorbed by the group. On December 31, year 1, M sells its S share for $60. After taking into account the effects of all applicable rules of law, M's basis in the S share is $100 (M's original $100 basis, unadjusted under §1.1502–32 because the $40 gain recognized on the sale of Asset 1 and the $40 loss on the sale of Asset 2 net, resulting in an adjustment of $0). M's sale of the S share is a transfer of a loss share and therefore subject to this section.

(B) *Application of paragraph (b) of this section*. Although the transfer is subject to this section, there is no basis redetermination under paragraph (b) of this section because there is only one share of S stock outstanding (and so there can be no disparity among members' bases in common shares and there are no outstanding preferred shares with respect to which there can be unrecognized gain or loss). See paragraph (b)(1)(ii)(A) of this section. Therefore, after the application of paragraph (b) of this section, the share is still a loss share and, as such, subject to this paragraph (c).

(C) *Basis reduction under this paragraph (c)*. Under this paragraph (c), M's basis in the S share is reduced, but not below the share's $60 value, by the lesser of the share's net positive adjustment and disconformity amount. The share's net positive adjustment is $0. Thus, although the share has a disconformity amount of $40 (the excess of M's basis in the share, $100, over the share's allocable portion of S's net inside attribute amount, $60), no basis reduction is required under this paragraph (c).

(D) *Application of paragraph (d) of this section*. After the application of this paragraph (c), M's sale of the S share is still a transfer of a loss share, and, accordingly, subject to paragraph (d) of this section. No adjustment is required under paragraph (d) of this section because there is no aggregate inside loss. See paragraph (d)(3)(iii) of this section.

(ii) *Recognition of gain accruing after S becomes a member*. (A) *Facts*. The facts are the same as in paragraph (i)(A) of this *Example 3*, except that M does not sell the S share and S does not sell either asset in year 1. In addition, in year 2, the value of Asset 1 declines to $0, the value of Asset 2 returns to $60, and S creates Asset 3 (with a basis of $0). In year 3, S sells Asset 3 for $40, recognizing a $40 gain. On December 31, year 3, M sells its S share for $100. After taking into account the effects of all applicable rules of law, M's basis in the S share is $140 (M's original $100 basis increased under §1.1502–32 by $40 (the share's allocable portion of the gain recognized on the sale of Asset 3 in year 3)). M's sale of the S share is a transfer of a loss share and therefore subject to this section.

(B) *Application of paragraph (b) of this section*. Although the transfer is subject to this section, there is no basis redetermination under paragraph (b) of this section for the reasons set forth in paragraph (i)(B) of this *Example 3*. Therefore, after the application of paragraph (b) of this section, the share is still a loss share and, as such, subject to this paragraph (c).

(C) *Basis reduction under this paragraph (c)*. Under this paragraph (c), M's basis in the S share, $140, is reduced, but not below value, $100, by the lesser of the share's net positive adjustment and disconformity amount. The share's net positive adjustment is $40 (the year 3 investment adjustment). The share's disconformity amount is the excess of its basis, $140, over its allocable portion of S's net inside attribute amount. S's net inside attribute amount is $100, the sum of S's money ($40 from the sale of Asset 3) and its basis in its assets ($60 (the sum of Asset 1's basis of $0 and Asset 2's basis of $60)). S's $100 net inside attribute amount is allocable entirely to the sole outstanding S share. Thus, the share's disconformity amount is the excess of $140 over $100, or $40. The lesser of the share's net positive adjustment, $40, and its disconformity amount, $40, is $40. Accordingly, the basis in the share is reduced by $40, from $140 to $100.

(D) *Application of paragraph (d) of this section*. Because M's sale of the S share is not a transfer of a loss share after the application of this paragraph (c), paragraph (d) of this section does not apply to the transfer.

(iii) *Recognition of income earned after S becomes a member*. The facts are the same as in paragraph (ii)(A) of this *Example 3*, except that instead of creating Asset 3, S earns $40 of income from services provided in year 3. Because the net positive adjustment includes items of income as well as items of gain, the results are the same as those described in paragraph (ii) of this *Example 3*.

Example 4. Computing the disconformity amount. (i) *Unrecognized loss reflected in stock basis*. (A) *Facts*. M owns the sole outstanding share of S stock with a basis of $100. S owns two assets, Asset 1 with a basis of $20 and a value of $60, and Asset 2 with a basis of $60 and a value of $40. In year 1, S sells Asset 1 for $60, recognizing a $40 gain. On December 31, year 1, M sells the S share for $100. After taking into account the effects of all applicable rules of law, M's basis in the S share is $140 (M's original $100 basis increased under §1.1502–32 by $40, the share's allocable portion of the gain recognized on the sale of Asset 1). M's sale of the S share is a transfer of a loss share and therefore subject to this section.

(B) *Application of paragraph (b) of this section*. Although the transfer is subject to this section, there is no basis redetermination under paragraph (b) of this section because there is only one share of S stock outstanding (and so there can be no disparity among members' bases in common shares and there are no outstanding preferred shares with respect to which there can be unrecognized gain or loss). See paragraph (b)(1)(ii)(A) of this section. Therefore, after the application of paragraph (b) of this section, the share is still a loss share and, as such, subject to this paragraph (c).

(C) *Basis reduction under this paragraph (c)*. Under this paragraph (c), M's basis in the S share, $140, is reduced, but not below the share's $100 value, by the lesser of the share's net positive adjustment and disconformity amount. The share's net positive adjustment is $40 (the year 1 investment adjustment). The share's disconformity amount is the excess of its basis, $140, over its allocable portion of S's net inside attribute amount. S's net inside attribute amount is $120, the sum of S's money ($60 from the sale of Asset 1) and S's basis in Asset 2, $60. S's net inside attribute amount is allocable entirely to the sole outstanding S share. Thus, the share's disconformity amount is $20, the excess of $140 over $120. The lesser of the share's net positive adjustment, $40, and its disconformity amount, $20, is $20. Accordingly, the basis in the share is reduced by $20, from $140 to $120.

(D) *Application of paragraph (d) of this section*. After the application of this paragraph (c), M's sale of the S share is still a transfer of a loss share, and, accordingly, S's attributes (to the extent of the $20 duplicated loss) are subject to reduction under paragraph (d) of this section.

(ii) *Loss carryover*. The facts are the same as in paragraph (i)(A) of this *Example 4*, except that Asset 2 has a basis of $0 (rather than $60) and S has a $60 loss carryover (as defined in paragraph (f)(6) of this section). The analysis is the same as paragraph (i) of this *Example 4*. Furthermore, the analysis of the application of this paragraph (c) would be the same if the $60 loss carryover were subject to a section 382 limitation from a prior ownership change, or if, instead, the $60 loss carryover were subject to the limitation in §1.1502–21(c) on losses carried from separate return limitation years.

(iii) *Liabilities*. The facts are the same as in paragraph (i)(A) of this *Example 4*, except that S borrows $100 before M sells the S share. S's net inside attribute amount remains $120, computed as the sum of S's money ($160, $60 from the sale of Asset 1 plus the $100 borrowed) and S's basis in Asset 2, $60, less its liabilities, $100. Thus, the S share's disconformity amount remains the excess of $140 over $120, or $20. The results are the same as in paragraph (i) of this *Example 4*.

Example 5. Computing the allocable portion of the net inside attribute amount. (i) *Facts*. On January 1, year 1, M owns all five outstanding shares of S stock with a basis of $20 per share. S owns Asset with a basis of $0. In year 1, S sells Asset for $100, recognizing a $100 gain. On December 31, year 1, M sells one of the S shares, Share 1, for $20. After taking into account the effects of all applicable rules of law, M's basis in Share 1 is $40 (M's original $20 basis increased under §1.1502–32 by $20 (the share's allocable portion of the gain recognized on the sale of Asset)). M's sale of Share 1 is a transfer of a loss share and therefore subject to this section.

(ii) *Application of paragraph (b) of this section*. Although the transfer is subject to this section, basis is not redetermined under paragraph (b) of this section because there is no disparity among M's bases in shares of S common stock and there are no shares of S preferred stock outstanding (so there can be no unrecognized gain or loss with respect to preferred shares). See paragraph (b)(1)(ii)(A) of this section. After the application of paragraph (b) of this section, M's sale of Share 1 is still a transfer of a loss share and therefore subject to this paragraph (c).

(iii) *Basis reduction under this paragraph (c).* Under this paragraph (c), M's $40 basis in Share 1 is reduced, but not below its $20 value by the lesser of the share's net positive adjustment and disconformity amount. Share 1's net positive adjustment is $20 (the year 1 investment adjustment). Share 1's disconformity amount is the excess of its $40 basis over its allocable portion of S's net inside attribute amount. S's net inside attribute amount is equal to the amount of S's money ($100 from the sale of the asset). Share 1's allocable portion of S's $100 net inside attribute amount is $20 (1/5 x $100). Thus, Share 1's disconformity amount is the excess of $40 over $20, or $20. The lesser of the share's $20 net positive adjustment and its $20 disconformity amount is $20. Accordingly, the basis in the share is reduced by $20, from $40 to $20.

(iv) *Application of paragraph (d) of this section.* Because M's sale of Share 1 is not a transfer of a loss share after the application of this paragraph (c), paragraph (d) of this section does not apply to the transfer.

Example 6. Liabilities. (i) *In general.* (A) *Facts.* On January 1, year 1, M purchases the sole outstanding share of S stock for $100. At that time, S owns Asset, with a basis of $0 and value of $100, and $100 cash. S also has a $100 liability. In year 1, S declares and makes a $60 dividend distribution to M and recognizes $20 of income. The value of Asset declines to $60 and, on December 31, year 1, M sells the S share for $20. After taking into account the effects of all applicable rules of law, M's basis in the S share is $60 (M's original $100 basis decreased under §1.1502–32 by $40 (the net of the $60 distribution and the $20 income recognized)). M's sale of the S share is a transfer of a loss share and therefore subject to this section.

(B) *Application of paragraph (b) of this section.* Although the transfer is subject to this section, there is no basis redetermination under paragraph (b) of this section because there is only one share of S stock outstanding (and so there can be no disparity among members' bases in common shares and there are no outstanding preferred shares with respect to which there can be unrecognized gain or loss). See paragraph (b)(1)(ii)(A) of this section. Therefore, after the application of paragraph (b) of this section, the share is still a loss share and, as such, subject to this paragraph (c).

(C) *Basis reduction under this paragraph (c).* Under this paragraph (c), M's basis in the S share, $60, is reduced, but not below value, $20, by the lesser of the share's net positive adjustment and disconformity amount. The share's net positive adjustment is $20 (the year 1 investment adjustment, as defined in paragraph (b)(1)(iii) of this section). The share's disconformity amount is the excess of its basis, $60, over its allocable portion of S's net inside attribute amount. S's net inside attribute amount is negative $40, computed as the sum of S's money ($60 ($100 less the $60 distribution plus the $20 income recognized)) and S's basis in Asset, $0, less S's liability, $100. S's net inside attribute amount is allocable entirely to the sole outstanding S share. Thus, the share's disconformity amount is the excess of $60 over negative $40, or $100. The lesser of the share's net positive adjustment, $20, and its disconformity amount, $100, is $20. Accordingly, the basis in the share is reduced by $20, from $60 to $40.

(D) *Application of paragraph (d) of this section.* After the application of this paragraph (c), the S share is still a loss share and, accordingly, S's attributes are subject to reduction under paragraph (d) of this section. No adjustment is required under paragraph (d) of this section, however, because there is no aggregate inside loss. See paragraph (d)(3)(iii) of this section.

(ii) *Excluded cancellation of indebtedness income—insufficient attributes available for reduction under sections 108 and 1017, and §1.1502–28.* (A) *Facts.* The facts are the same as in paragraph (i)(A) of this *Example 6*, except that M does not sell the S share. Instead, in year 4, Asset is destroyed in a fire and S spends its $60 on deductible expenses that are not absorbed by the group. S's loss becomes part of the consolidated net operating loss (CNOL). In year 5, S becomes insolvent and S's debt is discharged. Because of S's insolvency, S's discharge of indebtedness income is excluded under section 108 and, as a result, S's attributes are subject to reduction under sections 108 and 1017, and §1.1502–28. S's only attribute is the portion of the CNOL attributable to S, $60, and it is reduced to $0. There are no other consolidated attributes. In year 5, the S stock (which is treated as a capital asset) becomes worthless under section 165, taking into account §1.1502–80(c). After taking into account the effects of all applicable rules of law, M's basis in the S share is $60 (M's original $100 basis decreased under §1.1502–32 by the year 1 investment adjustment of $40 (the net of the $60 distribution and the $20 income recognized). The investment adjustment for year 5 is $0 (the net of the $60 tax exempt income from the excluded COD applied to reduce attributes and the $60 noncapital, nondeductible expense from the reduction of S's portion of the CNOL). Under paragraph (f)(10)(i)(D) of this section, a share is transferred on the last day of the taxable year during which it becomes worthless under section 165 if the share is treated as a capital asset, or the date the share becomes worthless if the share is not treated as a capital asset, taking into account §1.1502–80(c). Accordingly, M transfers the loss share of S stock on December 31, year 5, and the transfer is therefore subject to this section.

(B) *Application of paragraph (b) of this section.* Although the transfer is subject to this section, there is no basis redetermination under paragraph (b) of this section for the reasons set forth in paragraph (i)(B) of this *Example 6*. Therefore, after the application of paragraph (b) of this section, the share is still a loss share and, as such, subject to this paragraph (c).

(C) *Basis reduction under this paragraph (c).* Under this paragraph (c), M's basis in its S share, $60, is reduced, but not below value, $0, by the lesser of the share's net positive adjustment and disconformity amount. The share's net positive adjustment is $20 (the year 1 investment adjustment, as defined in paragraph (b)(1)(iii) of this section). The share's disconformity amount is the excess of its basis, $60, over its allocable portion of S's net inside attribute amount. S's net inside attribute amount is $0. (The effects of the attribute reduction required under sections 108 and 1017 and §1.1502–28 are taken into account in applying this section; therefore, for purposes of this section, S's portion of the CNOL is treated as eliminated under section 108 and §1.1502–28.) S's net inside attribute amount is allocable entirely to the sole outstanding S share. Thus, the share's disconformity amount is the excess of $60 over $0, or $60. The lesser of the share's net positive adjustment, $20, and its disconformity amount, $60, is $20. Accordingly, the basis in the share is reduced by $20, from $60 to $40, immediately before the transfer.

(D) *Application of paragraph (d) of this section.* After the application of this paragraph (c), the S share is still a loss share, and, accordingly, S's attributes are subject to reduction under paragraph (d) of this section. No adjustment is required under paragraph (d) of this section, however, because there is no aggregate inside loss. See paragraph (d)(3)(iii) of this section.

(iii) *Excluded cancellation of indebtedness income—full attribute reduction under sections 108 and 1017, and §1.1502–28 (using attributes attributable to another member).* (A) *Facts.* The facts are the same as in paragraph (ii)(A) of this *Example 6* except that M loses the $60 distributed in year 1 and the group does not absorb the loss. Thus, as of December 31, year 5, the CNOL is $120, attributable $60 to S and $60 to P. As a result, under §1.1502–28(a)(4), after the portion of the CNOL attributable to S is reduced to $0, the remaining $40 of excluded COD applies to the portion of the CNOL attributable to P, reducing it from $60 to $20. After taking into account the effects of all applicable rules of law, M's basis in the S share at the end of year 5 is $100 (M's original $100 basis decreased under §1.1502–32 by $40 at the end of the year 1 and then increased under §1.1502–32 by $40 at end of the year 5 (the net of the $100 tax exempt income from the excluded COD applied to reduce attributes and the $60 noncapital, nondeductible expense from the reduction of S's portion of the CNOL)). Under paragraph (f)(10)(i)(D) of this section, a share is transferred on the last day of the taxable year during which it becomes worthless under section 165 if the share is treated as a capital asset, or the date the share becomes worthless if the share is not treated as a capital asset, taking into account §1.1502–80(c). Accordingly, M transfers the loss share of S stock on December 31, year 5, and the transfer is therefore subject to this section.

(B) *Application of paragraph (b) of this section.* Although the transfer is subject to this section, there is no basis redetermination under paragraph (b) of this section for the reasons set forth in paragraph (i)(B) of this *Example 6*. Therefore, after the application of paragraph (b) of this section, the share is still a loss share and, as such, subject to this paragraph (c).

(C) *Basis reduction under this paragraph (c).* Under this paragraph (c), M's basis in the S share, $100, is reduced, but not below value, $0, by the lesser of the share's net positive adjustment and disconformity amount. The share's net positive adjustment is $60 (the sum of the year 1 investment adjustment, as defined in paragraph (b)(1)(iii) of this section, $20, and the year 5 investment adjustment, $40). The share's disconformity amount is the excess of its basis, $100, over its allocable portion of S's net inside attribute amount. S's net inside attribute amount is $0 (taking into account the effects of the attribute reduction required under sections 108 and 1017 and §1.1502–28). S's net inside attribute amount is allocable entirely to the sole outstanding S share. The share's disconformity amount is therefore $100. The lesser of the share's net positive adjustment, $60, and its disconformity amount, $100, is $60. Accordingly, M's basis in the share is reduced by $60, from $100 to $40, immediately before the transfer.

(D) *Application of paragraph (d) of this section.* After the application of this paragraph (c), the S share is still a loss share, and, accordingly, S's attributes are subject to reduction under paragraph (d) of this section. No adjustment is required under paragraph (d) of this section, however, because there is no aggregate inside loss. See paragraph (d)(3)(iii) of this section.

Example 7. Lower-tier subsidiary (no transfer of lower-tier stock). (i) *Facts.* M owns the sole outstanding share of S stock with a basis of $160. S owns two assets, Asset 1 with a basis and value of $100, and the sole outstanding share of S1 stock with a basis of $60. S1 owns one asset, Asset 2, with a basis of $20 and value of $60. In year 1, S1 sells Asset 2 to X for $60, recognizing a $40 gain. On December 31, year 1, M sells its S share to Y, a member of another consolidated group, for $160. After taking into account the effects of all applicable rules of law, M's basis in the S share is $200 (M's original $160 basis increased under §1.1502–32 by $40 (to reflect the tier-up of the adjustment to S's basis in the S1 stock for the gain recognized on S1's sale of Asset 2)). M's sale of the S share is a transfer of a loss share and therefore subject to this section. (S does not transfer the S1 share because S and S1 are members of the same group following the transfer. See paragraph (f)(10) of this section.)

(ii) *Application of paragraph (b) of this section.* Although the transfer is subject to this section, there is no basis redetermination under paragraph (b) of this section because there is only one share of S stock outstanding (and so there can be no disparity among members' bases in common shares and there are no outstanding preferred shares with respect to which there can be unrecognized gain or loss). See paragraph (b)(1)(ii)(A) of this section. Therefore, after the application of paragraph (b) of this section, the share is still a loss share and, as such, subject to this paragraph (c).

(iii) *Basis reduction under this paragraph (c).* (A) *In general.* Under this paragraph (c), M's basis in the S share, $200, is reduced, but not below value, $160, by the lesser of the share's net positive adjustment and disconformity amount. The S share's net positive adjustment is $40. The share's disconformity amount is the excess of its basis, $200, over the share's allocable portion of S's net inside attribute amount. S's net inside attribute amount is the sum of S's basis in Asset 1, $100, and S's basis in the S1 share.

(B) *S's basis in the S1 share.* Although S's actual basis in the S1 share is $100 (S's original $60 basis increased under §1.1502–32 by $40 (the share's allocable portion of the gain recognized on the sale of Asset 2)), for purposes of computing the S share's disconformity amount, S's net inside attribute amount is determined by treating S's basis in the S1 share as tentatively reduced by the lesser of the S1 share's net positive adjustment and the S1 share's disconformity amount. The S1 share's net positive adjustment is $40 (the year 1 investment adjustment). The S1 share's disconformity amount is the excess of its basis, $100, over the share's allocable portion of S1's net inside attribute amount. S1's net inside attribute amount is equal to the amount of S1's money ($60 from the sale of Asset 2), and is allocable entirely to the sole outstanding S1 share. Thus, the S1 share's disconformity amount is the excess of $100 over $60, or $40. The lesser of the S1 share's net positive adjustment, $40, and its disconformity amount, $40, is $40. Accordingly, for purposes of computing the disconformity amount of the S share, S's net inside attribute amount is determined by treating S's basis in its S1 share as tentatively reduced by $40, from $100 to $60.

(C) *The disconformity amount of M's S share.* S's net inside attribute amount is treated as the sum of its basis in Asset 1, $100, and its tentatively reduced basis in the S1 share, $60, or $160. S's net inside attribute amount is allocable entirely to the sole outstanding S share. Thus, the S share's disconformity amount is the excess of $200 over $160, or $40.

(D) *Amount of reduction.* M's basis in its S share is reduced by the lesser of the S share's net positive adjustment, $40, and disconformity amount, $40, or $40. Accordingly, M's basis in the S share is reduced by $40, from $200 to $160.

(E) *Effect on S's basis in its S1 share.* The tentative reduction under this paragraph (c) has no effect on S's actual basis in the S1 share. Thus, after the application of this paragraph (c), S owns the S1 share with a basis of $100 (S's original $60 basis increased under §1.1502–32 by $40 (the share's allocable portion of the gain recognized on the sale of Asset 2)).

(iv) *Application of paragraph (d) of this section.* Because M's sale of the S share is not a transfer of a loss share after the application of this paragraph (c), paragraph (d) of this section does not apply to the transfer.

(d) *Attribute reduction to prevent duplication of loss*—(1) *In general.* The rules of this paragraph (d) reduce attributes of S and its lower-tier subsidiaries to the extent they duplicate a net loss on shares of S stock transferred by members in one transaction. This rule furthers single-entity principles by preventing S (or its lower-tier subsidiaries) from using deductions and losses to the extent that the group or its members (including former members) have either used, or preserved for later use, a corresponding loss in S shares.

(2) *Attribute reduction rule*—(i) *General rule.* If a transferred share is a loss share after taking into account the effects of all applicable rules of law, including any adjustments under paragraph (b), (c), or (d)(5)(iii) of this section, S's attributes are reduced by S's attribute reduction amount immediately before the transfer. S's attribute reduction amount is determined under paragraph (d)(3) of this section and applied in accordance with the provisions of paragraphs (d)(4), (d)(5), and (d)(6) of this section. In addition, paragraph (d)(7) of this section

provides for additional attribute reduction in the case of certain transfers due to worthlessness and certain transfers not followed by a separate return year.

(ii) *Attribute reduction amount less than five percent of value.* This paragraph (d) generally does not apply to a transaction if the aggregate attribute reduction amount in the transaction is less than five percent of the aggregate value of the shares transferred by members in the transaction. However, in such a case, P may elect to apply this paragraph (d) to the transaction. If such an election is made, this paragraph (d) will apply with respect to the entire aggregate attribute reduction amount determined in the transaction. Such an election is made in the manner provided in paragraph (e)(5) of this section.

(3) *Attribute reduction amount*—(i) *In general.* S's *attribute reduction amount* is the lesser of—

(A) The net stock loss (as defined in paragraph (d)(3)(ii) of this section); and

(B) S's aggregate inside loss (as defined in paragraph (d)(3)(iii) of this section).

(ii) *Net stock loss.* The *net stock loss* is the excess, if any, of—

(A) The aggregate basis of all shares of S stock transferred by members in the transaction; over

(B) The aggregate value of those shares.

(iii) *Aggregate inside loss*—(A) *In general.* S's *aggregate inside loss* is the excess, if any, of—

(*1*) S's net inside attribute amount; over

(*2*) The value of all outstanding shares of S stock.

(B) *Net inside attribute amount.* S's *net inside attribute amount* generally has the same meaning as in paragraph (c)(5) of this section. However, if S holds stock of a lower-tier subsidiary, the provisions of paragraph (d)(5) of this section (and not the provisions of paragraph (c)(6) of this section) modify the computation of S's net inside attribute amount for purposes of this paragraph (d).

(iv) *Lower-tier subsidiaries.* See paragraph (d)(5) of this section for special rules relating to the application of this paragraph (d) if S owns shares of stock of a subsidiary.

(4) *Application of attribute reduction amount*—(i) *Attributes available for reduction.* S's attributes available for reduction under this paragraph (d) are—

(A) *Category A.* Capital loss carryovers;

(B) *Category B.* Net operating loss carryovers;

(C) *Category C.* Deferred deductions; and

(D) *Category D.* Basis of assets other than assets identified as Class I assets in §1.338–6(b)(1).

(ii) *Rules of application*—(A) *Category A, Category B, and Category C attributes.* S's attribute reduction amount is first allocated and applied to reduce the attributes in Category A, Category B, and Category C.

(*1*) *Attribute reduction amount less than total attributes in Category A, Category B, and Category C.* If S's attribute reduction amount is less than S's total attributes in Category A, Category B, and Category C, all of S's attribute reduction amount will be applied to reduce such attributes. However, P may specify the allocation of S's attribute reduction amount among such attributes. An election to specify the allocation of S's attribute reduction amount is made in the manner provided in paragraph (e)(5) of this section. To the extent that P does not specify an allocation of S's attribute reduction amount, S's attribute reduction amount will be applied to reduce any Category A attributes not reduced as a result of the specific allocation of S's attribute reduction amount, from oldest to newest, until they are eliminated. Then, any remaining attribute reduction amount will be applied to reduce any Category B attributes not reduced as a result of the specific allocation of S's attribute reduction amount, from oldest to newest, until they are eliminated. Finally, any remaining attribute reduction amount will be applied to reduce any Category C attributes not reduced as a result of the specific allocation of S's attribute reduction amount, proportionately.

(*2*) *Attribute reduction amount not less than the total attributes in Category A, Category B, and Category C.* If S's attribute reduction amount equals or exceeds S's total attributes in Category A, Category B, and Category C, all such attributes are eliminated and any remaining attribute reduction amount is allocated and applied as provided in paragraphs (d)(4)(ii)(B) and (d)(4)(ii)(C) of this section.

(B) *Category D attributes.* Any attribute reduction amount not applied to reduce S's Category A, Category B, and Category C attributes is allocated and applied as provided in this paragraph (d)(4)(ii)(B) and, to the extent applicable, paragraph (d)(5) of this section.

(*1*) *Allocation if S holds stock of another subsidiary.* If S holds shares of stock of another subsidiary, the attribute reduction amount not applied to reduce S's Category A, Category B, and Category C attributes is first allocated between S's shares of lower-tier subsidiary stock and S's other Category D assets in the manner provided in paragraph (d)(5)(ii) of this section. S's attribute reduction amount allocated to shares of lower-tier subsidiary stock is applied to reduce S's bases in those shares, becomes an attribute reduction amount of the lower-tier subsidiary, and, subject to certain limitations, reduces the lower-tier subsidiary's attributes. See paragraphs (d)(5)(iii) through (d)(5)(vi) of this section.

(*2*) *Allocation and application of attribute reduction amount not applied to lower-tier subsidiary stock.* Any portion of S's attribute reduction amount not applied to reduce S's Category A, Category B, and Category C attributes and not allocated to lower-tier subsidiary stock is allocated to S's Category D assets other than lower-tier subsidiary stock in the manner provided in this paragraph (d)(4)(ii)(B)(*2*). Such amount is first allocated to S's bases (if any) in its assets identified as Class VII assets in §1.338–6(b)(2)(vii). If the attribute reduction amount allocated to Class VII assets is less than S's aggregate basis in those assets, it is applied proportionately (by basis) to reduce the bases of such assets. If the attribute reduction amount allocated to Class VII assets equals or exceeds S's aggregate basis in those assets, it is applied to reduce the bases of such assets to zero. Any remaining attribute reduction amount is then allocated and applied in the same manner to reduce S's bases (if any) in assets identified as Class VI assets in §1.338–6(b)(2)(vi), and then to reduce S's bases (if any) in its assets identified in §1.338–6(b)(2) as Class V, Class IV, Class III, and Class II, successively.

(C) *Attribute reduction amount exceeding attributes available for reduction.* If the amount to be allocated and applied to attributes in Category D other than lower-tier subsidiary stock exceeds the amount of attributes in that category, then—

(*1*) To the extent of any liabilities of S that are not taken into account for tax purposes before the transfer, such excess amount is suspended. The suspended amount is applied proportionately to reduce any amounts attributable to S that would be deductible or capitalizable as a result of such liabilities being taken into account by S or any other person. Solely for purposes of this paragraph (d)(4)(ii)(C)(*1*) and paragraph (d)(5)(ii)(B) of this section, the term *liability* means any liability or obligation the satisfaction of which would be required to be capitalized as an assumed liability by a person that purchased all of S's assets and assumed all of S's liabilities in a single transaction.

(*2*) To the extent such excess amount is greater than any amount suspended under paragraph (d)(4)(ii)(C)(*1*) of this section, it is disregarded and has no further effect.

(iii) *Time and effect of attribute reduction.* In general, the reduction of attributes is effective immediately before the transfer of a loss share of S stock. If the reduction to a member's basis in a share of lower-tier subsidiary stock exceeds the basis of that share, to the extent the excess is not restored under paragraph (d)(5)(vi) of this section it is an excess loss account in that share (and such excess loss account is not taken into account under §1.1502–19 or otherwise as a result of the transaction). The reductions to attributes required under this paragraph (d)(4), including by reason of paragraph (d)(5)(v) of this section (tier down of attribute reduction amounts to lower-tier subsidiaries), are not noncapital, nondeductible expenses described in §1.1502–32(b)(2)(iii).

(5) *Special rules applicable if S holds stock of another subsidiary.* If S holds

shares of stock of any other subsidiary (S1) as of a transfer of loss shares of S stock, the rules of this paragraph (d)(5) apply with respect to each such subsidiary.

(i) *Treatment of lower-tier subsidiary stock for computation of S's attribute reduction amount.* For purposes of determining S's net inside attribute amount and attribute reduction amount under paragraph (d)(3) of this section—

(A) *Single share.* All of S's shares of S1 stock held as of the transfer of S stock (whether or not transferred in, or held by S immediately after, the transaction) are treated as a single share of stock (generally referred to as the S1 stock); and

(B) *Deemed basis.* S's basis in its S1 stock is treated as its *deemed basis* in the stock, which is equal to the greater of—

(*1*) The sum of S's basis in each share of S1 stock (adjusted to reflect any gain or loss recognized on the transfer of any S1 shares in the transaction, whether allowed or disallowed); and

(*2*) The portion of S1's net inside attribute amount allocable to S's shares of S1 stock.

(C) *Multiple tiers.* For purposes of computing deemed basis under paragraph (d)(5)(i)(B) of this section, a subsidiary's basis in stock of a lower-tier subsidiary is the deemed basis in that lower-tier subsidiary stock. Thus, if stock is held in multiple tiers, the computation of deemed basis begins at the lowest tier, so that the computation of deemed basis at each tier takes into account the deemed basis of all lower-tier shares.

(ii) *Allocation of S's attribute reduction amount between lower-tier subsidiary stock and other Category D assets.* The portion of S's attribute reduction amount that is not applied to reduce S's Category A, Category B, and Category C attributes must be allocated between each of S's deemed single shares of S1 stock and all of S's other Category D assets. For this purpose, S's Category D assets other than lower-tier subsidiary stock are treated as one asset with a basis equal to the aggregate bases of all Category D assets other than lower-tier subsidiary stock (non-stock Category D asset). S's attribute reduction amount is allocated proportionately (by basis) between (among) the non-stock Category D asset and S's deemed single share(s) of subsidiary stock. (See paragraphs (d)(4)(ii)(B)(*2*) and (d)(4)(ii)(C) of this section regarding the portion of S's attribute reduction amount allocated to the Category D assets other than lower-tier subsidiary stock.) For allocation purposes, S's basis in each deemed single share of S1 stock is its deemed basis (determined under paragraphs (d)(5)(i)(B) and (d)(5)(i)(C) of this section), reduced by—

(A) The value of S's transferred shares of S1 stock; and

(B) The nontransferred S1 shares' allocable portion of the excess of S1's non-loss assets over S1's liabilities (including liabilities described in paragraph (d)(4)(ii)(C)(*1*) of this section). For this purpose, S1's non-loss assets are—

(*1*) S1's assets identified as Class I assets in §1.338–6(b)(1),

(*2*) The value of S1's transferred shares of lower-tier subsidiary stock, and

(*3*) The nontransferred lower-tier subsidiary shares' allocable portions of lower-tier non-loss assets (net of liabilities, including liabilities described in paragraph (d)(4)(ii)(C)(*1*) of this section) of all lower-tier subsidiaries.

(iii) *Application of attribute reduction amount to S's S1 stock.* The portion of S's attribute reduction amount allocated under paragraph (d)(5)(ii) of this section to each deemed single share of S1 stock (allocated attribute reduction amount) is apportioned among, and applied to reduce S's bases in, individual S1 shares in accordance with the following—

(A) No portion of the allocated attribute reduction amount is apportioned to an individual share of transferred S1 stock if gain or loss is recognized on its transfer (recognition transfer);

(B) The allocated attribute reduction amount is apportioned among all of S's other shares of S1 stock in a manner that, first reduces the loss in and disparity among S's bases in loss shares of S1 preferred stock to the greatest extent possible, and then reduces the disparity among S's bases in the shares of S1 common stock (other than those transferred in a recognition transfer) to the greatest extent possible;

(C) The allocated attribute reduction amount apportioned to an individual S1 share is applied to reduce the basis of that share to, but not below, value if the share is either a preferred share or a common share that is transferred other than in a recognition transfer; and

(D) The allocated attribute reduction amount apportioned to an individual S1 share is applied to reduce the basis of that share without regard to value if the share is a common share that is not transferred in the transaction.

(iv) *Unapplied allocated attribute reduction amount.* Any portion of the allocated attribute reduction amount that is not applied to reduce S's basis in a share of S1 stock has no effect on any other attributes of S, it is not a noncapital, nondeductible expense of S, and it does not cause S to recognize income or gain. However, such amounts continue to be part of the allocated attribute reduction amount for purposes of the tier down rule in paragraph (d)(5)(v) of this section.

(v) *Tier down of attribute reduction amount*—(A) *General rule.* The allocated attribute reduction amount of each deemed single share of S1 stock is an attribute reduction amount of S1 (tier-down attribute reduction amount). Accordingly, the tier-down attribute reduction amount, in combination with any attribute reduction amount computed with respect to the transferred S1 shares (if any) (direct S1 attribute reduction amount), applies to reduce S1's attributes under the provisions of this paragraph (d). The tier-down attribute reduction amount is an attribute reduction amount of S1 that must be allocated to S1's assets, and may become an allocated attribute reduction amount of lower-tier subsidiary stock (and thus a tier-down attribute reduction amount of a lower-tier subsidiary), even if its application to S1's attributes is limited under paragraph (d)(5)(v)(B) of this section.

(B) *Conforming limitation on reduction of lower-tier subsidiary's attributes.* Notwithstanding the general rule in paragraph (d)(5)(v)(A) of this section, and unless P elects otherwise in the manner provided in paragraph (e)(5) of this section, the application of S1's tier-down attribute reduction amount to S1's attributes is limited to an amount equal to the excess of the portion of S1's net inside attribute amount that is allocable to all S1 shares held by members as of the transaction (whether or not transferred in the transaction) over the sum of—

(*1*) Any direct S1 attribute reduction amount;

(*2*) The aggregate value of all S1 shares transferred by members in the transaction with respect to which gain or loss was recognized (recognition transfer);

(*3*) The sum of all members' bases (after any reduction under this section, including this paragraph (d)) in any shares of S1 stock transferred by members in the transaction (other than in a recognition transfer), reduced by any direct S1 attribute reduction amount computed with respect to the transfer of such S1 shares; and

(*4*) The sum of all members' bases (after any reduction under this section, including this paragraph (d)) in any nontransferred shares of S1 stock held as of the transaction.

(vi) *Stock basis restoration*—(A) *In general.* After paragraph (d)(5)(v) of this section has applied with respect to all shares of subsidiary stock transferred in the transaction, lower-tier subsidiary stock basis is restored under this paragraph (d)(5)(vi). Under this paragraph (d)(5)(vi), the reductions to members' bases in shares of lower-tier subsidiary stock under paragraph (d)(5)(iii) of this section are reversed to the extent necessary to restore such bases to an amount that conforms the basis of each such share to its allocable portion of the subsidiary's net inside attribute amount, taking into account any reductions under this paragraph (d). Restoration adjustments are first made at the lowest tier and then at each next higher tier successively. Restoration adjustments do not tier up to affect the bases of higher-tier shares. Rather, restoration is computed and applied separately at each tier. For purposes of this rule, when computing a subsidiary's net inside attribute amount—

(*1*) The subsidiary's basis in stock of a lower-tier subsidiary is the actual basis of the stock after application of this paragraph (d); and

(*2*) Any attribute reduction amount allocated to the subsidiary's Category D assets other than lower-tier subsidiary stock that is suspended under paragraph (d)(4)(ii)(C)(*1*) of this section is treated as reducing the subsidiary's net inside attribute amount.

(B) *Election not to restore basis.* Notwithstanding paragraph (d)(5)(vi)(A) of this section, P may elect not to restore basis in stock of a lower-tier subsidiary that was reduced under paragraph (d)(5)(iii) of this section. An election not to restore lower-tier subsidiary stock basis is made in the manner provided in paragraph (e)(5) of this section.

(6) *Elections to reduce the potential for loss duplication*—(i) *In general.* Notwithstanding the general operation of this paragraph (d), P may elect to reduce the potential for loss duplication, and thereby reduce or avoid attribute reduction. To the extent of S's attribute reduction amount tentatively computed without regard to any election under this paragraph (d)(6), P may elect—

(A) To reduce all or any portion (including any portion in excess of a specified amount) of members' bases in transferred loss shares of S stock;

(B) To reattribute all or any portion (including any portion in excess of a specified amount) of S's Category A, Category B, and Category C attributes (including such attributes of lower-tier subsidiaries), to the extent they would otherwise be subject to reduction under this paragraph (d); or

(C) Any combination thereof.

(ii) *Manner and effect of election.* An election to reduce loss duplication under this paragraph (d)(6) is made in the manner provided in paragraph (e)(5) of this section. Although such elections are irrevocable, they have no effect—

(A) If there is no attribute reduction amount; or

(B) To the extent S's attribute reduction amount is less than the amount specified in the election.

(iii) *Order of application*—(A) *Stock of one subsidiary transferred in the transaction.* If shares of stock of only one subsidiary are transferred in the transaction, any stock basis reduction and reattribution of attributes (including from lower-tier subsidiaries) is deemed to occur immediately before the application of this paragraph (d). If a transferred share is still a loss share after giving effect to this election, the other provisions of this paragraph (d) then apply with respect to that share.

(B) *Stock of multiple subsidiaries transferred in the transaction.* If shares of stock of more than one subsidiary are transferred in the transaction and elections under this paragraph (d)(6) are made with respect to transfers of stock of subsidiaries in multiple tiers, effect is given to the elections from the lowest tier to the highest tier in the manner provided in this paragraph (d)(6)(iii)(B). The amount of the election for the transfer at the lowest tier is determined by applying this paragraph (d) with respect to the transferred loss shares of this lowest-tier subsidiary immediately after applying paragraphs (b) and (c) of this section to the stock of such subsidiary. The effect of any stock basis reduction or reattribution of losses immediately tiers up under §1.1502–32 to adjust members' bases in higher-tier shares. Elections and adjustments are then made with respect to transfers at each next higher tier successively.

(iv) *Special rules for reattribution elections*—(A) *In general.* Because the reattribution election is intended to provide the group a means to retain certain S attributes, and not to change the location of attributes where S continues to be a member of the same group as P, the election to reattribute attributes may only be made if S becomes a nonmember (within the meaning of §1.1502–19(c)(2)) as a result of the transaction and S does not become a member of any group that includes P. The election to reattribute S's attributes can only be made for attributes in Category A, Category B, and Category C. The attributes that would otherwise be reduced under paragraph (d)(4) of this section may be reattributed to P. Accordingly, P may specify the attributes in Category A, Category B, and Category C to be reattributed. Such an election is made in the manner provided in paragraph (e)(5) of this section. To the extent that P elects to reattribute attributes but does not specify the attributes to be reattributed, any attributes not specifically reattributed will be reattributed in the default amount, order, and category described in paragraph (d)(4)(ii)(A)(*1*) of this section. P succeeds to reattributed attributes as if such attributes were succeeded to in a transaction to which section 381(a) applies. Any owner shift of the subsidiary (including any deemed owner shift resulting from section 382(g)(4)(D) or section 382(l)(3)) in connection with the transaction is not taken into account under section 382 with respect to the reattributed attributes. (See §1.1502–96(d) for rules relating to section 382 and the reattribution of losses under this paragraph (d)(6).) The reattribution of S's attributes is a noncapital, nondeductible expense described in §1.1502–32(b)(2)(iii). See §1.1502–32(c)(1)(ii)(A) regarding special allocations applicable to such noncapital, nondeductible expense. If P elects to reattribute S attributes (including attributes of a lower-tier subsidiary) and reduce S stock basis, the reattribution is given effect before the stock basis reduction.

(B) *Insolvency limitation.* If S, or any higher-tier subsidiary, is insolvent within the meaning of section 108(d)(3) at the time of the transfer, S's losses may be reattributed only to the extent they exceed the sum of the separate insolvencies of any subsidiaries (taking into account only S and its higher-tier subsidiaries) that are insolvent. For purposes of determining insolvency, liabilities owed to higher-tier members are not taken into account, and stock of a subsidiary that is limited and preferred as to dividends and that is not owned by higher-tier members is treated as a liability to the extent of the amount of preferred distributions to which the stock would be entitled if the subsidiary were liquidated on the date of the transfer.

(C) *Limitation on reattribution from lower-tier subsidiaries.* P's ability to reattribute attributes of lower-tier subsidiaries is limited under this paragraph (d)(6)(iv)(C) in order to prevent circular computations of the attribute reduction amount. Accordingly, attributes that would otherwise be reduced as a result of tier-down attribute reduction under paragraph (d)(5)(v) of this section may only be reattributed to the extent that the reduction in the basis of any lower-tier subsidiary stock resulting from the noncapital, nondeductible expense (as allocated under §1.1502–32(c)(1)(ii)(A)(*2*)) will not create an excess loss account in any such stock.

(v) *Special rules for stock basis reduction elections*—(A) *In general.* An election to reduce basis in S stock is made with respect to all members' bases in loss shares of S stock that are transferred in the transaction. The reduction is allocated among all such shares in proportion to the amount of loss on each share. This reduction in S stock basis is a noncapital, nondeductible expense described in §1.1502–32(b)(2)(iii) of the transferring member.

(B) *Adjustment to the attribute reduction amount.* The attribute reduction amount (determined under paragraph (d)(3)(i) of this section) is treated as reduced by the amount of any elective reduction in the basis of the S stock under this paragraph (d)(6). Accordingly, the election to reduce stock basis under this paragraph (d)(6) is treated as reducing or eliminating the duplication even if the shares of S stock are loss shares after giving effect to the election.

(C) *Deemed stock basis reduction election in the case of certain disallowed stock losses.* If there is a net stock loss in transferred shares after taking into account any actual elections under this paragraph (d)(6), and the stock loss would otherwise be permanently disallowed (for example, under section 311(a)), P will be deemed to have made a stock basis reduction election equal to such net stock loss.

(7) *Additional attribute reduction in the case of certain transfers due to worthlessness and certain transfers not followed by a separate return year*—(i) *In general.* Notwithstanding any other provision of this paragraph (d), if a transfer is subject to this paragraph (d)(7) any of S's Category A, Category B, and Category C attributes not otherwise reduced or reattributed under this paragraph (d), and any credit carryover attributable to S, including any consolidated credits that would be apportioned to S under the principles of §1.1502–79 if S

had a separate return year, are eliminated. Attributes other than consolidated tax attributes are eliminated under this paragraph (d)(7)(i) immediately before the transfer subject to this paragraph (d)(7)(i). The elimination of attributes under this paragraph (d)(7)(i) is not a noncapital, nondeductible expense described in § 1.1502–32(b)(2)(iii).

(ii) *Transfers subject to this paragraph (d)(7).* A transfer is subject to this paragraph (d)(7) if—

(A) M transfers a share of S stock solely by reason of a transfer defined in paragraph (f)(10)(i)(D) of this section (worthlessness where the provisions of § 1.1502–80(c) are satisfied), M recognizes a net deduction or loss on the share, and S is a member of the group on the day following the last day of the group's taxable year during which the share becomes worthless under section 165 (taking into account the provisions of § 1.1502–80(c)), or

(B) M recognizes a net deduction or loss on the stock of S in a transaction in which S ceases to be a member and does not become a nonmember within the meaning of § 1.1502–19(c)(2).

(iii) *Example.* The application of this paragraph (d) to transfers due to worthlessness and to loss transfers not followed by separate return years is illustrated by the following example.

Example. (i) *Worthlessness where S continues as a member.* M owns the sole share of S stock. The share is worthless under section 165. In addition, S has disposed of all its assets within the meaning of § 1.1502–19(c)(1)(iii)(A) and therefore satisfies the provisions of § 1.1502–80(c). M claims a worthless securities deduction with respect to the share. The worthlessness is a transfer of the S share, a loss share, and therefore subject to this section. After the application of paragraphs (b) and (c) of this section, M's basis in the share (and therefore M's net stock loss) is $75. The portion of the consolidated net operating loss attributable to S is $100. Under the general rules of this paragraph (d), S's attribute reduction amount is $75 (the lesser of M's $75 net stock loss and S's $100 aggregate inside loss ($100 net inside attribute amount over $0 value of S share)). S's attributes are reduced by $75, from $100 to $25. In addition, if S remains a member of the P group, this paragraph (d)(7) applies to eliminate the remaining $25 of the consolidated net operating loss attributable to S because the S share is worthless, and M recognizes a deduction (taking into account § 1.1502–80(c)) with respect to the share. Accordingly, after the application of this section, M recognizes a $75 worthless securities deduction, S has $0 net inside attributes, and the consolidated net operating loss is reduced by a total of $100.

(ii) *Dissolution of insolvent subsidiary.* The facts are the same as in paragraph (i) of this *Example,* except that S is insolvent, does not dispose of all its assets within the meaning of § 1.1502–19(c)(1)(iii)(A), M causes S to be legally dissolved, and the S share held by M is cancelled without consideration. Under paragraph (d)(7)(ii)(B) of this section, the dissolution of S is subject to this paragraph (d)(7) and the result is the same as in paragraph (i) of this *Example.* The result would also be the same if instead of being legally dissolved, S was converted into an entity that is disregarded as separate from M.

(iii) *Stock cancelled in connection with a section 381(a) transaction with another member.* M owns the sole share of S common stock with a basis of $75. M1 owns the sole share of S preferred stock. The value of S's assets (net of liabilities) is less than the liquidation preference on the S preferred stock. In a reorganization described in section 368(a)(1)(D), S transfers all of its assets to M2 in exchange for M2 common stock and M2's assumption of S's liabilities, S distributes all of the M2 common stock received in the exchange to M1 in exchange for M1's S preferred stock, the S common stock held by M is cancelled without consideration, and S ceases to exist. Notwithstanding that M is not entitled to treat its common share of S stock as worthless until § 1.1502–80(c) is satisfied, M's share is transferred within the meaning of paragraph (f)(10)(i)(A) of this section because M ceases to own the share in a transaction in which, but for this section (and notwithstanding the deferral of any amount recognized on the transfer, other than by reason of § 1.1502–13), M would recognize a loss or deduction with respect to the share. Accordingly, there is a transfer of the S common share and this section applies to the transfer. There are no adjustments under paragraphs (b) or (c) of this section because no investment adjustments have been applied to the bases of the shares. The transfer of the S common stock is subject to the general rules of this paragraph (d), but is not subject to the additional attribute reduction under this paragraph (d)(7) because the transfer was not solely by reason of worthlessness where § 1.1502–80(c) is satisfied, and S did not cease to be a member because M2 is a successor to S.

(iv) *Stock cancelled in connection with a section 381(a) transaction with a nonmember.* The facts are the same as in paragraph (iii) of this *Example,* except that the S preferred share is held by X, instead of M2 acquiring

S's assets, S merges into Y in a reorganization described in section 368(a)(1)(A), M1 receives all of the Y stock issued in the merger in exchange for M1's S preferred stock, and Y does not become a member as a result of the transaction. M treats the cancelled S common stock as worthless, and §1.1502–80(c) is satisfied because S ceases to be a member. In this case, there is a transfer of M's S common share because it becomes worthless (taking into account §1.1502–80(c)); because M ceases to own the share in a transaction in which, but for this section (and notwithstanding the deferral of any amount recognized on the transfer, other than by reason of §1.1502–13), M would recognize a loss or deduction with respect to the share; and because M and S cease to be members of the same group. The transfer of the S common stock is subject to the general rules of this paragraph (d), but is not subject to the additional attribute reduction under this paragraph (d)(7) because the transfer was not solely by reason of worthlessness where §1.1502–80(c) is satisfied and, although S did cease to be a member, S became a nonmember within the meaning of §1.1502–19(c)(2) because Y is a successor to S.

(8) *Examples*. The application of this paragraph (d) is illustrated by the following examples:

Example 1. Computation of attribute reduction amount. (i) *Transfer of all S shares*. (A) *Facts*. M owns all 100 of the outstanding shares of S stock with a basis of $2 per share. S owns land with a basis of $100, has a $120 loss carryover, and has no liabilities. Each share has a value of $1. M sells 30 of the S shares to X for $30. As a result of the sale, M and S cease to be members of the same group. Accordingly, all 100 of the S shares are transferred. See paragraphs (f)(10)(i)(A), (f)(10)(i)(B), and (f)(10)(i)(C) (with respect to the 30 S shares sold to X) of this section. M's transfer of the S shares is a transfer of loss shares and therefore subject to this section.

(B) *Application of paragraphs (b) and (c) of this section*. Although the transfer is subject to this section, there is no basis redetermination under paragraph (b) of this section because there is no disparity among M's bases in shares of S common stock and there are no shares of S preferred stock outstanding (so there can be no unrecognized gain or loss on preferred stock). See paragraph (b)(1)(ii)(A) of this section. Therefore, after the application of paragraph (b) of this section, the share is still a loss share and, as such, subject to paragraph (c) of this section. No adjustment is required under paragraph (c) of this section because the net positive adjustment is $0. See paragraph (c)(3) of this section. Thus, after the application of paragraph (c) of this section, M's transfer of the S shares is still a transfer of loss shares and, accordingly, subject to this paragraph (d).

(C) *Attribute reduction under this paragraph (d)*. Under this paragraph (d), S's attributes are reduced by S's attribute reduction amount. Paragraph (d)(3) of this section provides that S's attribute reduction amount is the lesser of the net stock loss and S's aggregate inside loss. The net stock loss is the excess of the $200 aggregate bases of the transferred shares over the $100 aggregate value of the transferred shares, or $100. S's aggregate inside loss is the excess of its $220 net inside attribute amount (the sum of the $100 basis in the land and the $120 loss carryover) over the $100 value of all outstanding S shares, or $120. The attribute reduction amount is therefore the lesser of the $100 net stock loss and the $120 aggregate inside loss, or $100. Under paragraph (d)(4) of this section, S's $100 attribute reduction amount is allocated and applied to reduce S's $120 loss carryover to $20. Under paragraph (d)(4)(iii) of this section, the reduction of the loss carryover is not a noncapital, nondeductible expense and has no effect on M's basis in the S stock.

(ii) *Transfer of less than all S shares*. (A) *Facts*. The facts are the same as in paragraph (i)(A) of this *Example 1*, except that M only sells 20 S shares to X. M's sale of the 20 S shares is a transfer of loss shares and therefore subject to this section. See paragraph (f)(10)(i)(A) and (f)(10)(i)(C) of this section. (There is no transfer of the remaining shares because S and M remain members of the same group.)

(B) *Application of paragraphs (b) and (c) of this section*. No adjustment is required under paragraph (b) or paragraph (c) of this section for the reasons set forth in paragraph (i)(B) of this *Example 1*. Thus, after the application of paragraph (c) of this section, M's transfer of the S shares is still a transfer of loss shares and, accordingly, subject to this paragraph (d).

(C) *Attribute reduction under this paragraph (d)*. Under this paragraph (d), S's attributes are reduced by S's attribute reduction amount. Paragraph (d)(3) of this section provides that S's attribute reduction amount is the lesser of the net stock loss and S's aggregate inside loss. The net stock loss is $20, the excess of the $40 aggregate bases of the transferred shares over the $20 aggregate value of the transferred shares. S's aggregate inside loss is $120, the excess of its $220 net inside attribute amount (the sum of the $100 basis in the land and the $120 loss carryover) over the $100 value of all outstanding S shares. The attribute reduction amount is therefore $20, the lesser of the $20 net stock loss and the $120 aggregate inside loss. Under paragraph (d)(4) of this section, S's $20 attribute reduction amount is allocated and applied to reduce S's $120 loss carryover to $100.

Example 2. Proportionate allocation of attribute reduction amount. (i) *Facts.* M owns the sole outstanding share of S stock with a basis of $150. S owns land with a basis of $60, a factory with a basis of $30, publicly traded property with a basis of $30 and goodwill with a basis of $30. M sells its S share for $90. M's sale of the S share is a transfer of a loss share and therefore subject to this section. See paragraphs (f)(10)(i)(A), (f)(10)(i)(B), and (f)(10)(i)(C) of this section.

(ii) *Application of paragraphs (b) and (c) of this section.* Although the transfer is subject to this section, there is no basis redetermination under paragraph (b) of this section because there is only one share of S stock outstanding (and so there can be no disparity among members' bases in common shares and there are no outstanding preferred shares with respect to which there can be unrecognized gain or loss). See paragraph (b)(1)(ii)(A) of this section. Therefore, after the application of paragraph (b) of this section, the share is still a loss share and, as such, subject to paragraph (c) of this section. No adjustment is required under paragraph (c) of this section because both the disconformity amount and the net positive adjustment are $0. See paragraph (c)(3) of this section. Thus, after the application of paragraph (c) of this section, M's sale of the S share is still a transfer of a loss share and, accordingly, subject to this paragraph (d).

(iii) *Attribute reduction under this paragraph (d).* Under paragraph (d)(3) of this section, S's attribute reduction amount is determined to be $60, the lesser of the $60 net stock loss ($150 basis over $90 value) and S's $60 aggregate inside loss (the excess of S's $150 net inside attribute amount (the $60 basis of the land, plus the $30 basis of the factory, plus the $30 basis of the publicly traded property, plus the $30 basis of the goodwill) over the $90 value of the S share). Under paragraph (d)(4)(ii)(B)(*2*) of this section, the $60 attribute reduction amount is allocated and applied to reduce S's bases in its Category D assets, S's only attributes available for reduction, as follows:

Available attributes, basis in Category D assets	Attribute amount	Allocable portion of attribute reduction amount	Adjusted attribute amount
Class VII, Goodwill	$30	$30	$0
Class V:			
Land	60	(60/90 × 60) 40	20
Factory	30	(30/90 × 60) 20	10
Total Class V	90	60	30
Class II, publicly traded property	30	0	30
Totals	150	60	90

Example 3. Attribute reduction amount less than total attributes in Category A, Category B, and Category C. (i) *No election to prescribe the allocation of S's attribute reduction amount.* (A) *Facts.* P owns the sole outstanding share of M stock with a basis of $1,000 and M owns the sole outstanding share of S stock with a basis of $210. M sells its S share to X for $100. M's sale of the S share is a transfer of a loss share and therefore subject to this section. See paragraphs (f)(10)(i)(A), (f)(10)(i)(B), and (f)(10)(i)(C) of this section. At the time of the sale, S has no liabilities and the following attributes:

Category	Attribute	Attribute amount
Category A	Capital loss carryover	$10
Category B	NOL carryover	200
Category C	Deferred deductions	40
Category D, Class V	Basis in Land	50
Total Attributes		300

(B) *Application of paragraphs (b) and (c) of this section.* Although the transfer is subject to this section, there is no basis redetermination under paragraph (b) of this section because there is only one share of S stock outstanding (and so there can be no disparity among members' bases in common shares and there are no outstanding preferred shares with respect to which there can be unrecognized gain or loss). See paragraph (b)(1)(ii)(A) of this section. Therefore, after the application of paragraph (b) of this section, the share is still a loss share and, as such, subject to paragraph (c) of this section. No adjustment is required under paragraph

(c) of this section because both the disconformity amount and the net positive adjustment are $0. See paragraph (c)(3) of this section. Thus, after the application of paragraph (c) of this section, M's transfer of the S share is still a transfer of a loss share and, accordingly, subject to this paragraph (d).

(C) *Attribute reduction under this paragraph (d).* (*1*) *Computation of attribute reduction amount.* Under paragraph (d)(3) of this section, S's attribute reduction amount is the lesser of the $110 net stock loss ($210 basis over $100 value) and S's aggregate inside loss. S's aggregate inside loss is $200 (S's $300 net inside attribute amount (the $10 capital loss carryover, plus the $200 NOL carryover, plus the $40 deferred deductions, plus the $50 basis in land) less the $100 value of all outstanding S shares). Thus, the attribute reduction amount is $110, the lesser of the $110 net stock loss and S's $200 aggregate inside loss. Under paragraph (d)(4)(ii)(A)(*1*) of this section, the $110 attribute reduction amount is allocated and applied to reduce S's attributes as follows:

Category	Attribute	Attribute amount	Allocation of attribute reduction amount	Adjusted attribute amount
Category A	Capital loss carryover	$10	$10	$0
Category B	NOL carryover	200	100	100
Category C	Deferred deductions	40	0	40
Category D, Class V	Basis in land	50	0	50
Totals		300	110	190

(ii) *Election to prescribe the allocation of attribute reduction amount.* (A) *Facts.* The facts are the same as in paragraph (i)(A) of this *Example 3,* except that P elects to allocate the attribute reduction amount to eliminate the Category C attributes, preserve the capital loss carryover, and reduce Category B attributes.

(B) *Application of paragraphs (b) and (c) of this section.* No adjustment is required under paragraph (b) or paragraph (c) of this section for the reasons set forth in paragraph (i)(B) of this *Example 3.* Thus, after the application of paragraph (c) of this section, M's sale of the S share is still a transfer of a loss share, and accordingly, subject to this paragraph (d).

(C) *Attribute reduction under this paragraph (d).* For the reasons set forth in paragraph (i)(C) of this *Example 3,* under this paragraph (d)(3), S's attribute reduction amount is determined to be $110. M elects to apply S's $110 attribute reduction amount as follows:

Category	Attribute	Attribute amount	Allocation of attribute reduction amount	Adjusted attribute amount
Category A	Capital loss carryover	$10	$0	$10
Category B	NOL carryover	200	70	130
Category C	Deferred deductions	40	40	0
Category D, Class V	Basis of land	50	0	50
Totals		300	110	190

Example 4. Attributes attributable to liability not taken into account. (i) *S operates one business.* (A) *Facts.* On January 1, year 1, M forms S by exchanging $150 for the sole outstanding share of S stock. In year 1, S earns $500, purchases land for $50, spends $100 to build a factory on that land, and then purchases publicly traded property for $250. In year 2, S earns a section 38 general business credit of $50. However, pollution generated by S's business gives rise to an environmental remediation liability under Federal law that would be required to be capitalized if a person purchased S's assets and assumed the liability. Before any amounts have been taken into account with respect to the environmental remediation liability, when the liability has a present value of $500, M sells its S share to X for $150. After giving effect to all other provisions of law, M's basis in the S share is $650 (the original basis of $150 increased under §1.1502–32 by $500 for the income earned). The sale is therefore a transfer of a loss share of subsidiary stock and subject to this section. See paragraphs (f)(10)(i)(A), (f)(10)(i)(B), and (f)(10)(i)(C) of this section.

(B) *Application of paragraphs (b) and (c) of this section.* Although the transfer is subject to this section, there is no basis redetermination under paragraph (b) of this section because there is only one share of S stock outstanding (and so there can be no disparity among members' bases in common shares and there are no outstanding preferred shares with respect to which there can be unrecognized gain or loss). See paragraph (b)(1)(ii)(A) of this section. Therefore, after the application of paragraph (b) of this section, the share is still a loss share and, as such, subject to paragraph (c) of this section. No adjustment to basis is made under paragraph (c) of this section because, although the net positive adjustment is $500, the disconformity amount is $0. See paragraph (c)(3) of this section. Thus, after the application of paragraph (c) of this section, M's sale of the S share is still a transfer of a loss share and, accordingly, subject to this paragraph (d).

(C) *Attribute reduction under this paragraph (d).* (*1*) Under paragraph (d)(3) of this section, S's attribute reduction amount is the lesser of the $500 net stock loss ($650 basis over $150 value) and the aggregate inside loss. The aggregate inside loss is $500, computed as the excess of S's $650 net inside attribute amount (the sum of S's $100 basis in the factory, $50 basis in the land, $250 basis in the publicly traded property, and $250 cash remaining after the purchases) over the $150 value of the S share. Thus, S's attribute reduction amount is $500, the lesser of the $500 net stock loss and the $500 aggregate inside loss. Under paragraph (d)(4)(ii)(B)(*2*) of this section, S's $500 attribute reduction amount is allocated and applied to reduce S's attributes as follows:

Available attributes	Attribute amount	Allocable portion of attribute reduction amount	Adjusted attribute amount
Category D:			
Class V Assets:			
Basis of factory	$100	$100	$0
Basis of land	50	50	0
Class II Assets:			
Publicly traded property	250	250	0

(*2*) The remaining $100 attribute reduction amount is not applied to S's $250 cash (Class I asset) or to S's $50 general business tax credit. Under the general rule of this paragraph (d), that remaining $100 attribute reduction amount would have no further effect on S's attributes. However, S has a $500 liability that has not been taken into account. Therefore, under paragraph (d)(4)(ii)(C)(*1*) of this section, the remaining $100 attribute reduction amount is suspended and will be allocated and applied to reduce any amounts that become deductible or capitalizable as a result of the environmental remediation liability later being taken into account. If the liability is satisfied for an amount that is less than $100, under paragraph (d)(4)(ii)(C)(*2*) of this section the remaining portion of that $100 suspended attribute reduction amount is disregarded and has no further effect.

(ii) *Lower-tier subsidiary with additional liability.* (A) *Facts.* The facts are the same as in paragraph (i)(A) of *Example 4,* except that, in addition, S exchanged $50 for the sole outstanding share of stock of S1. S1 has $50 and equipment with an aggregate basis of $0. S1 also has employee medical expense liabilities that have not been taken into account and that would be required to be capitalized if a person purchased S1's assets and assumed the liabilities. At the time of the sale, S's environmental remediation liability had a present value of $475 and S1's employee medical expenses had a present value of $25. For the reasons set forth in paragraph (i)(A) of this *Example 4,* M's sale of the S share is a transfer of a loss share and therefore subject to this section.

(B) *Application of paragraphs (b) and (c) of this section.* No adjustment is made under paragraph (b) or paragraph (c) of this section for the reasons set forth in paragraph (i)(B) of this *Example 4.* Thus, after the application of paragraph (c) of this section, M's sale of the S share is still a transfer of a loss share and, accordingly, subject to this paragraph (d).

(C) *Attribute reduction under this paragraph (d).* (*1*) *Computation of attribute reduction amount.* Under paragraph (d)(3) of this section, S's attribute reduction amount is the lesser of the $500 net stock loss ($650 basis over $150 value) and the aggregate inside loss. The aggregate inside loss is the excess of S's net inside attribute amount over the value of the S share. Under paragraphs (d)(3)(iii)(B) and (d)(5)(i)(B) of this section, S's net inside attribute amount is determined by using S's $50 deemed basis in the S1 share (the greater of S's $50 actual basis in the share and S1's $50 net inside attribute amount). Accordingly, S's net inside attribute amount is $650 (the sum of its $100 basis in the factory, $50 basis in the land, $250 basis in the publicly traded property, $200 cash, and $50 deemed basis in its S1 share). The aggregate inside loss is $500, the excess of S's $650 net inside attribute amount over the $150 value of the S share. Thus, S's attribute reduction amount is $500, the lesser of the $500 net stock loss and S's $500 aggregate inside loss.

(*2*) *Allocation, apportionment, and application of attribute reduction amount.* Under paragraphs (d)(4) and (d)(5)(ii) of this section, S's $500 attribute reduction amount is allocated proportionately (by basis) between its S1 share and its non-stock Category D asset (consisting of all S's Category D assets other than its share of S1 stock, with a basis equal to $600, the aggregate basis of S's non-stock assets). However, under paragraph (d)(5)(ii) of this section, for purposes of allocating S's attribute reduction amount between its non-stock Category D asset and the S1 share, S's $50 deemed basis in its S1 share is treated as reduced by S1's $25 net non-loss assets (its Class I asset, $50 cash over S1's liabilities (which, for this purpose include the $25 of employee medical expense liabilities not taken into account as of the transfer)). As a result, S's attribute reduction amount is allocated $480 (600/625 × 500) to S's non-stock Category D asset and $20 (25/625 × 500) to the S1 share. The $480 attribute reduction amount allocated to S's non-stock Category D asset produces the same reduction in the bases of S's assets (other than the S1 stock) as in paragraph (i)(C) of this *Example 4;* in addition, the $80 attribute reduction amount not applied to reduce S's attributes is suspended and applied to reduce any amounts that become deductible or capitalizable as a result of the environmental remediation liability later being taken into account. If the liability is satisfied for an amount that is less than $80, under paragraph (d)(4)(ii)(C)(*2*) of this section the remaining portion of that $80 suspended attribute reduction amount is disregarded and has no further effect. Because the S1 share is not transferred within the meaning of paragraph (f)(10) of this section, the allocated attribute reduction amount apportioned to the S1 share is applied fully to reduce the basis of the S1 share to $30. See paragraph (d)(5)(iii) of this section.

(D) *Tier down of S's attribute reduction amount.* The $20 portion of S's attribute reduction amount allocated to the S1 share is an attribute reduction amount of S1. Because S1 holds only cash, it has no attributes available for reduction under this paragraph (d). However, because S1 has a $25 liability not taken into account for tax purposes, paragraph (d)(4)(ii)(C)(*1*) of this section requires that $20 of the unapplied attribute reduction amount be suspended and then allocated and applied to reduce any amounts that become deductible or capitalizable as a result of the employee medical expense liabilities later being taken into account. If these liabilities are satisfied for an amount that is less than $20, under paragraph (d)(4)(ii)(C)(*2*) of this section the remaining portion of that $20 suspended attribute reduction amount is disregarded and has no further effect.

Example 5. Wholly owned lower-tier subsidiary (no lower-tier transfer). (i) *Application of conforming limitation.* (A) *Facts.* M owns the sole outstanding share of S stock with a basis of $250. S owns Asset with a basis of $100 and the only two outstanding shares of S1 stock (Share A has a basis of $40 and Share B has a basis of $60). S1 owns Asset 1 with a basis of $50. M sells its S share to P1, the common parent of another consolidated group, for $50. The sale is a transfer of a loss share and therefore subject to this section. See paragraphs (f)(10)(i)(A), (f)(10)(i)(B), and (f)(10)(i)(C) of this section.

(B) *Application of paragraphs (b) and (c) of this section.* Although the transfer is subject to this section, there is no basis redetermination under paragraph (b) of this section because there is only one share of S stock outstanding (and so there can be no disparity among members' bases in common shares and there are no outstanding preferred shares with respect to which there can be unrecognized gain or loss). See paragraph (b)(1)(ii)(A) of this section. Therefore, after the application of paragraph (b) of this section, the share is still a loss share and, as such, subject to paragraph (c) of this section. No adjustment is required under paragraph (c) of this section because, although there is a $50 disconformity amount, the net positive adjustment is $0. See paragraph (c)(3) of this section. Thus, after the application of paragraph (c) of this section, M's sale of the S share is still a transfer of a loss share and, accordingly, subject to this paragraph (d).

(C) *Attribute reduction under this paragraph (d).* (*1*) *Computation of attribute reduction amount.* Under paragraph (d)(3) of this section, S's attribute reduction amount is the lesser of M's net stock loss and S's aggregate inside loss. M's net stock loss is $200 ($250 basis over $50 value). S's aggregate inside loss is the excess of S's net inside attribute amount over the value of the S share. Under paragraphs (d)(3)(iii)(B) and (d)(5)(i)(B) of this section, S's net inside attribute amount is $200, computed as the sum of S's $100 basis in Asset and its $100 deemed basis in the deemed single share of S1 stock (computed as the greater of S's $100 aggregate basis in the S1 shares and S1's $50 basis in Asset 1). S's aggregate inside loss is therefore $150, $200 net inside attribute amount over the $50 value of the S share. Accordingly, S's attribute reduction amount is $150, the lesser of the $200 net stock loss and the $150 aggregate inside loss.

(*2*) *Allocation, apportionment, and application of S's attribute reduction amount.* Under paragraphs (d)(4) and (d)(5)(ii) of this section, S's $150 attribute reduction amount is allocated proportionately (by basis) between Asset (non-stock Category D asset) with a basis of $100, and the S1 stock (treated as a single share with a deemed basis of $100). Accordingly, $75 of the attribute reduction amount ($100/$200 × $150) is allocated to Asset and $75 of the attribute reduction amount ($100/$200 × $150) is allocated to the S1 stock. The $75 of the attribute reduction amount allocated to Asset is applied to reduce S's basis in Asset from $100 to $25. The $75 of the attribute reduction amount allocated to the S1 stock is first apportioned between the shares in a manner that reduces disparity to the greatest extent possible. Thus, of the total $75 allocated to the S1 stock, $27.50 is apportioned to Share A and $47.50 is apportioned to Share B. Because neither of the S1 shares is transferred within the meaning of paragraph (f)(10) of this section, the allocated attribute reduction amount apportioned to each of the individual S1 shares is applied fully to reduce the basis of each share to $12.50. See paragraph (d)(5)(iii) of this section. As a result, immediately after the allocation, apportionment, and application of S's attribute reduction amount, S's basis in Asset is $25 and S's basis in each of the S1 shares is $12.50.

(*3*) *Tier down of S's attribute reduction amount, application of conforming limitation.* Under paragraph (d)(5)(v)(A) of this section, the $75 portion of S's attribute reduction amount allocated to the S1 stock is an attribute reduction amount of S1 (regardless of the extent, if any, to which it is apportioned and applied to reduce the basis of any shares of S1 stock). Under the general rules of this paragraph (d), the $75 tier-down attribute reduction amount would be allocated and applied to reduce S1's basis in Asset 1 from $50 to $0. However, under paragraph (d)(5)(v)(B) of this section, S1's attributes can be reduced by only $25, the excess of the $50 portion of S1's net inside attribute amount that is allocable to all S1 shares held by members as of the transaction over $25, the aggregate amount of members' bases in nontransferred S1 shares after reduction under this paragraph (d). Thus, of S1's $75 tier-down attribute reduction amount, only $25 is applied to reduce S1's basis in Asset 1, from $50 to $25. The $50 unapplied portion of the tier-down attribute reduction amount subject to the conforming limitation has no further effect.

(ii) *Application of basis restoration rule.* (A) *Facts.* The facts are the same as in paragraph (i)(A) of this *Example 5*, except that S's basis in Share A is $15 and S's basis in Share B is $35, and S1's basis in Asset 1 is $100.

(B) *Basis redetermination and basis reduction under paragraphs (b) and (c) of this section.* No adjustment is required under paragraph (b) or paragraph (c) of this section for the reasons set forth in paragraph (i)(B) of this *Example 5*. Thus, after the application of paragraph (c) of this section, M's transfer of the S share is still a transfer of a loss share and, accordingly, subject to this paragraph (d).

(C) *Attribute reduction under this paragraph (d).* (*1*) *Computation of attribute reduction amount.* Under paragraph (d)(3) of this section, S's attribute reduction amount is the lesser of M's net stock loss and S's aggregate inside loss. M's net stock loss is $200 ($250 basis over $50 value). S's aggregate inside loss is the excess of S's net inside attribute amount over the value of the S share. Under paragraphs (d)(3)(iii)(B) and (d)(5)(i)(B) of this section, S's net inside attribute amount is $200, the sum of S's $100 basis in Asset and its $100 deemed basis in the deemed single share of S1 stock (computed as the greater of S's $50 aggregate basis in the S1 shares and S1's $100 basis in Asset 1). S's aggregate inside loss is therefore $150, $200 net inside attribute amount over the $50 value of the S share. Accordingly, S's attribute reduction amount is $150, the lesser of the $200 net stock loss and the $150 aggregate inside loss.

(*2*) *Allocation, apportionment, and application of S's attribute reduction amount.* Under paragraphs (d)(4) and (d)(5)(ii) of this section, S's $150 attribute reduction amount is allocated proportionately (by basis) between Asset (non-stock Category D asset) with a basis of $100, and the S1 stock (treated as a single share with a deemed basis of $100). Accordingly, $75 of the attribute reduction amount ($100/$200 × $150) is allocated to Asset and $75 of the attribute reduction amount ($100/$200 × $150) is allocated to the S1 stock. The $75 of the attribute reduction amount allocated to Asset is applied to reduce S's basis in Asset from $100 to $25. The $75 of the attribute reduction amount allocated to the S1 stock is first apportioned between the shares in a manner that reduces disparity to the greatest extent possible. Thus, of the total $75 allocated to the S1 stock, $27.50 is apportioned to Share A and $47.50 is apportioned to Share B. Because neither of the S1 shares is transferred within the meaning of paragraph (f)(10) of this section, the allocated attribute reduction amount apportioned to each of the individual S1 shares is applied fully to reduce the basis of each share to an excess loss account of $12.50. See paragraph (d)(5)(iii) of this section. As a result, immediately after the allocation, apportionment, and application of S's attribute reduction amount, S's basis in Asset is $25 and S's basis in each of the S1 shares is an excess loss account of $12.50.

(*3*) *Tier down of S's attribute reduction amount.* Under paragraph (d)(5)(v)(A) of this section, the $75 portion of S's attribute reduction amount allocated to S1 stock is an attribute reduction amount of S1 (regardless of the extent, if any, to which it is apportioned and applied to reduce the basis of any shares of S1 stock). Accordingly, under the general rules of this paragraph (d), the $75 tier-down attribute reduction amount is applied to reduce S1's basis in Asset 1 from $100 to $25.

(*4*) *Basis restoration*. Under paragraph (d)(5)(vi)(A) of this section, after this paragraph (d) has been applied with respect to all transfers of subsidiary stock, any reduction made to the basis of a share of lower-tier subsidiary stock under paragraph (d)(5)(iii) of this section is reversed to the extent necessary to conform the basis of that share to the share's allocable portion of the subsidiary's net inside attribute amount (after reduction). S1's net inside attribute amount after the application of this paragraph (d) is $25 and thus each of the two S1 share's allocable portion of S1's net inside attribute amount is $12.50. Accordingly, the reductions to Share A and to Share B under paragraph (d)(5)(iii) of this section are reversed to the extent necessary to restore the basis of each share to $12.50. Thus, $25 of the $27.50 of reduction to the basis of Share A, and $25 of the $47.50 of reduction to the basis of share B, is reversed, restoring the basis of each share to $12.50.

Example 6. Multiple blocks of lower-tier subsidiary stock outstanding. (i) *Excess loss account taken into account (transfer of upper-tier share causes disposition within the meaning of §1.1502–19(c)(1)(ii)(B)).* (A) *Facts.* M owns the sole outstanding share of S stock with a basis of $200. S holds all five outstanding shares of S1 common stock (Shares A, B, C, D, and E). S has an excess loss account of $20 in Share A and a positive basis of $20 in each of the other shares. The only investment adjustment applied to any S1 share was a negative $20 investment adjustment applied to Share A when it was the only outstanding share, and this amount tiered up and adjusted M's basis in the S share. S1 owns one asset with a basis of $250. M sells its S share to P1, the common parent of a consolidated group, for $20. The sale of the S share is a disposition of Share A under §1.1502–19(c)(1)(ii)(B) (S1 becomes a nonmember because it will have a separate return year as a member of the P1 group). Accordingly, under §1.1502–19(b)(1)(i) and paragraph (a)(3)(i) of this section, before the application of this section, S's excess loss account in Share A is taken into account, increasing S's basis in Share A to $0 and M's basis in its S share to $220. After giving effect to the recognition of the excess loss account, M's sale of the S share is a transfer of a loss share and therefore subject to this section. See paragraphs (f)(10)(i)(A), (f)(10)(i)(B), and (f)(10)(i)(C) of this section.

(B) *Basis redetermination and basis reduction under paragraphs (b) and (c) of this section.* Although the transfer is subject to this section, there is no basis redetermination under paragraph (b) of this section because there is only one share of S stock outstanding (and so there can be no disparity among members' bases in common shares and there are no outstanding preferred shares with respect to which there can be unrecognized gain or loss). See paragraph (b)(1)(ii)(A) of this section. Therefore, after the application of paragraph (b) of this section, the share is still a loss share and, as such, subject to paragraph (c) of this section. No adjustment is made under paragraph (c) of this section because, even though there is a disconformity amount of $140, the net positive adjustment is $0. See paragraph (c)(3) of this section. Thus, after the application of paragraph (c) of this section, M's sale of the S share remains a transfer of a loss share and, accordingly, subject to this paragraph (d).

(C) *Attribute reduction under this paragraph (d).* (*1*) *Computation of attribute reduction amount*. Under paragraph (d)(3) of this section, S's attribute reduction amount is the lesser of M's net stock loss and S's aggregate inside loss. M's net stock loss is $200 ($220 basis over $20 value). S's aggregate inside loss is the excess of S's net inside attribute amount over the value of the S share. Under paragraphs (d)(3)(iii)(B) and (d)(5)(i)(B) of this section, S's net inside attribute amount is $250, S's $250 deemed basis in the deemed single share of S1 stock (computed as the greater of S's $80 aggregate basis in the S1 shares ($0 basis in Share A plus $20 basis in each of the four other shares) and S1's $250 basis in its asset). S's aggregate inside loss is therefore $230, $250 net inside attribute amount over the $20 value of the S share. Accordingly, S's attribute reduction amount is $200, the lesser of the $200 net stock loss and the $230 aggregate inside loss.

(*2*) *Allocation, apportionment, and application of S's attribute reduction amount*. Under paragraphs (d)(4) and (d)(5)(ii) of this section, S's $200 attribute reduction amount is allocated entirely to the S1 stock (treated as a single share) and then apportioned among the shares in a manner that reduces disparity to the greatest extent possible. Thus, $24 is apportioned to Share A and $44 is apportioned to each of the other shares. Because none of the S1 shares are transferred within the meaning of paragraph (f)(10) of this section (notwithstanding that there is a disposition under §1.1502–19(c)(1)(ii)(B)), the allocated attribute reduction amount apportioned to each of the individual S1 shares is applied fully to reduce the basis of each share to an excess loss account of $24. See paragraph (d)(5)(iii) of this section.

(*3*) *Tier down of S's attribute reduction amount*. Under paragraph (d)(5)(v)(A) of this section, the $200 of S's attribute reduction amount allocated to the S1 shares is an attribute reduction amount of S1 (regardless of the extent, if any, to which it is apportioned and applied to reduce the basis of any shares of S1 stock). Under the general rules of this paragraph (d), S1's $200 tier-down attribute reduction amount is allocated and applied to reduce S1's basis in its asset from $250 to $50.

(*4*) *Basis restoration*. Under paragraph (d)(5)(vi)(A) of this section, after this paragraph (d) has been applied with respect to all transfers of subsidiary stock, any reduction made to the basis of a share of lower-tier subsidiary stock under paragraph (d)(5)(iii) of this section is reversed to the extent necessary to conform the basis of that share to the share's allocable portion of the subsidiary's net inside attribute amount (after reduction). S1's net inside attribute amount after the application of this paragraph (d) is $50 and thus each of the five S1 share's allocable portion of S1's net inside attribute amount is $10. Accordingly, the reductions to the bases of S1 shares under paragraph (d)(5)(iii) of this section are reversed to the extent necessary to restore (to the extent possible) the basis of each share to $10. Thus, $24 of the $24 of reduction to the basis of Share A is reversed, restoring the basis of Share A to $0, and $34 of the $44 of reduction to the basis of each other share is reversed, restoring the basis of each of those shares to $10.

(ii) *Sale of gain share to member*. (A) *Facts*. The facts are the same as in paragraph (i)(A) of this *Example 6*, except that M owns Shares A, B, C, and D, S owns Share E, S has a liability of $20, and S1's basis in its asset is $500. Also, as part of the transaction, S sells Share E to M for $40. Unlike under the facts of paragraph (i)(A) of this *Example 6*, there is no disposition of Share A within the meaning of §1.1502–19(c)(1)(ii)(B) (S1 continues to be a member of the group, and thus does not have a separate return year). As a result, the Share A excess loss account is not taken into account. Although S's sale of Share E is a transfer of that share, the share is not a loss share and thus the transfer is not subject to this section. M's sale of the S share, however, is a transfer of a loss share and therefore subject to this section. See paragraphs (f)(10)(i)(A), (f)(10)(i)(B), and (f)(10)(i)(C) of this section.

(B) *Transfer in lowest tier (gain share)*. S's sale of Share E is the lowest-tier transfer in the transaction. Under paragraph (a)(3)(ii)(A) of this section, because there are no transfers of loss shares at that tier, no adjustments are required under paragraph (b) or (c) of this section. However, S's gain recognized on the transfer of Share E is computed and immediately adjusts members' bases in subsidiary stock under §1.1502–32 (because M and S are not members of the same group immediately after the transaction, the sale is not an intercompany transaction subject to §1.1502–13). Accordingly, M's basis in its S share is increased by $20, from $200 to $220.

(C) *Transfers in next higher tier, application of paragraphs (b) and (c) of this section*. The next higher tier transfer is M's sale of the S stock. The sale is a transfer of a loss share and therefore subject to this section. Although the transfer is subject to this section, there is no basis redetermination under paragraph (b) of this section because there is only one share of S stock outstanding (and so there can be no disparity among members' bases in common shares and there are no outstanding preferred shares with respect to which there can be unrecognized gain or loss). See paragraph (b)(1)(ii)(A) of this section. Therefore, after the application of paragraph (b) of this section, the share is still a loss share and, as such, subject to paragraph (c) of this section. Under paragraph (c) of this section, M's basis in its S share is decreased by $20, the lesser of S's $200 disconformity amount (computed as the excess of M's $220 basis in the S stock over S's $20 net inside attribute amount (computed as the $20 basis in Share E, increased by $20 to reflect the gain recognized with respect to the share, less the $20 liability)), and the $20 net positive adjustment. Thus, after the application of paragraph (c) of this section, M's basis in the S share is $200, and the sale remains a transfer of a loss share. There are no higher tier transfers and, therefore, M's transfer of the S share is then subject to this paragraph (d).

(D) *Attribute reduction under this paragraph (d)*. (*1*) *Computation of attribute reduction amount*. Under paragraph (d)(3) of this section, S's attribute reduction amount is the lesser of M's net stock loss and S's aggregate inside loss. M's net stock loss is $180 ($200 basis over $20 value). S's aggregate inside loss is the excess of S's net inside attribute amount over the value of the S share. Under paragraphs (d)(3)(iii)(B) and (d)(5)(i)(B) of this section, S's net inside attribute amount is $80, computed as $100 (S's deemed basis in Share E (the greater of $40 (S's $20 basis in Share E, adjusted for the $20 gain recognized with respect to the share), and Share E's allocable portion of S1's net inside attribute amount of $100 (1/5 of S1's $500 basis in its asset)), less S's $20 liability. Accordingly, S's aggregate inside loss is $60 ($80 net inside attribute amount over the $20 value of the S stock). S's attribute reduction amount is therefore $60, the lesser of $180 net stock loss and $60 aggregate inside loss.

(*2*) *Allocation, apportionment, and application of S's attribute reduction amount*. Under paragraphs (d)(4) and (d)(5)(ii) of this section, S's $60 attribute reduction amount is allocated entirely to its S1 stock, Share E. However, because Share E was transferred within the meaning of paragraph (f)(10) of this section and gain was recognized on its transfer, none of the allocated amount is apportioned to, or applied to reduce the basis of Share E. See paragraph (d)(5)(iii)(A) of this section. Under paragraph (d)(5)(iv) of this section, the $60 allocated attribute reduction amount not apportioned or applied to Share E has no effect on S or S's attributes.

(*3*) *Tier down of S's attribute reduction amount*. Notwithstanding the fact that no portion of the allocated attribute reduction amount was apportioned to or applied to reduce the basis of Share E, the entire $60 allocated attribute reduction amount is an attribute reduction amount of S1. See paragraph (d)(5)(v)(A) of this section.

(*4*) *Basis restoration.* Under paragraph (d)(5)(vi)(A) of this section, after this paragraph (d) has been applied with respect to all transfers of subsidiary stock, any reduction made to the basis of a share of subsidiary stock under paragraph (d)(5)(iii) of this section is reversed to the extent necessary to conform the basis of that share to the share's allocable portion of the subsidiary's net inside attribute amount. No reduction was made to the basis of the S1 stock under paragraph (d)(5)(iii) of this section. Therefore, no stock basis is increased under the basis restoration rule in paragraph (d)(5)(vi)(A) of this section.

Example 7. Allocation of attribute reduction if lower-tier subsidiary has non-loss assets or liabilities. (i) *S1 holds cash.* (A) *Facts.* M owns the sole outstanding share of S stock with a basis of $800. S owns Asset with a basis of $400 and the sole outstanding share of S1 stock with a basis of $300. S1 holds Asset 1 with a basis of $50, and $100 cash. M sells its S share to P1, the common parent of a consolidated group, for $100. The sale is not a transfer of the S1 share because S and S1 are members of the same group following the transaction. However, the sale is a transfer of the S share, a loss share, and therefore subject to this section. See paragraphs (f)(10)(i)(A), (f)(10)(i)(B), and (f)(10)(i)(C) of this section.

(B) *Application of paragraphs (b) and (c) of this section.* Although the transfer is subject to this section, there is no basis redetermination under paragraph (b) of this section because there is only one share of S stock outstanding (and so there can be no disparity among members' bases in common shares and there are no outstanding preferred shares with respect to which there can be unrecognized gain or loss). See paragraph (b)(1)(ii)(A) of this section. Therefore, after the application of paragraph (b) of this section, the share is still a loss share and, as such, subject to the provisions of this paragraph (c). No adjustment is required under paragraph (c) of this section because, even though there is a disconformity amount of $100, the net positive adjustment is $0. See paragraph (c)(3) of this section. Thus, after the application of paragraph (c) of this section, M's sale of the S share is still a transfer of a loss share and, accordingly, subject to this paragraph (d).

(C) *Attribute reduction under this paragraph (d).* (*1*) *Computation of attribute reduction amount.* Under paragraph (d)(3) of this section, S's attribute reduction amount is the lesser of M's net stock loss and S's aggregate inside loss. M's net stock loss is $700 ($800 basis over $100 value). S's aggregate inside loss is the excess of S's net inside attribute amount over the value of the S share. Under paragraphs (d)(3)(iii)(B) and (d)(5)(i)(B) of this section, S's net inside attribute amount is $700, the sum of its $400 basis in Asset and its $300 deemed basis in the S1 share (computed as the greater of S's $300 basis in the S1 share and S1's $150 net inside attribute amount (reflecting the sum of S1's $50 basis in Asset 1 and S1's $100 cash)). Therefore, S's aggregate inside loss is $600 ($700 net inside attribute amount over the $100 value of the S stock). S's attribute reduction amount is $600, the lesser of the $700 net stock loss and the $600 aggregate inside loss.

(*2*) *Allocation, apportionment, and application of S's attribute reduction amount.* Under paragraphs (d)(4) and (d)(5)(ii) of this section, S's $600 attribute reduction amount is allocated proportionately (by basis) between S's $400 basis in Asset (non-stock Category D asset) and its deemed basis in the S1 share. However, under paragraph (d)(5)(ii) of this section, for purposes of allocating the attribute reduction amount, S's $300 deemed basis in the S1 share is treated as reduced by S1's net non-loss assets (its Class I asset, $100 cash) to $200. Thus, the $600 is allocated $400 to Asset ($400/$600 × $600) and $200 to the S1 share ($200/$600 × $600). The $400 allocated to Asset is applied to reduce S's basis in Asset from $400 to $0. Because the S1 share is not transferred within the meaning of paragraph (f)(10) of this section, the allocated attribute reduction amount apportioned to the S1 share is applied fully to reduce the basis of the S1 share to $100. See paragraph (d)(5)(iii) of this section.

(*3*) *Tier down of S's attribute reduction amount.* Under paragraph (d)(5)(v)(A) of this section, the $200 portion of S's attribute reduction amount allocated to the S1 stock is an attribute reduction amount of S1 (regardless of the extent, if any, to which it is apportioned and applied to reduce the basis of any shares of S1 stock). Under the general rules of this paragraph (d), S1's $200 tier-down attribute reduction amount is allocated and applied to reduce S1's basis in Asset 1 (S1's only attribute available for reduction) from $50 to $0. The $150 unapplied attribute reduction amount is disregarded and has no further effect.

(*4*) *Basis restoration.* Under paragraph (d)(5)(vi)(A) of this section, after this paragraph (d) has been applied with respect to all transfers of subsidiary stock, any reduction made to the basis of a share of subsidiary stock under paragraph (d)(5)(iii) of this section is reversed to the extent necessary to conform the basis of that share to the share's allocable portion of the subsidiary's net inside attribute amount. There is only one share of S1 stock outstanding and so S1's entire $100 net inside attribute amount is allocable to that share. Because S's $100 basis in the S1 share (as reduced under this paragraph (d)) is already conformed with its $100 allocable portion of S1's net inside attribute amount, there is no restoration under paragraph (d)(5)(vi)(A) of this section.

(ii) *S1 borrows cash.* The facts are the same as in paragraph (i)(A) of this *Example 7* except that, in addition, S1 borrows $50 from X immediately before M sells the S share. The computation of the attribute reduction amount is the same as in paragraph (i)(C) of this *Example 7* (the $50 cash from the loan proceeds and the $50 liability offset in the computation of S1's net inside attribute amount and so the net amount is unaffected, and the computation of S's deemed basis in the S1 stock is unaffected). Similarly, for purposes of allocating the attribute reduction amount between the non-stock Category D asset and the S1 stock, paragraph (d)(5)(ii) of this section requires S's deemed basis in the S1 share to be treated as reduced by S1's net non-loss assets (S1's non-loss assets over S1's liabilities). Accordingly, the additional $50 cash proceeds is offset by the $50 liability and there is no effect on the allocation of the attribute reduction amount. The results are the same as in paragraph (i) of this *Example 7*.

(iii) *S1 has a liability not taken into account for tax purposes.* (A) *Facts.* The facts are the same as in paragraph (ii) of this *Example 7* except that, in addition, S1 has a $40 liability that is not taken into account for tax purposes as of the transfer and that would be required to be capitalized if a person purchased S1's assets and assumed the liability.

(B) *Application of paragraphs (b) and (c) of this section.* No adjustment is required under paragraph (b) or paragraph (c) of this section for the reasons set forth in paragraph (i)(B) of this *Example 7*. Thus, after the application of paragraph (c) of this section, P's sale of the S share is still a transfer of a loss share and, accordingly, subject to this paragraph (d).

(C) *Attribute reduction under this paragraph (d).* (*1*) *Computation of attribute reduction amount.* The attribute reduction amount is the same as computed in paragraph (i)(C)(*1*) of this *Example 7* (under paragraph (f)(5) of this section, the term liability does not include liabilities not taken into account for tax purposes and so the additional $40 liability not yet taken into account for tax purposes does not affect the computation of S's attribute reduction amount).

(*2*) *Allocation, apportionment, and application of S's attribute reduction amount.* Under paragraphs (d)(4) and (d)(5)(ii) of this section, S's $600 attribute reduction amount is allocated proportionately (by basis) between S's $400 basis in Asset 1 (non-stock Category D asset) and its deemed basis in the S1 share. However, under paragraph (d)(5)(ii) of this section, for purposes of allocating the attribute reduction amount, S's $300 deemed basis in the S1 share is treated as reduced by S1's net non-loss assets (S1's non-loss assets over S1's liabilities). For this purpose, the term liabilities includes liabilities not taken into account for tax purposes, as described in paragraph (d)(4)(ii)(C)(*1*) of this section (generally, liabilities that, if assumed in a purchase, would give rise to a capitalized amount when satisfied). Thus, for this purpose, S's $300 deemed basis in the S1 share is reduced by S1's $60 net non-loss assets (the excess of S1's $150 non-loss assets (its Class I asset, $150 cash) over S1's $90 liabilities ($50 loan and $40 liability not yet taken into account for tax purposes)), to $240. Accordingly, S's $600 attribute reduction amount is allocated and applied $375 ($400/$640 × $600) to Asset (reducing S's basis in Asset from $400 to $25) and $225 ($240/$640 × $600) to the S1 share. Because the S1 share is not transferred within the meaning of paragraph (f)(10) of this section, the allocated attribute reduction amount apportioned to the S1 share is applied fully to reduce the basis of the S1 share to $75. See paragraph (d)(5)(iii) of this section.

(*3*) *Tier down of S's attribute reduction amount, application of conforming limitation.* Under paragraph (d)(5)(v)(A) of this section, the $225 portion of S's attribute reduction amount allocated to the S1 stock is an attribute reduction amount of S1 (regardless of the extent, if any, to which it is apportioned and applied to reduce the basis of any shares of S1 stock). Under the general rules of this paragraph (d), S1's $225 tier-down attribute reduction amount would be allocated and applied to reduce S1's attributes. However, under paragraph (d)(5)(v)(B) of this section, S1's attributes can be reduced by only $75, the excess of the $150 portion of S1's net inside attribute amount that is allocable to all S1 shares held by members as of the transaction over $75, the aggregate amount of members' bases in nontransferred S1 shares, after reduction under this paragraph (d). Thus, of S1's $225 tier-down attribute reduction amount, $50 is applied to reduce S1's basis in Asset 1, from $50 to $0. Although the $25 unapplied attribute reduction amount not subject to the conforming limitation would generally be disregarded without further effect, because S1 has a $40 liability not taken into account for tax purposes, paragraph (d)(4)(ii)(C)(*1*) of this section requires that the $25 of the unapplied attribute reduction amount not subject to the conforming limitation be suspended and then allocated and applied to reduce any amounts that become deductible or capitalizable as a result of that liability later being taken into account. If the liability is satisfied for an amount that is less than $25, under paragraph (d)(4)(ii)(C)(*2*) of this section the remaining portion of that $25 suspended attribute reduction amount is disregarded and has no further effect. The $150 unapplied portion of the tier-down attribute reduction amount subject to the conforming limitation has no further effect.

(*4*) *Basis restoration*. Under paragraph (d)(5)(vi)(A) of this section, after this paragraph (d) has been applied with respect to all transfers of subsidiary stock, any reduction made to the basis of a share of lower-tier subsidiary stock under paragraph (d)(5)(iii) of this section is reversed to the extent necessary to conform the basis of that share to the share's allocable portion of the subsidiary's net inside attribute amount. Paragraph (d)(5)(vi)(A) provides that, for this purpose, S1's net inside attribute amount is its net inside attribute amount, taking into account any reductions under this paragraph (d) and treating it as reduced by any attribute reduction amount suspended under paragraph (d)(4)(ii)(C)(*1*) of this section. Because S's $75 basis in its S1 stock (after application of this paragraph (d)) is already conformed with its $75 allocable portion of S1's net inside attribute amount ($100 net inside attributes after reduction, reduced by S1's $25 suspended attribute reduction amount), there is no restoration under paragraph (d)(5)(vi)(A) of this section.

Example 8. Election to reduce stock basis or reattribute attributes under paragraph (d)(6) of this section. (i) *Deconsolidating sale*. (A) *Facts*. P owns the sole outstanding share of M stock with a basis of $1,000. M owns all 100 outstanding shares of S stock with a basis of $2.10 per share ($210 total). M sells all its S shares to X for $1 per share ($100 total). M's sale of the S shares is a transfer of loss shares and therefore subject to this section. See paragraphs (f)(10)(i)(A), (f)(10)(i)(B), and (f)(10)(i)(C) of this section. At the time of the sale, S has no liabilities and the following:

Category	Attribute	Attribute amount
Category A	Capital loss carryover	$10
Category B	NOL carryover	90
Category C	Deferred deduction	40
Total Category A, Category B, and Category C Attributes	140.	
Category D, Class V	Basis in land	70
Total Attributes	210.	

(B) *Application of paragraphs (b) and (c) of this section*. Although the transfer is subject to this section, there is no basis redetermination under paragraph (b) of this section because there is no disparity among M's bases in shares of S common stock and there are no shares of S preferred stock outstanding (so there can be no unrecognized gain or loss with respect to preferred shares). See paragraph (b)(1)(ii)(A) of this section. No adjustment is required under paragraph (c) of this section because both the disconformity amount and the net positive adjustment are $0. See paragraph (c)(3) of this section. Thus, after the application of paragraph (c) of this section, M's transfer of the S shares is still a transfer of loss shares and, accordingly, subject to this paragraph (d).

(C) *Attribute reduction under this paragraph (d)*. (*1*) *Computation of attribute reduction amount*. Under paragraph (d)(3) of this section, S's attribute reduction amount is the lesser of the $110 net stock loss ($210 aggregate basis over the $100 aggregate value) and S's aggregate inside loss. S's aggregate inside loss is $110 (S's $210 net inside attribute amount (the $10 capital loss carryover, plus the $90 NOL carryover, plus the $40 deferred deduction, plus the $70 basis in the land) over the $100 value of all outstanding S shares). S's attribute reduction amount is $110, the lesser of the $110 net stock loss and the $110 aggregate inside loss.

(*2*) *Application of attribute reduction amount*. (*i*) S's $110 attribute reduction amount is applied as follows:

Category	Attribute	Attribute amount	Allocation of attribute reduction amount	Adjusted attribute amount
Category A	Capital loss carryover	$10	$10	$0
Category B	NOL carryover	90	90	0
Category C	Deferred deduction	40	10	30
Category D, Class V	Basis in land	70	0	70
Totals	210	110	100	

(*ii*) Alternatively, under paragraph (d)(4)(ii)(A)(*1*) of this section, P could specify the allocation of S's $110 attribute reduction amount among S's $10 capital loss carryover, S's $90 NOL carryover, and S's $40 deferred deduction.

(D) *Results.* The P group recognizes a $110 loss on M's sale of the S shares that is absorbed by the group, which reduces P's basis in the M share under § 1.1502–32 from $1,000 to $890. Immediately after the transaction, the entities own the following:

Entity	Asset	Basis
P	M share	$890
X	100 S shares	100
S	Category C, deferred deduction	30
	Category D, Class V Asset (land)	70

(E) *Election to reduce stock basis.* The facts are the same as in paragraph (i)(A) of this *Example 8* except that P elects under paragraph (d)(6) of this section to reduce M's basis in the S shares by the full attribute reduction amount of $110, in lieu of S reducing its attributes. The election is effective for all transferred loss shares and is allocated to those shares in proportion to the loss in each. See paragraph (d)(6)(v)(A) of this section. Accordingly, the basis of each of the 100 transferred shares is reduced from $2.10 to $1.00. After giving effect to the election, the S shares are not loss shares and this section has no further application to the transfer. The $110 reduction in M's basis in the S shares pursuant to the election under paragraph (d)(6) of this section is a noncapital, nondeductible expense of M that will reduce P's basis in the M share. See paragraph (d)(6)(v)(A) of this section. Immediately after the transaction, the entities own the following:

Entity	Asset	Basis/ attribute
P	M share	$890
X	100 S shares	100
S	Category A, capital loss carryover	10
	Category B, NOL carryover	90
	Category C, deferred deduction	40
	Category D, Class V Asset (land)	70

(F) *Election to reattribute losses.* The facts are the same as in paragraph (i)(A) of this *Example 8* except that P elects under paragraph (d)(6) of this section to reattribute S's attributes. S's attribute reduction amount is $110, and P can reattribute all or any portion of the attributes in Category A, Category B, and Category C to the extent of $110. P elects to reattribute the $90 NOL, and, as a result, S's NOL is $0. Under paragraph (d)(6)(iv)(A) of this section, the reattribution of the $90 NOL is a noncapital, nondeductible expense of S. Under § 1.1502–32(c)(1)(ii)(A)(*1*) this $90 expense is allocated to the transferred loss shares of S stock in proportion to the loss in the shares, or $.90 per share. Further, this expense tiers up under § 1.1502–32 and reduces P's basis in the M stock by $90. After giving effect to the election, the P group would recognize a $20 loss on M's sale of the S shares, S would have an aggregate inside loss of $20 (S's $120 net inside attribute amount (the $10 capital loss carryover, plus the $40 deferred deduction, plus the $70 basis in the land) over the $100 value of all outstanding S shares), and S's attribute reduction amount would be $20 (applied $10 to the $10 capital loss carryover and $10 to the $40 deferred deduction). (Alternatively, under paragraph (d)(4)(ii)(A)(*1*) of this section, P could specify the allocation of S's $20 attribute reduction amount between S's $10 capital loss carryover and S's $40 deferred deduction. Further, P could elect to reduce M's remaining basis in the S shares by any amount up to the $20 attribute reduction amount, thereby reducing or eliminating S's attribute reduction amount.)

(ii) *Nondeconsolidating sale.* (A) *Facts.* The facts are the same as in paragraph (i)(A) of this *Example 8*, except that M only sells 20 S shares ($20 total).

(B) *Application of paragraphs (b) and (c) of this section.* No adjustment is required under paragraph (b) or paragraph (c) of this section for the reasons set forth in paragraph (i)(B) of this *Example 8*. Thus, after the application of paragraph (c) of this section, M's sale of the S shares is still a transfer of loss shares and, accordingly, subject to this paragraph (d).

(C) *Attribute reduction under this paragraph (d).* (*1*) *Computation of attribute reduction amount.* Under paragraph (d)(3) of this section, S's attribute reduction amount is the lesser of the $22 net stock loss ($42 aggregate basis over $20 aggregate value) and S's $110 aggregate inside loss (as calculated in paragraph (i)(C)(*1*) of this *Example 8*). S's attribute reduction amount is $22, the lesser of the $22 net stock loss and the $110 aggregate inside loss.

(*2*) *Application of attribute reduction amount.* (*i*) S's $22 attribute reduction amount is applied as follows:

Category	Attribute	Attribute amount	Allocation of attribute reduction amount	Adjusted attribute amount
Category A	Capital loss carryover	$10	$10	$0
Category B	NOL carryover	90	12	78
Category C	Deferred deduction	40	0	40

Category	Attribute	Attribute amount	Allocation of attribute reduction amount	Adjusted attribute amount
Category D, Class V	Land	70	0	70

(*ii*) Alternatively, under paragraph (d)(4)(ii)(A)(*1*) of this section, P could specify the allocation of S's $22 attribute reduction amount among S's $10 capital loss carryover, S's $90 NOL carryover, and S's $40 deferred deduction.

(D) *Results*. The P group recognizes a $22 loss on M's sale of the S shares that is absorbed by the group, which reduces P's basis in the M share under § 1.1502–32 from $1,000 to $978. Immediately after the transaction, the entities have the following:

Entity	Asset	Basis
P	M share	$978
X	20 S shares	20
S	Category B, NOL carryover	78
	Category C, deferred deduction	40
	Category D, Class V Asset (land)	70

(E) *Election to reduce stock basis*. The facts are the same as in paragraph (ii)(A) of this *Example 8*, except that P elects under paragraph (d)(6) of this section to reduce M's basis in the S shares by the full attribute reduction amount of $22, in lieu of S reducing its attributes. The election is effective for all transferred loss shares and is allocated to such shares in proportion to the loss in each share. See paragraph (d)(6)(v)(A) of this section. Accordingly, the basis of each of the 20 transferred shares is reduced from $2.10 to $1.00. After giving effect to the election, the transferred S shares are not loss shares and this section has no further application to the transfer. The $22 reduction in M's basis in the S shares pursuant to the election under paragraph (d)(6) of this section is a noncapital, nondeductible expense of M that will reduce P's basis in the M share. See paragraph (d)(6)(v)(A) of this section. Immediately after the transaction, the entities have the following:

Entity	Asset	Basis/ attribute
P	M share	$978
M	80 S shares	168
X	20 S shares	20
S	Category A, capital loss carryover	10
	Category B, NOL	90
	Category C, deferred deduction	40
	Category D Class V Asset (land)	70

(F) *Election to reattribute attributes*. The facts are the same as in paragraph (ii)(A) of this *Example 8*. Because S remains a member of the same group as P following M's sale of S stock, P cannot elect under paragraph (d)(6) of this section to reattribute any portion of S's attributes in lieu of attribute reduction.

Example 9. Transfers at multiple tiers, gain and loss shares. (i) *Facts*. M owns the sole outstanding share of S stock with a basis of $700. S owns Asset 1 (basis of $170) and all ten outstanding shares of S1 common stock ($170 basis in share 1, $10 basis in share 2, and $15 basis in each of share 3 through share 10). S1 owns the sole outstanding share of S2 ($0 basis), the sole outstanding share of S3 ($60 basis), and the sole outstanding share of S4 ($100 basis). S2's sole asset is Asset 2 ($75 basis). S3's sole asset is Asset 3 ($75 basis). S4's sole asset is Asset 4 ($80 basis). In one transaction, M sells its S share to P1 (the common parent of a consolidated group) for $240, S sells S1 share 1 to X for $20, S contributes S1 share 2 to a partnership in a section 721 transaction, and S1 sells its S2 share to Y for $50. M's sale of the S share and S1's sale of the S2 share are transfers under paragraphs (f)(10)(i)(A), (f)(10)(i)(B), and (f)(10)(i)(C) of this section. S's sale of S1 share 1 to X is a transfer under paragraphs (f)(10)(i)(A) and (f)(10)(i)(C) of this section. S's contribution of S1 share 2 to the partnership is a transfer under paragraph (f)(10)(i)(C) of this section.

(ii) *Transfer in lowest tier (gain share)*. However, S1's gain recognized on the transfer of the S2 share is computed and immediately adjusts members' bases in subsidiary stock under § 1.1502–32. Under paragraph (a)(3)(ii)(A) of this section, because there are no transfers of loss shares at that tier, no adjustments are required under paragraph (b) or (c) of this section. However, S1's gain recognized on the transfer of the S2 share is computed and immediately adjusts members bases in subsidiary stock under § 1.1502–32. Accordingly, $5 is allocated to each of 10 S1 shares, increasing the basis of share 1 to $175, the basis of share 2 to $15, and the basis of each other share to $20. The $50 applied to S's bases in the S1 shares then tiers up to increase P's basis in the S share from $700 to $750.

(iii) *Transfers in next highest tier (loss share)*. S's sale of the S1 share 1 and S's transfer of the S1 share 2 to a partnership are both transfers of stock in the next higher tier. However, only the S1 share 1 is a loss share and so this section only applies with respect to the transfer of that share.

(A) *Basis redetermination under paragraph (b) of this section*. Under paragraph (b)(2)(i)(A) of this section, members' bases in S1 shares are redetermined by first removing the positive investment adjustments applied to the bases of transferred loss common shares. Accordingly, the $5 positive investment adjustment applied to the basis of S1 share 1 is removed, reducing the basis of S1 share 1 from $175 to $170. Because there were no negative adjustments applied to the bases of S1 shares, there are no negative adjustments that can be reallocated to further reduce the basis of S1 share 1 under paragraph (b)(2)(i)(B) of this section. Finally, under paragraph (b)(2)(ii)(B) of this section, the $5 positive investment adjustment removed from S1 share 1 is reallocated and applied to increase the bases of other S1 common shares in a manner that reduces disparity to the greatest extent possible. Accordingly, the entire $5 investment adjustment removed from S1 share 1 is reallocated and applied to increase the basis of S1 share 2, from $15 to $20. After basis is redetermined under paragraph (b) of this section, the S1 share 1 is still a loss share and therefore subject to basis reduction under paragraph (c) of this section. (Because the S1 share 2 is not a loss share, this section does not apply with respect to the transfer of that share.)

(B) *Basis reduction under paragraph (c) of this section.* No adjustment is required to the basis of S1 share 1 under paragraph (c) of this section. The S1 share 1 has a disconformity amount of $149. This $149 disconformity amount is computed as the excess of the $170 basis in the S1 share 1 over the S1 share 1's $21 allocable portion (1/10) of S1's $210 net inside attribute amount. S1's $210 net inside attribute amount is determined under paragraph (c)(5) of this section as the sum of $50 (S1's $0 basis in the S2 share, adjusted for the $50 gain recognized with respect to that share), S1's $60 basis in the S3 stock, and S1's $100 basis in the S4 stock. (In computing the disconformity amount, the basis of the S2 share is not treated as tentatively reduced because that share is transferred in the transaction, and the bases of the S3 and S4 shares are not treated as tentatively reduced because no positive investment adjustments were applied to the bases of those shares.) However, the S1 share 1's net positive adjustment is $0 because the $5 positive investment adjustment originally allocated to S1 share 1 was reallocated to S1 share 2 under paragraph (b) of this section. See paragraph (c)(3) of this section. No adjustment is required to the basis of S1 share 2 under paragraph (c) of this section because S1 share 2 is not a loss share.

(C) *Computation of loss, adjustments to stock basis.* S recognizes a loss of $150 on the sale of the S1 share 1 ($170 basis over $20 amount realized) that is absorbed by the group. Under §1.1502–32, M's basis in its S share is therefore decreased by $100, the net of the $150 loss recognized by S on the sale of the S1 share, and the $50 gain that tiered up from S1 (as a result of S1's sale of the S2 share). Following these adjustments, M's basis in the S share is $600 and the sale of the S share is still a transfer of a loss share.

(iv) *Transfer in highest tier (loss share).* The sale of the S share is a transfer in the next higher tier, which is the highest tier in this transaction. Because the sale is a transfer of a loss share, it is subject to this section.

(A) *Basis redetermination and basis reduction under paragraphs (b) and (c) of this section.* Although the transfer is subject to this section, there is no basis redetermination under paragraph (b) of this section because there is only one share of S stock outstanding (and so there can be no disparity among members' bases in common shares and there are no outstanding preferred shares with respect to which there can be unrecognized gain or loss). See paragraph (b)(1)(ii)(A) of this section. Therefore, after the application of paragraph (b) of this section, the share is still a loss share and, as such, subject to paragraph (c) of this section. In addition, no adjustment is required under paragraph (c) of this section. The S share has a disconformity amount of $230. This $230 disconformity amount is computed as the excess of the $600 basis in the S share over the S share's $370 allocable portion (1/1) of S's $370 net inside attribute amount. S's $370 net inside attribute amount is determined under paragraph (c)(5) of this section as the sum of $200 (S's $170 basis in the S1 share 1, adjusted for the $150 loss recognized with respect to that share, and S's $20 basis in each of S1 share 2 through share 10), and S's $170 basis in Asset 1. (In computing the disconformity amount, the bases of S1 share 1 and share 2 are not treated as tentatively reduced because those shares are transferred in the transaction, and the bases of S1 share 3 through share 10 are not treated as tentatively reduced because none of those shares have a disconformity amount—each share has a basis of $20 and a $21 allocable portion (1/10) of S1's $210 net inside attribute amount, as determined in paragraph (iii)(B) of this *Example 9.*) However, the S share's net positive adjustment is $0 (the S share's net adjustment is negative $100). See paragraph (c)(3) of this section. Accordingly, the sale of the S share is still a transfer of a loss share. Because there are no higher-tier loss shares transferred in the transaction, this paragraph (d) then applies with respect to the transfer of the S share.

(B) *Attribute reduction under this paragraph (d).* (*1*) *Computation of S's attribute reduction amount.* Under paragraph (d)(3) of this section, S's attribute reduction amount is the lesser of P's net stock loss and S's aggregate inside loss. P's net stock loss is $360 ($600 basis over $240 amount realized). S's aggregate inside loss is the excess of S's net inside attribute amount over the value of the S share. S's net inside attribute amount is the sum of its bases in its assets, treating its S1 shares as a single share (the S1 stock) and treating S's deemed basis in the S1 stock as its basis in that stock. Under paragraph (d)(5)(i)(C) of this section, when subsidiaries are owned in multiple tiers, deemed basis is first determined for shares at the lowest tier, and then for stock in each next higher tier. Under paragraph (d)(5)(i)(B) of this section, S1's deemed basis in the S2 stock is $75 (computed as the greater of $50 (S1's $0 basis in the S2 share, adjusted for the $50 gain recognized with respect to the share) and $75 (S2's net inside attribute amount, the basis in Asset 2)). S1's deemed basis in the S3 stock is $75 (computed as the greater of $60 (S1's basis in the S3 share) and $75 (S3's net inside attribute amount, the basis in Asset 3)). S1's deemed basis in the S4 stock is $100 (computed as the greater of $100 (S1's basis in the S4 share) and $80 (S4's net inside attribute amount, the basis in Asset 4)). Accordingly, S1's net inside attribute amount is $250 ($75 deemed basis in the S2 stock plus $75 deemed basis in the S3 stock plus $100 deemed basis in the S4 stock). S's deemed basis in the S1 stock is the greater of the sum of S's actual basis in each share of S1 stock (adjusted for any gain or loss recognized) and S1's net inside attribute amount. S's actual basis in the S1 stock, adjusted for the loss recognized, is $200 (the sum of S's $170 basis in the S1 share 1, adjusted by the $150 loss recognized with respect to the share, and S's $20 basis in each of S1 share 2 through share 10). Thus, S's deemed basis in the S1 stock is $250, the greater of $200 (aggregate basis in S1 shares, adjusted for loss recognized) and $250 (S1's net inside attribute amount). As a result, S's net inside attribute amount is $420, the sum of S's $250 deemed basis in the S1 stock and S's $170 basis in Asset 1. Accordingly, the aggregate inside loss is $180, the excess of S's $420 net inside attribute amount over the $240 value of all of the S stock. S's attribute reduction amount is therefore $180, the lesser of the $360 net stock loss and the $180 aggregate inside loss.

(*2*) *Allocation, apportionment, and application of S's attribute reduction amount.* Under paragraphs (d)(4) and (d)(5)(ii) of this section, S's $180 attribute reduction amount is allocated proportionately (by basis) between Asset 1 (non-stock Category D asset) and the S1 stock. However, under paragraph (d)(5)(ii) of this section, for purposes of allocating S's $180 attribute reduction amount between S's non-stock Category D asset and the S1 stock, S's $250 deemed basis in the S1 stock is reduced by the $40 value of the transferred S1 shares (S1 share 1 and share 2) and the non-transferred S1 shares' $40 allocable portion (8/10) of S1's $50 net non-loss assets. S1's net non-loss assets is the $50 value of S1's transferred S2 shares. (S1 has no other non-loss assets, and there are no non-loss assets held by lower-tier subsidiaries.) Accordingly, for this purpose, S's deemed basis in the S1 stock is reduced by $80, from $250 to $170. Thus, $90 of the attribute reduction amount ($170/$340 × $180) is allocated to Asset 1 (reducing S's basis in Asset 1 from $170 to $80) and $90 of the attribute reduction amount ($170/$340 × $180) is allocated to the S1 stock. Under paragraph (d)(5)(iii)(A) of this section, none of the $90 allocated attribute reduction amount is apportioned to S1 share 1 because loss is recognized on the transfer of S1 share 1. Under paragraph (d)(5)(iii)(B) of this section, the $90 allocated attribute reduction amount is apportioned among the other nine shares of S1 common stock in a manner that reduces disparity to the greatest extent possible. Accordingly, of the total $90 allocated amount, $10 is apportioned to each of the remaining nine shares of S1 stock. Under paragraph (d)(5)(iii)(C) of this section, the allocated attribute reduction amount apportioned to an individual share cannot be applied to reduce the basis of the share below its value if the share is transferred other than in a recognition transfer. Because the S1 share 2 is transferred (contributed to the partnership) and the basis of S1 share 2 is already equal to its value, none of the $10 allocated attribute reduction amount apportioned to S1 share 2 is applied to reduce its basis. Because none of S1 share 3 through share 10 are transferred within the meaning of paragraph (f)(10) of this section, the $10 allocated attribute reduction amount apportioned to each of S1 share 3 through share 10 is applied fully to reduce the basis of each of those shares from $20 to $10. As a result, immediately after the allocation and application of S's attribute reduction amount, S's basis in Asset 1 is $80 ($170 minus $90), its bases in S1 share 1 and share 2 are not adjusted under paragraph (d)(5)(iii), and its basis in each of S1 share 3 through share 10 is $10. Under paragraph (d)(5)(v)(A) of this section, the entire $90 of S's attribute reduction amount that was allocated to the S1 stock is an attribute reduction amount of S1, regardless of the fact that none of the allocated amount was apportioned to S1 share 1 and none of the amount apportioned to S1 share 2 was applied to reduce the basis of S1 share 2.

(v) *Attribute reduction under this paragraph (d) in next lower tier. (A) Computation of S1's attribute reduction amount.* S's sale of S1 share 1 is a transfer of a loss share and it is in the next lower tier. Thus, this paragraph (d) next applies with respect to S's transfer of S1 share 1. S1's attribute reduction amount will include both the $90 attribute reduction amount that tiered down from S and any attribute reduction amount resulting from the application of this paragraph (d) with respect to S's transfer of S1 share 1 and share 2 (S1's direct attribute reduction amount). Under paragraph (d)(3) of this section, S1's direct attribute reduction amount is the lesser of the net stock loss on transferred S1 shares and S1's aggregate inside loss. The net stock loss on transferred S1 shares is $150, computed as the excess of S's $190 adjusted bases in transferred shares of S1 stock ($170 in S1 share 1 plus $20 in S1 share 2) over the $40 aggregate value of those shares. S1's aggregate inside loss is $50, the excess of S1's $250 net inside attribute amount (as calculated in paragraph (iv)(B)(*1*) of this *Example 9*) over the $200 value of all outstanding S1 shares. Therefore, S1's direct attribute reduction amount is $50, the lesser of the $150 net stock loss and S1's $50 aggregate inside loss. S1's total attribute reduction amount is thus $140, the sum of the $90 tier-down attribute reduction amount and the $50 direct attribute reduction amount.

(B) *Allocation, apportionment, and application of S1's attribute reduction amount*. Under paragraphs (d)(4) and (d)(5)(ii) of this section, S1's $140 attribute reduction amount is allocated proportionately (by basis) among the S2 stock, the S3 stock, and the S4 stock. However, under paragraph (d)(5)(ii) of this section, for purposes of allocating S1's $140 attribute reduction amount among S1's lower-tier subsidiary stock, S1's $75 deemed basis in the S2 stock is reduced by the $50 value of the transferred S2 share. Accordingly, for this purpose, S1's deemed basis in the S2 stock is reduced by $50, from $75 to $25. Thus, $17.50 of S1's attribute reduction amount ($25/$200 × $140) is allocated to the S2 stock, $52.50 of S1's attribute reduction amount ($75/$200 × $140) is allocated to the S3 stock, and $70 of S1's attribute reduction amount ($100/$200 × $140) is allocated to the S4 stock. Under paragraph (d)(5)(iii)(A) of this section, none of the $17.50 of S1's attribute reduction amount allocated to S2 stock is apportioned to the S2 share because gain was recognized on the transfer of the S2 share. Because neither the S3 share nor the S4 share is transferred within the meaning of paragraph (f)(10) of this section, the $52.50 of S1's attribute reduction amount allocated to the S3 stock, and the $70 of S1's attribute reduction amount allocated to the S4 stock, is apportioned to and applied fully to reduce the basis of such shares. Thus, S1's basis in the S3 share is reduced by $52.50, from $60 to $7.50, and S1's basis in the S4 stock is reduced by $70, from $100 to $30. (Note: The conforming limitation in paragraph (d)(5)(v)(B) of this section limits the application of the $90 tier down attribute reduction amount to $80, the amount by which the portion (10/10) S1's $250 net inside attribute amount attributable to S1 shares held by members exceeds $170 (the sum of the $50 direct attribute reduction amount, the $20 value of the S1 share 1 transferred in a recognition transfer, the $20 basis (after reduction) in the S1 share 2 transferred other than in a recognition transfer, and the $80 aggregate basis (after reduction) in the nontransferred S1 shares held by members). However, the conforming limitation does not limit the application of S1's $90 tier-down attribute reduction amount because none of the $17.50 of S1's total attribute reduction amount allocated to the S2 share was applied to reduce the basis of the share. Accordingly, only $78.75 ($90—($17.50 × ($90/$140)) of the $90 tier-down attribute reduction was applied to reduce S1's attributes.) Under paragraph (d)(5)(v)(A) of this section, the attribute reduction amount allocated to the S2 stock, the S3 stock, and the S4 stock becomes an attribute reduction amount of S2, S3, and S4, respectively (even though the amount allocated to S2 stock was not apportioned to or applied to reduce the basis of the S2 share).

(vi) *Attribute reduction under this paragraph (d) in lowest tier*. Although the sale of the S2 share is a transfer of subsidiary stock at the next lower tier, the S2 share is not a loss share. Thus, this paragraph (d) does not apply with respect to that transfer. However, S2, S3, and S4 have attribute reduction amounts that tiered down from S1 and that are applied to reduce attributes under this paragraph (d).

(A) *Tier down of S1's attribute reduction amount to S2*. Under the general rules of this paragraph (d), S2's $17.50 tier-down attribute reduction amount is allocated and applied to reduce S2's basis in Asset 2 from $75 to $57.50.

(B) *Tier down of S1's attribute reduction amount to S3*. Under the general rules of this paragraph (d), S3's $52.50 tier-down attribute reduction amount is allocated and applied to reduce S3's basis in Asset 3 from $75 to $22.50.

(C) *Tier down of S1's attribute reduction amount to S4, application of conforming limitation*. Under the general rules of this paragraph (d), S4's $70 tier-down attribute reduction amount is allocated to, and would be applied to reduce, S4's basis in Asset 4. However, under paragraph (d)(5)(v)(B) of this section, the reduction is limited to the excess of S4's $80 net inside attribute amount over the $30 basis of the S4 share (after reduction under this paragraph (d)). As a result, only $50 (the excess of $80 over $30) of S4's $70 attribute reduction amount is applied to S4's basis in Asset 4, reducing it from $80 to $30. The $20 unapplied portion of S4's tier-down attribute reduction amount subject to the conforming limitation is disregarded and has no further effect.

(vii) *Application of basis restoration rule*. Under paragraph (d)(5)(vi)(A) of this section, after this paragraph (d) has been applied with respect to all transfers of subsidiary stock, any reduction made to the basis of a share of lower-tier subsidiary stock under paragraph (d)(5)(iii) of this section is reversed to the extent necessary to conform the basis of that share to the share's allocable portion of the subsidiary's net inside attribute amount. Restoration adjustments are first made at the lowest tier and then at each next higher tier successively.

(A) *Basis restoration at lowest tier*. The basis of the S2 share was not reduced under paragraph (d)(5)(iii) of this section and so there is no restoration of any basis in the S2 share. S3's $22.50 net inside attribute amount (after reduction under this paragraph (d)) exceeds S1's $7.50 basis in the S3 share (after reduction under this paragraph (d)) by $15. To conform S1's basis in the S3 share to S3's net inside attribute amount, the $52.50 reduction to the basis of the S3 share under paragraph (d)(5)(iii) of this section is reversed by $15 (restoring S1's basis in the S3 share to $22.50). The restoration of S1's basis in the S3 share does not tier up to affect the basis in stock of any other subsidiary. S1's $30 basis in the S4 share (after reduction under this paragraph (d)) is already conformed with S4's $30 net inside attribute amount (after reduction under this paragraph (d)) and so there is no restoration of any basis in the S4 share.

(B) *Basis restoration at next higher tier*. Each share of S1 stock has an allocable portion of S1's net inside attribute amount (after reduction) equal to $10.25 (1/10 × $102.50, the sum of S1's $0 basis in the S2 stock, adjusted for the $50 gain recognized with respect to the share, S1's $22.50 basis in the S3 stock (after restoration), and S1's $30 basis in the S4 stock). Neither S's basis in S1 share 1 nor S's basis in S1 share 2 was reduced under paragraph (d)(5)(iii) of this section. Accordingly, there is no restoration of any basis in either S1 share 1 or share 2. However, S's basis in each of S1 share 3 through share 10 was reduced under paragraph (d)(5)(iii) of this section by $10, from $20 to $10. Accordingly, the $10 reduction to the basis of each of those shares is reversed to the extent of $.25, to restore the basis of each such share to $10.25 (its allocable portion of S1's net inside attribute amount).

(viii) *Results*. After the application of this section, P recognizes a loss of $360 on the sale of the S share, S recognizes a loss of $150 on the sale of S1 share 1, and S1 recognizes a $50 gain on the sale of the S2 share. Immediately after the transaction, the entities each directly own the following:

Entity	Asset	Basis	Value
P1	S share	$240	$240
P	Proceeds of the sale of S share	240	240
S	Proceeds of sale of S1 share 1	20	20
	Partnership interest received for S1 share 2	20	20
	S1 share 3 through share 10	82 ($10.25 per share).	
	Asset 1	80.	
S1	Proceeds of sale of S2 share	50	50
	The S3 share	22.50.	
	The S4 share	30.	
S2	Asset 2	57.50.	
S3	Asset 3	22.50.	
S4	Asset 4	30.	
X	S1 share 1	20	20
Partnership	S1 share 2	20	20
Y	The S2 share	50	50

(e) *Operating rules*—(1) *Predecessors, successors*. This section applies to predecessor or successor persons, groups, and assets to the extent necessary to effectuate the purposes of this section.

(2) *Adjustments for prior transactions that altered stock basis or other attributes*. In certain situations, M's basis in S stock or S's attributes may be adjusted in a manner that alters the relationship between stock basis and inside attributes and prevents that relationship from identifying the extent to which stock basis reflects unrecognized gain and duplicated loss. The provisions of this paragraph (e)(2) modify the computations in paragraphs (c) and (d) of this section to adjust for the effects of such adjustments.

(i) *Prior reductions to S's basis in assets or other attributes pursuant to section 362(e)(2)(A)*. If M transferred loss property to S in an intercompany transaction subject to section 362(e)(2) (for example, if the transfer was prior to September 17, 2008, no election was made to apply §1.1502–80(h), and, as a result, S's attributes were reduced under section 362(e)(2)), then the disconformity amount of the S shares received in the section 362(e)(2) transaction is reduced by the amount that the basis in such shares would have been reduced under section 362(e)(2)(C) had such an election been made. In addition, for purposes of determining the attribute reduction amount under paragraph (d) of this section resulting from the transfer of any S shares received (or deemed received) in such a transfer, and for purposes of applying paragraph (d)(5)(v)(B) of this section (conforming limitation) to S, the bases in such shares is treated as reduced by the amount the bases in such shares would have been reduced under section 362(e)(2)(C) had such an election been made.

(ii) *Prior reductions to the basis of any share of S stock pursuant to an election under section 362(e)(2)(C).* If M transferred loss property to S in an intercompany transaction subject to section 362(e)(2) and the basis of any share of S stock was reduced as the result of an election under section 362(e)(2)(C) (including in the hands of a predecessor, to the extent that the effect of the election remains reflected in the basis of the S stock), then, for purposes of computing either any S share's disconformity amount or S's aggregate inside loss, and for purposes of applying paragraph (d)(5)(vi)(A) of this section (stock basis restoration) to S, S's net inside attribute amount is treated as reduced by the amount that S's attributes would have been reduced under section 362(e)(2)(A) in the absence of an election under section 362(e)(2)(C). Notwithstanding the general rule of this paragraph (e)(2)(ii), no reduction will be required to the extent that the group can establish that the net loss in the S shares transferred by M is no longer reflected in S's net inside attributes.

(iii) *Other adjustments.* Appropriate adjustments will be made in any other case in which an adjustment to S's net inside attributes or to M's basis in a share of S stock alters the relationship between such amounts, and the adjustment does not relate to the extent to which loss reflected in M's basis in S stock is noneconomic or duplicated within the meaning of this section.

(3) *Special rules for subsidiary stock transferred in an intercompany transaction*—(i) *In general.* This section applies with respect to M's transfer of a share of S stock to another member in an intercompany transaction in which M's intercompany item is deferred under §1.1502–13 (and to any subsequent transfer of that share by a member) as of the time M's intercompany item is taken into account under §1.1502–13. In determining the application of this section, all transferor-members are treated as divisions of a single corporation. Appropriate adjustments will be made to the intercompany item(s), any member's basis in an S share, to S's attributes, or any combination thereof, to further the purposes of this section and §1.1502–13.

(ii) *Certain prior intercompany transactions.* If M transferred a share of S stock to another member before September 17, 2008 and M's intercompany item related to the transfer is taken into account on or after September 17, 2008, P may elect to apply this paragraph (e)(3) to the transfer. The election is made in the manner provided in paragraph (e)(5) of this section.

(iii) *Examples.* The application of this paragraph (e)(3) is illustrated by the following examples:

Example 1. Intercompany sale with duplicated loss. (i) *Buying member later sells at gain.* (A) *Facts.* M owns the sole outstanding share of stock of S with a basis of $100. S has one asset with a basis of $100. M sells the S share to M1 for $70, recognizing a loss of $30. While owned by M1, S recognizes $10 of depreciation deductions that are absorbed by the group. S's basis in the asset is reduced by $10 (from $100 to $90), and M1's basis in the S stock is reduced under §1.1502–32 by $10 (from $70 to $60). Later, M1 sells the S share to X, an unrelated person, for $80.

(B) *Analysis.* M's sale of its S share to M1 is a transfer of the share, but this section applies as of the time M's intercompany item is taken into account under §1.1502–13, as if M and M1 were divisions of a single corporation. If M and M1 were divisions of a single corporation, the S share's basis would be $90 ($100 reduced by $10 for the depreciation deductions absorbed by the group) and the group would recognize a $10 loss on the sale of the share that is potentially subject to this section. Thus, the sale would be a transfer of a loss share (to the extent of $10) and would be subject to this section (to the extent of that $10). Although the transfer would be subject to this section, there would be no adjustment under paragraph (b) of this section (S has only one share outstanding and so there is no disparity in bases of common shares and no unrecognized gain or loss with respect to preferred) or under paragraph (c) of this section (S has no net positive adjustment). Thus, after the application of paragraph (c) of this section, the share would still be a loss share and would therefore be subject to paragraph (d) of this section. Under paragraph (d) of this section, S would be subject to $10 of attribute reduction (the lesser of the $10 net stock loss and S's $10 aggregate inside loss), allocable to the basis in S's asset. Accordingly, S's basis in its asset is reduced by $10, from $90 to $80, M takes its $30 intercompany stock loss into account, and M1 recognizes a $20 stock gain.

(ii) *Selling member deconsolidates.* Assume the same facts as in paragraph (i)(A) of this *Example 1*, except that M1 does not sell the S share and M ceases to be a member of the group when the value of the S share is $80. Under §1.1502–13, M's deconsolidation causes M's intercompany loss to be taken into account and this section applies at that time. At the time that M deconsolidates, if M and M1 were divisions of a single corporation, the basis in the S share would be $90 ($100 reduced by $10 for the depreciation deductions absorbed by the group) and the group would recognize a $10 loss on the sale of the share that is potentially subject to this section. Such a sale would be a transfer of a loss share (to the extent of $10) and would be subject to this section (to the extent of that $10). The analysis is then the same as in paragraph (i)(B) of this *Example 1*. As a result, S's basis in its asset is reduced from $90 to $80, M takes its $30 intercompany stock loss into account, and M1 holds the S stock with a basis of $60 (and an unrecognized gain of $20).

(iii) *M1 sells the S share at a loss.* Assume the same facts as in paragraph (i)(A) of this *Example 1*, except that S declines in value and M1 sells the S share to X for $50, realizing a $10 loss. In this case, if M and M1 were divisions of a single corporation, the share's basis would be $90 ($100 reduced by $10 for the depreciation deductions absorbed by the group) and the group would recognize a $40 loss on the sale of the share that is potentially subject to this section. Thus, the sale would be a transfer of a loss share (to the extent of $40) and would be subject to this section (to the extent of that $40). Although the transfer would be subject to this section, for the reasons set forth in paragraph (i)(B) of this *Example 1*, there would be no adjustment under either paragraph (b) or paragraph (c) of this section. Thus, after the application of paragraph (c), the share would still be a loss share and would therefore be subject to paragraph (d) of this section. Under paragraph (d) of this section, S would be subject to $40 of attribute reduction (the lesser of the $40 net stock loss and S's $40 aggregate inside loss), allocable to the basis in S's asset. Accordingly, S's basis in its asset is reduced by $40, from $90 to $50, M takes its $30 intercompany stock loss into account, and M1 recognizes a $10 stock loss.

Example 2. Intercompany sale of built-in gain stock. (i) *Facts.* M owns the sole outstanding share of stock of S with a basis of $100. S's sole asset has a basis of $0. S sells its asset for $100 and recognizes a $100 gain that increases M's basis in its S share under §1.1502–32 to $200. M sells the S share to M1 for $100 and recognizes a $100 intercompany loss. Later, M1 sells the S share to X, an unrelated person, for $120.

(ii) *Analysis.* M's sale of the S share to M1 is a transfer of the share, but this section applies as of the time M's intercompany item is taken into account under §1.1502–13, as if M and M1 were divisions of a single corporation. If M and M1 were divisions of a single corporation, the S share's basis would be $200 ($100 increased by $100 for the gain recognized on the sale of the asset) and the group would recognize an $80 loss on the sale of the share that is potentially subject to this section. Thus, the sale would be a transfer of a loss share (to the extent of $80) and would be subject to this section (to the extent of that $80). Although the transfer would be subject to this section, there would be no adjustment under paragraph (b) of this section (S has only one share outstanding and so there is no disparity in bases of common shares and no unrecognized gain or loss with respect to preferred). Thus, after the application of paragraph (b), the share would still be a loss share and would therefore be subject to paragraph (c) of this section. Under paragraph (c) of this section, the basis in the S share would be reduced, but not below its $120 value, by the lesser of the $100 disconformity amount and the $100 net positive adjustment that was applied to the share when held by M. Accordingly, the basis in the S share would be reduced by $80, to $120. Because the S share would not be a loss share after the application of paragraph (c) of this section, paragraph (d) of this section would not apply to the transfer. As a result, because the positive adjustment was applied to the share when held by M, M's intercompany item is adjusted to reflect what it would have been had M's basis in its S share been reduced by $80 immediately before its sale to M1. Thus, M's intercompany loss is reduced to $20 and M takes this loss into account, and M1 recognizes a gain of $20.

Example 3. Intercompany sale creates built-in gain stock. (i) *Facts.* M owns the sole outstanding share of stock of S with a basis of $0. S's sole asset has a basis of $0. M sells the S share to M1 for $100 and recognizes a $100 intercompany gain. While owned by M1, S sells its asset for $100, recognizing a $100 gain that increases M1's basis in the S share under §1.1502–32 to $200. Later, M1 sells the S share to X for $120.

(ii) *Analysis.* M's sale of its S share to M1 is a transfer of the share, but this section applies as of the time M's intercompany item is taken into account under §1.1502–13, as if M and M1 were divisions of a single corporation. If M and M1 were divisions of a single corporation, the S share's basis would be $100 ($0 increased by $100 for the gain recognized on the sale of the asset) and the group would recognize a $20 gain on the sale of the share. Thus, the sale would not be a transfer of a loss share and this section would not apply to the transfer. Accordingly, under this paragraph (e)(3), no portion of M1's $80 loss is subject to this section. M takes its $100 intercompany stock gain into account, and M1 recognizes an $80 loss.

Example 4. Disparate bases in members' shares. (i) *Facts.* M holds Share A, one of the two outstanding shares of S stock, with a basis of $50 and M1 holds Share B, the other outstanding share of S stock with a basis of $0. S has $50 cash and an asset with a basis of $0. S sells the asset for $50, recognizing a $50 gain that increases M's basis in its S share under §1.1502–32 by $25 (from $50 to $75) and increases M1's basis under §1.1502–32 by $25 (from $0 to $25). Later, M sells its Share A to M1 for $50 and recognizes a $25 intercompany loss. Later, M1 sells both S shares to X for $100.

(ii) *Analysis.* M's sale of its Share A to M1 is a transfer of the share, but this section applies as of the time M's intercompany item is taken into account under §1.1502–13, as if M and M1 were divisions of a single corporation. If M and M1 were divisions of a single corporation, the basis of Share A would be $75 ($50 increased by $25 for its share of the gain recognized on the sale of the asset), the basis of Share B would be $25, and the group would recognize a $25 loss on the sale of Share A that is potentially subject to this section and a $25 gain on the sale of Share B. Thus, the sale would be a transfer of a loss share (to the extent of $25) and would be subject to this section (to the extent of that $25). Although the transfer is subject to this section, there would be no adjustment under paragraph (b) of this section (all S shares held by members are transferred to a nonmember in one taxable transaction). Thus, after the application of paragraph (b), Share A would still be a loss share and therefore subject to paragraph (c) of this section. Under paragraph (c)(7) of this section, the basis of Share A would be treated as reduced by the gain recognized and taken into account with respect to the transfer of Share B in the same transaction, and so Share A would not be a loss share for purposes of paragraph (c) of this section. Although the share would be a loss share after the application of paragraph (c) of this section, no adjustment would be required under paragraph (d) of this section because there would be no net stock loss in the transaction. Because no adjustment would be made under this section if M and M1 were divisions of a single corporation, M takes its $25 intercompany stock loss into account and M1 recognizes a gain of $25. Alternatively, if the group elects to apply paragraph (b) of this section, M's intercompany item would be adjusted to reflect what it would have been had the $25 investment adjustment applied to Share A been reallocated to Share B, and M1's basis in Share B would be increased by that amount. If so, M's $25 intercompany loss would be reduced to zero, M1's basis in Share B would be increased from $25 to $50, and there would be no gain or loss recognized on either share.

Example 5. Subsidiary with built-in gain and built-in loss assets. (i) *Facts.* M owns the sole outstanding share of stock of S with a basis of $100. S has two assets, Asset 1 with a basis of $0 and Asset 2 with a basis of $80. M sells the S share to M1 for $90 and recognizes a $10 intercompany loss. While owned by M1, S sells Asset 1 for $60, recognizing a $60 gain that increases M1's basis in the S share under §1.1502–32 to $150. Later, M1 sells the S share to X for $90.

(ii) *Analysis.* M's sale of the S share to M1 is a transfer of the share, but this section applies as of the time M's intercompany item is taken into account under §1.1502–13, as if M and M1 were divisions of a single corporation. If M and M1 were divisions of a single corporation, the S share's basis would be $160 ($100 increased by $60 for the gain recognized on the sale of Asset 1) and the group would recognize a $70 loss on the sale of the share that is potentially subject to this section. Thus, the sale would be a transfer of a loss share (to the extent of $70) and would be subject to this section (to the extent of that $70). Although the transfer is subject to this section, there would be no adjustment under paragraph (b) of this section (S has only one share outstanding and so there is no disparity in bases of common shares and no unrecognized gain or loss with respect to preferred). Thus, after the application of paragraph (b), the share would still be a loss share and would therefore be subject to paragraph (c) of this section. Under paragraph (c) of this section, the basis in the S share would be reduced, but not below its $90 value, by the lesser of the $20 disconformity amount ($160 stock basis over $140 net inside attribute amount) and the $60 net positive adjustment that was applied to the share when held by M1. Accordingly, the basis in the S share would be reduced by $20, to $140. Because the S share would still be a loss share after the application of paragraph (c) of this section, paragraph (d) of this section would apply to the transfer. Under paragraph (d) of this section, S would have an attribute reduction amount of $50, the lesser of the $50 net stock loss ($140 basis over $90 value) and S's $50 aggregate inside loss (the excess of the sum of S's $80 basis in Asset 2 and S's $60 cash from the sale of Asset 1, over the $90 value of the S share). The adjustments required under this section are applied as follows: because the positive adjustment was applied to the share when held by M1, the $20 basis reduction required under paragraph (c) of this section is applied to M1's basis in its

S share immediately before its sale to X, reducing it from $150 to $130. In addition, pursuant to paragraph (d) of this section, S's basis in Asset 2 is reduced by $50, from $80 to $30. M takes its $10 intercompany stock loss into account and M1 recognizes a loss of $40.

(iii) *Allocation of basis reduction.* Assume the same facts as in paragraph (i) of this *Example 5*, except that, while S is held by M, S earns $30 (consuming a portion of Asset 1) and, while S is held by M1, S earns $20 (consuming a portion of Asset 1) and sells Asset 1 for $10. Thus, M's basis in the S share immediately before the sale to M1 is $130, and M recognizes a $40 intercompany stock loss, and M1's basis in the S share immediately before the sale to X is $120. The analysis regarding the application of this section is the same as in paragraph (ii) of this *Example 5*. On a separate entity basis, M's basis in the S share would be subject to a $20 reduction under paragraph (c) of this section (at the time M transferred the S share the share had a $30 net positive adjustment and a $20 disconformity amount), and M1's basis in the S share would not be subject to reduction under paragraph (c) of this section (at the time M1 transferred the S share the share had a $30 net positive adjustment and a $20 negative disconformity amount). Therefore, the $20 basis reduction required under paragraph (c) of this section is allocated entirely to M. Accordingly, M's intercompany item is adjusted to reflect what it would have been had the entire $20 basis reduction been applied to the S share while held by M, and M1's basis in the S share is not reduced. Thus, M's intercompany stock loss is reduced by $20 to $20 and M takes this loss into account, and M1 recognizes a $30 loss. S's basis in Asset 2 is reduced by $50, from $80 to $30.

(4) *Limited application to multiple-member section 332 liquidations.* If more than one member owns shares of S stock, paragraphs (c) and (d) of this section do not apply to any transfer of S shares resulting from a liquidation of S to which section 332 applies.

(5) *Form and manner of election(s) under this section.* The elections provided in this section are irrevocable and made in the form of a statement titled ''Section 1.1502–36 Statement.'' The statement must be included on or with the group's timely filed return (original or amended, if filed by the due date for the return, including extensions) for the taxable year of the transfer of the subsidiary stock to which the election relates or, in the case of an intercompany transfer, the year in which the intercompany item from the transfer is taken into account. The statement must include—

(i) The name and employer identification number (E.I.N.) of each subsidiary with respect to which an election is being made;

(ii) If P is electing under paragraph (b)(1)(ii) of this section to redetermine basis with respect to the transfer of stock of one or more subsidiaries, a statement that members' bases in shares of [name of subsidiary or subsidiaries] stock are being redetermined notwithstanding that all members' shares of [name of subsidiary or subsidiaries] are being transferred to one or more nonmembers in one fully taxable transaction;

(iii) If P is electing under paragraph (d)(2)(ii) of this section (attribute reduction amount less than five percent of value) to apply the attribute reduction provisions, a statement that paragraph (d) of this section is being applied to the transfer of shares of stock of [names of all subsidiaries whose shares are transferred] notwithstanding that the aggregate attribute reduction amount in the transaction is less than five percent of the aggregate value of the stock of [names of all subsidiaries whose shares are transferred] transferred by members in the transaction;

(iv) If P is electing under paragraph (d)(4)(ii)(A)(*1*) of this section to specify the allocation of the attribute reduction amount, a statement (for each subsidiary for which the election is being made) that the attribute reduction amount of [name of subsidiary] is being applied (or not applied) to reduce [identify the attributes in Category A, Category B, and Category C, and the amount of each, with respect to which the election is being made];

(v) If P is electing under paragraph (d)(5)(v)(B) of this section not to apply the conforming limitation on tier-down attribute reduction with respect to one or more subsidiaries, a statement that the conforming limitation in paragraph (d)(5)(v)(B) of this section is not being applied with respect to [name of subsidiary or subsidiaries];

(vi) If P is electing under paragraph (d)(5)(vi)(B) of this section not to restore lower-tier subsidiary stock basis with respect to one or more subsidiaries, a statement that members' bases in [name of subsidiary or subsidiaries] is not being restored under paragraph (d)(5)(vi)(A) of this section;

(vii) If P is electing under paragraph (d)(6) of this section to reattribute attributes, a statement (for each subsidiary for which the election is being made) that [identify the attributes in Category A, Category B, and Category C, and the amount of each or the amount in excess of an amount, with respect to which the election is being made] of [name of subsidiary] are being reattributed (or not) to P;

(viii) If P is electing under paragraph (d)(6) of this section to reduce stock basis, a statement (for each subsidiary for which the election is being made) that members' bases in shares of stock of [name of subsidiary] are being reduced by [specify amount or the amount in excess of an amount];

(ix) If P is electing under paragraph (e)(3)(ii) of this section to apply paragraph (e)(3) of this section to an intercompany transfer that occurred before September 17, 2008, a statement that paragraph (e)(3) of this section is being elected to apply to the transfer of stock of [name of subsidiary] by [name of transferor subsidiary] to [name of transferee subsidiary] on [date of transfer]; and

(x) If P is electing under §1.1502–96(d)(5) to reattribute to itself all or any part of a section 382 limitation, a statement that P is electing to reattribute a section 382 limitation with respect to losses of [name of subsidiary or, if two or more subsidiaries are members of a loss subgroup, the name of each subsidiary in the loss subgroup]. A separate statement is made for each subsidiary or loss subgroup for which an election is being made. Each statement must include—

(A) The date of the ownership change giving rise to the separate section 382 limitation or subgroup section 382 limitation that is being apportioned;

(B) The amount of the separate (or subgroup) section 382 limitation for the taxable year in which the reattribution occurs (determined without reference to any apportionment under this section or §1.1502–95(c)); and

(C) The amount of each net operating loss carryover, capital loss carryover, or deferred deduction, and the year in which it arose, of the subsidiary (or subsidiaries) that is subject to the separate section 382 limitation or subgroup section 382 limitation that is being apportioned to the common parent, and the amount of the value element and adjustment element of that limitation that is apportioned to the common parent.

(f) *Definitions.* In addition to the definitions in other paragraphs of this section and in other provisions of the regulations under section 1502, the following definitions apply for purposes of this section.

(1) *Allocable portion* has the same meaning as in §1.1502–32(b)(4)(iii)(B). Thus, for example, within a class of stock, each share has the same allocable portion of the net inside attribute amount and, if there is more than one class of stock, the net inside attribute amount is allocated to each class by taking into account the terms of each class and all other facts and circumstances relating to the overall economic arrangement.

(2) *Deferred deduction* means any deduction for expenses or loss that would be taken into account under general tax accounting principles as of the time of the transfer of the share, but that is nevertheless not taken into account immediately after the transfer by reason of the application of a deferral provision. Such provisions include, for example, sections 267(f) and 469, and §1.1502–13. ''Deferred deduction'' also includes S's portion of such consolidated tax attributes, for example consolidated excess charitable contributions that would be apportioned to S under the principles of §1.1502–79(e) if S had a separate return year. Additionally, it includes amounts equivalent to deductions, such as negative adjustments under section 475 (mark to market accounting method for dealers in securities) and section 481 (adjustments required by changes in method of accounting).

(3) *Distribution* has the same meaning as in §1.1502–32(b)(3)(v).

(4) *Higher-tier, lower-tier.* A subsidiary (S1) (and its shares of stock) is ''higher-tier'' with respect to another subsidiary (S2) (and its shares of stock) if investment adjustments made to the bases of shares of S2 stock under §1.1502–32 affect the investment adjustments made to the bases of shares of S1 stock. A subsidiary (S1) (and its shares of stock) is ''lower-tier'' with respect to another subsidiary (S) (and its shares of stock) if investment adjustments made to the bases of shares of S1 stock affect the investment adjustments made to the bases of shares of S stock. The term *lowest-tier subsidiary* generally refers to a subsidiary that owns no stock of another subsidiary. The term *highest-tier subsidiary* generally refers to a subsidiary the stock of which is not lower tier to any shares transferred in the transaction.

(5) *Liability* means a liability that has been incurred within the meaning of section 461(h), except to the extent otherwise provided in paragraph (d)(4)(ii)(C)(*1*) of this section.

(6) *Loss carryover* means any net operating or capital loss carryover that is attributable to S, including any losses that would be apportioned to S under the principles of §1.1502–21(b)(2) if S had a separate return year. However, solely for purposes of applying paragraph (d) of this section, loss carryovers do not include the amount of any losses waived under §1.1502–32(b)(4).

(7) *Loss share, gain share.* A *loss share* is a share of stock with a basis that exceeds its value. A *gain share* is a share of stock with a value that exceeds its basis.

(8) *Preferred stock, common stock. Preferred stock* and *common stock* have the same meanings as in §1.1502–32(d)(2) and (3), respectively.

(9) *Transaction* includes all the steps taken pursuant to the same plan or arrangement.

(10) *Transfer*—(i) *Definition.* Except as provided in paragraph (f)(10)(ii) of this section, for purposes of this section, M transfers a share of S stock on the earliest of—

(A) The date that M ceases to own the share as a result of a transaction in which, but for the application of this section (and notwithstanding the deferral of any amount recognized on the transfer, other than by reason of §1.1502–13), M would recognize income, gain, loss or deduction with respect to the share (see paragraph (e)(3) of this section in the case of a transfer in an intercompany transaction);

(B) The date that M and S cease to be members of the same group;

(C) The date that a nonmember acquires the share from M; and

(D) The last day of the taxable year during which the share becomes worthless under section 165 (taking into account the provisions of §1.1502–80(c)) if the share is treated as a capital asset, or the date the share becomes worthless (taking into account the provisions of §1.1502–80(c)) if the share is not treated as a capital asset.

(ii) *Excluded transactions.* Notwithstanding paragraph (f)(10)(i) of this section, M does not transfer a share of S stock if—

(A) M ceases to own the share as a result of a transaction to which section 381(a) applies and in which either a member acquires assets from S or S acquires assets from M, provided that—

(*1*) M recognizes no income, gain, loss, or deduction with respect to the share, and

(*2*) If the transaction is a liquidation to which section 332 applies, M is the only member that owns shares of S stock (if another member owns shares of S stock, see paragraph (e)(4) of this section for a limitation on the application of this section); or

(B) M ceases to own the share as a result of a distribution of the share to a nonmember in a transaction to which section 355 applies, and in which the share is treated as qualified property for purposes of section 355(c) or section 361(c).

(11) *Value* means the amount realized, if any, or otherwise the fair market value.

(g) *Anti-abuse rule*—(1) *General rule.* If a taxpayer acts with a view to avoid the purposes of this section or to apply the rules of this section to avoid the purposes of any other rule of law, appropriate adjustments will be made to carry out the purposes of this section or such other rule of law.

(2) *Examples.* The following examples illustrate the principles of the anti-

abuse rule in this paragraph (g). No implication is intended regarding the potential applicability of any other anti-abuse rules:

Example 1. Loss Trafficking. (i) *Facts.* M purchases the sole outstanding share of S stock for $100. At that time, S owns Asset 1 with a basis of $0. S sells Asset 1 for $100. Later, S purchases the sole outstanding share of X stock, a corporation with losses, with a view to liquidating X in a transaction to which section 332 applies in order to reduce S's disconformity amount. S purchases the X share for $1, and X has a $100 NOL and an asset with a basis of $1. Subsequently, M sells its S share for $100. After taking into account the effects of all applicable rules of law, M's basis in the S share is $200 (M's original $100 basis, increased under §1.1502–32 to reflect the $100 gain recognized on the sale of Asset 1). M's sale of the S share is a transfer of a loss share and therefore subject to this section.

(ii) *Analysis.* Although M's transfer of the S share is subject to this section, there is no adjustment under paragraph (b) of this section (S has only one share outstanding and so there is no disparity in bases of common shares and no shares of S preferred stock outstanding (and so there is no unrecognized gain or loss on S preferred stock)). See paragraph (b)(1)(ii)(A) of this section. Accordingly, after the application of paragraph (b) of this section, M's sale of the S share is still a transfer of a loss share and therefore subject to paragraph (c) of this section. Under paragraph (c) of this section, M's $200 basis in the S share is reduced, but not below the share's $100 value, by the lesser of the share's net positive adjustment and disconformity amount. The share's net positive adjustment is $100, the positive adjustment attributable to the gain recognized on the sale of Asset 1. The share's disconformity amount is $0, the excess of M's $200 basis in the S share over S's $200 net inside attribute amount. Thus, the reduction to basis under paragraph (c) of this section would be $0. However, because S purchased the X stock and liquidated X with a view to avoiding the purposes of this section (by using X's attributes to minimize the disconformity amount of the S share), the attributes acquired from X are disregarded for purposes of applying this section. Accordingly, S's net inside attribute amount is limited to the $100 of attributes S would have had absent the purchase of the X stock, S's money ($100 from the sale of Asset 1). The loss share's disconformity amount is therefore the excess of $200 over $100, or $100. The lesser of the share's $100 net positive adjustment and $100 disconformity amount is $100. As a result, M's $200 basis in the S share is reduced by $100, to $100, and M recognizes no gain or loss on the sale of the S share.

Example 2. Use of a partnership to prevent current attribute reduction. (i) *Facts.* M owns all 5 outstanding shares of S common stock with a basis of $200 each. S owns Asset 1 with a basis of $1000. In year 1, with a view to preventing a current reduction in the basis of Asset 1, S contributes Asset 1 to a partnership in a transaction in which S recognizes no gain or loss. On December 31, year 2, M sells one S share for $20. After taking into account the effects of all applicable rules of law, M's basis in each S share is $200. M's sale of the S share is a transfer of a loss share and therefore subject to this section.

(ii) *Analysis.* Although M's transfer of the S share is subject to this section, there is no basis redetermination under paragraph (b) of this section because there is no disparity among M's bases in its shares of S common stock and there are no shares of S preferred stock outstanding (and so there is no unrecognized gain or loss on S preferred stock). See paragraph (b)(1)(ii)(A) of this section. Accordingly, after the application of paragraph (b) of this section, M's sale of the S share is still a transfer of a loss share and therefore subject to paragraph (c) of this section. However, no adjustment is required under paragraph (c) of this section because both the disconformity amount and the net positive adjustment are $0. See paragraph (c)(3) of this section. Under paragraph (d) of this section, S's attribute reduction amount is $180 (the lesser of the $180 net stock loss and S's $900 aggregate inside loss ($1000 of attributes over $100 value of all of the S shares)). Absent the application of this paragraph (g), the $180 attribute reduction amount would be applied to reduce S's basis in the partnership interest. However, because S acted with a view to avoiding a current reduction in the basis of Asset 1 under paragraph (d) of this section, this section is applied by treating S as if it held Asset 1 at the time of the stock sale. The basis of Asset 1 is reduced by $180, to $820, effective immediately before the transfer to the partnership and, as a result, S's basis in its partnership interest is $820.

Example 3. Creation of an intercompany receivable to mitigate attribute reduction. (i) *Facts.* M owns all five outstanding shares of S common stock each with equal basis that exceeds value. S holds cash and Asset 1 with a basis that exceeds value. In year 1, with a view to mitigating a reduction in the basis of Asset 1, S lends the cash to M1. Asset 1 and the intercompany note received from M1 are assets of the same class under §1.338–6(b)(2). On December 31, year 2, M sells one of its S shares and, without regard to this section, recognizes a loss. M's sale of the S share is a transfer of a loss share and therefore subject to this section.

(ii) *Analysis.* Although M's transfer of the S share is subject to this section, no adjustment is required under paragraph (b) of this section because there is no disparity among M's bases in shares of S common stock and there are no shares of S preferred stock outstanding (and so there is no unrecognized gain or loss on S preferred stock). See paragraph (b)(1)(ii)(A) of this section. Accordingly, after the application of paragraph (b) of this section, M's sale of the S shares is still a transfer of a loss share and therefore subject to paragraph (c) of this section. However, there is no adjustment under paragraph (c) of this section because the net positive adjustment is $0. See paragraph (c)(3) of this section. Under paragraph (d) of this section, S's attribute reduction amount would be applied to reduce S's basis in Asset 1 and the intercompany receivable in proportion to basis. However, because S acted with a view to mitigating the reduction in the basis of Asset 1 under paragraph (d) of this section, this section is applied without regard to the intercompany receivable. Accordingly, S's basis in Asset 1 is reduced by the full attribute reduction amount.

Example 4. Use of a partnership to reduce net stock loss. (i) *Facts.* M owns all ten outstanding shares of S common stock, one share (Share 1) has a basis of $0, and one share (Share 2) has a basis of $160. S has an aggregate inside loss of $80. In one transaction and with a view to mitigating a reduction in S's attributes, M contributes Share 1 to a partnership, recognizing no gain or loss, and sells Share 2 for $80. M's contribution of Share 1 to the partnership is a transfer, but the share is not a loss share and so the transfer is not subject to this section. M's sale of Share 2 is a transfer of a loss share and is therefore subject to this section.

(ii) *Analysis.* Although M's transfer of Share 2 is subject to this section, there is no adjustment under paragraph (b) of this section because there are no investment adjustments that have been applied to the shares. Accordingly, after the application of paragraph (b) of this section, M's sale of Share 2 is still a transfer of a loss share and therefore subject to paragraph (c) of this section. There is no adjustment under paragraph (c) of this section because the net positive adjustment is $0. See paragraph (c)(3) of this section. Accordingly, after the application of paragraph (c) of this section, M's sale of Share 2 is still a transfer of loss shares and therefore subject to paragraph (d) of this section. Under paragraph (d) of this section, the net stock loss would be determined to be $0, the excess of the $160 aggregate basis in all of the transferred shares over the $160 aggregate value of those shares. S's attribute reduction amount would be determined to be $0, the lesser of the $0 net stock loss and S's $80 aggregate inside loss. Thus, there would be no reduction of attributes under this paragraph (d) of this section. However, because M acted with a view to reducing the attribute reduction amount by transferring a gain share to a partnership while avoiding the recognition of the gain on the share, this section is applied without regard to the transfer of the gain share. Accordingly, the net stock loss is determined to be $80, and the attribute reduction amount is determined to be $80.

Example 5. Stuffing gain asset. (i) *Facts.* M owns the sole outstanding share of S stock (Share 1) with a basis of $100. S owns Asset 1 with a basis of $100 and a value of $20. With a view to avoid the purposes of this section, M transfers Asset 2 with a basis of $0 and a value of $80 to S in exchange for four additional shares of S stock (Share 2 through Share 5) in a transaction to which section 351 applies. M later sells Share 1 to X for $20. M's sale of Share 1 is a transfer of a loss share and therefore subject to this section.

(ii) *Analysis.* Although M's transfer of the Share 1 is subject to this section, there is no adjustment under paragraph (b) of this section because no investment adjustments have been applied to the basis of any S shares. Thus, after the application of paragraph (b) of this section, M's sale of the S share is still a transfer of a loss share and therefore subject to paragraph (c) of this section. There is no adjustment under paragraph (c) of this section because the net positive adjustment is $0. Accordingly, after the application of paragraph (c) of this section, M's sale of the S share is still a transfer of a loss share and therefore subject to paragraph (d) of this section. Under paragraph (d) of this section, S's attribute reduction amount would be $0, the lesser of the $80 net stock loss and S's $0 aggregate inside loss ($100 of attributes does not exceed the $100 value of all of the S shares). However, because M transferred Asset 2 to S with a view to avoid the purposes of this section, the application of this section to M's transfer of Share 1 is made without regard to the transfer of Asset 2. Accordingly, under paragraph (d) of this section, S's attribute reduction amount is $80, the lesser of the $80 net stock loss and S's $80 aggregate inside loss (computed without regard to Asset 2). S's basis in Asset 1 is therefore reduced by $80, from $100 to $20, under paragraph (d) of this section.

(iii) *Transfer of all S shares.* Assume the same facts as in paragraph (i) of this *Example 5*, except that M sells all five S shares to X, recognizing both the gain and the loss on the S shares. The transfer of Share 1 is still a transfer of a loss share and therefore subject to this section. However, because all the shares are transferred, the group's income is clearly reflected. Therefore, the purposes of this section are not avoided and this section applies without modification. S's attribute reduction amount is $0, the lesser of the $0 net stock loss and S's $0 aggregate inside loss.

(h) *Effective/applicability date.* This section applies to transfers of shares of subsidiary stock on or after September 17, 2008 unless the transfer was made pursuant to a binding agreement that was in effect prior to September 17, 2008 and at all times thereafter. For transfers of shares of subsidiary stock that are not subject to this section, see §§1.337(d)–2 and 1.1502–35.

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SPECIAL TAXES AND TAXPAYERS

§ 1.1502–42 Mutual savings banks, etc.

(a) *In general.* This section applies to mutual s avings banks and other institutions described in section 593(a).

(b) *Total deposits.* In computing for purposes of section 593(b)(1)(B)(ii) total deposits or withdrawable accounts at the close of the taxable year, the total deposits or withdrawable accounts of other members shall be excluded.

(c) *Taxable income; taxable years for which the due date (without extensions) for filing returns is before March 15, 1983.* For taxable years for which the due date (without extensions) for filing returns is before March 15, 1983, a member's taxable income for purposes of section 593(b)(2) is determined under §1.1502–27(b) (computed without regard to any deduction under section 593(b)(2)). In addition, for taxable years beginning after July 11, 1969, taxable income as computed under the preceding sentence is subject to the adjustments provided in section 593(b)(2)(E). See §1.593–6A(b)(5).

(d) *Taxable income; taxable years for which the due date (without extensions) for filing returns is after March 14, 1983*—(1) *In general.* For a taxable year for which the due date (without extensions) for filing returns is after March 14, 1983, a thrift's taxable income for purposes of section 593(b)(2) is its tentative taxable income (as defined in paragraph (e)(1) of this section).

(2) *Definitions.* For purposes of this section:

(i) A *thrift* is a member described in section 593(a).

(ii) A *nonthrift* is a member that is not a thrift.

(e) *Tentative taxable income (or loss)*—(1) *Thrift.* For purposes of this section, a thrift's tentative taxable income (or loss) is its separate taxable income (determined under §1.1502–12 without paragraph (q) thereof and without any deduction under section 593(b)), subject to the following adjustments in the following order:

(i) The adjustments described in paragraph (e)(3) of this section;

(ii) The adjustments described in section 593(b)(2)(E) for those thrifts with separate taxable income greater than zero (determined after the adjustments under paragraph (e)(3) of this section); and

(iii) The adjustments described in paragraph (f) of this section.

(2) *Nonthrift.* For purposes of this section, a nonthrift's tentative taxable income (or loss) is its separate taxable income (determined under §1.1502–12), adjusted for the portion of the consolidated net operating loss deduction attributable to the member, the portion of the consolidated net capital loss carryover or carryback attributable to the member, and further adjusted as described in paragraph (e)(3) of this section.

(3) *Adjustments for all members.* For each member, the following adjustments taken into account in the computation of consolidated taxable income are included in determining its tentative taxable income (or loss) in order to adjust separate taxable income of the member to take into account certain consolidated items:

(i) The portions of the consolidated charitable contributions deduction and the consolidated dividends received deduction attributable to the member.

(ii) The member's capital gain net income, determined without any net capital loss carryover or carryback attributable to the member.

(iii) The member's net capital loss and section 1231 net loss, reduced by the portion of the consolidated net capital loss attributable to the member.

(f) *Adjustments for thrifts*—(1) *Reductions.* A thrift's separate taxable income (as adjusted under paragraph (e)(3) of this section) is reduced (but not below zero) by losses of thrifts and