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26 CFR Part 1

Unified Rule for Loss on Subsidiary Stock; Proposed Rule

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–157711–02]

RIN 1545–BB61

Unified Rule for Loss on Subsidiary Stock

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations under sections 358, 362(e)(2) and 1502 of the Internal Revenue Code (Code). The regulations apply to corporations filing consolidated returns. The regulations implement aspects of the repeal of the *General Utilities* doctrine by redetermining members' bases in subsidiary stock and requiring certain reductions in subsidiary stock basis on a transfer of the stock. The regulations also promote the clear reflection of income by redetermining members' bases in subsidiary stock and reducing the subsidiary's attributes to prevent the duplication of loss. Additionally, the regulations provide guidance limiting the application of section 362(e)(2) with respect to transactions between members of a consolidated group.

DATES: Written or electronic comments or a request for a public hearing must be received by April 23, 2007.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–157711–02), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–157711–02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically, via the IRS Internet site at *www.irs.gov/regs* or via the Federal eRulemaking Portal at *www.regulations.gov* (IRS/REG–157711–02).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Theresa Abell (202) 622–7700 or Phoebe Bennett (202) 622–7770; concerning submissions of comments, Richard Hurst, *Richard.A.Hurst@irscounsel.treas.gov*, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by March 26, 2007.

Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information;

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information in these proposed regulations is in §§ 1.1502–13(e)(4)(v) and 1.1502–36(d)(7). The respondents are corporations filing consolidated returns. The collection of information is required to allow a corporation to preserve a subsidiary's attributes by foregoing a stock loss. The collection of information is required to obtain a benefit.

Estimated total annual reporting and/or recordkeeping burden: 25 hours.

Estimated average annual burden per respondent and/or recordkeeper: 15 minutes.

Estimated number of respondents and/or recordkeepers: 100.

Estimated annual frequency of responses: Once.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to the collection of information must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

The discussion in this preamble begins with an overview of the history of the regulatory attempts to address both the circumvention of *General Utilities* repeal and the duplication of loss by consolidated groups, in particular, in § 1.1502–20 (the Loss Disallowance Rule, or LDR). The discussion then turns to *Rite Aid Corp.* v. *United States*, 255 F.3d 1357 (2001), which rejected the loss duplication rule in the LDR. Section A.4 of this preamble discusses the immediate administrative responses to *Rite Aid.* Section A.5 of this preamble discusses the legislative response to *Rite Aid.* Following the *Rite Aid* decision, the IRS and Treasury Department undertook a study to reconsider the issues addressed by § 1.1502–20. Section B of this preamble discusses the various issues considered in that study, including both the original noneconomic and duplicated stock loss specifically addressed by the LDR and certain related issues with which the Internal Revenue Service and Treasury Department have grown concerned since the LDR was promulgated. Section C of this preamble describes the various approaches that were considered to address noneconomic stock loss and sets forth the conclusions reached regarding each. Section D of this preamble describes the various approaches that were considered to address loss duplication and sets forth the conclusions reached regarding each. Section E of this preamble describes the various approaches that were considered to address the noneconomic and duplicated loss that can arise from the general operation of the investment adjustment system and sets forth the conclusions reached regarding each. Section F of this preamble describes the specific provisions of this proposed regulation § 1.1502–36. Section G of this preamble discusses the proposed removal of §§ 1.337(d)–1, 1.337(d)–2, and 1.1502–35.

The IRS and Treasury Department are also proposing regulations to address the application of section 362(e)(2) to members of consolidated groups. These proposed regulations are described in section H of this preamble.

Finally, the IRS and Treasury Department are proposing various technical and administrative revisions to the consolidated return regulations. These proposed regulations are described in section I of this preamble.

The IRS and Treasury Department request comments on the proposed regulations and other approaches that could be adopted, as well as other issues currently under study. See section J of this preamble for further discussion of comments requested.

A. History of General Utilities Repeal and Loss Disallowance Under § 1.1502–20

1. The Repeal of the General Utilities Doctrine

In 1986, Congress enacted section 337(d), which directs the Secretary to prescribe such regulations as may be necessary or appropriate to carry out the repeal of the *General Utilities* doctrine (*GU* repeal). See Tax Reform Act of 1986, Public Law 99–514 (100 Stat. 2085 (1986)). The legislative history states that Congress was concerned that the *General Utilities* doctrine allowed ''assets to leave corporate solution and to take a stepped-up basis in the hands of the transferee without the imposition of a corporate-level tax'' and thus ''tend[ed] to undermine the corporate income tax.'' H.R. Rep. No. 99–426, 99th Cong., 1st Sess. 282 (1985). The *General Utilities* doctrine and *GU* repeal are discussed extensively in the Treasury Decisions referenced in this preamble; in addition, see generally, H.R. Rep. No. 99–426 at 274–282 for a discussion of the history of the *General Utilities* doctrine; see also *General Utilities & Operating Co.* v. *Helvering*, 296 U.S. 200 (1935).

2. The Administrative Response to GU Repeal: § 1.1502–20

The IRS and Treasury Department first responded to *GU* repeal by issuing Notice 87–14 (1987–1 CB 445), which set forth the intent to promulgate regulations affecting adjustments to members' bases in stock of any subsidiary acquired when the subsidiary held an appreciated asset. Notice 87–14 indicated that, in general, adjustments to subsidiary stock basis would not reflect gains on such assets. Thus, Notice 87–14 implied that a tracing-based regime would be adopted to determine adjustments to member's bases in shares of subsidiary stock.

After several years of study, the IRS and Treasury Department concluded that any approach relying on the identification and tracing of appreciation on particular assets, while theoretically accurate, would impose substantial administrative burdens on taxpayers and on the government. See TD 8294 (1990–1 CB 69), 55 FR 9426, 9428 (March 14, 1990). As a result, the tracing-based approach envisioned in Notice 87–14 was implemented only in regulations promulgated under section 337(d). Those regulations applied only for the period of time between the issuance of Notice 87–14 and the effective date of final regulations under § 1.1502–20 (February 1, 1991). See TD 8364 (1991–2 CB 43), 56 FR 47379 (September 19, 1991), §§ 1.337(d)–1 and 1.337(d)–2 (as contained in 26 CFR part 1 revised as of April 1, 1991).

In lieu of tracing, the LDR used certain operating presumptions to determine the extent to which investment adjustments would be permitted to give rise to allowable stock loss. Because the LDR only disallowed loss, noneconomic investment adjustments were able to increase stock basis and thus reduce gain without limitation. As a result, the LDR reduced the duplication of gain in the tax system. The IRS and Treasury Department considered the reduction of gain duplication an important balance to the imprecision inherent in the LDR's use of irrebuttable presumptions.

The study following the issuance of Notice 87–14 led the IRS and Treasury Department to consider the issue of loss duplication by members of consolidated groups. Their conclusion was that loss duplication was inappropriate in the consolidated setting. Further, the IRS and Treasury Department recognized that there were administrative advantages to addressing both issues in a single integrated rule. Thus, unlike the regulations under section 337(d), the LDR was at once directed at both the circumvention of *GU* repeal through the use of noneconomic stock loss and the duplication of loss. See TD 8294 and TD 8364.

3. The Rite Aid Opinion

Ten years after the promulgation of the LDR, the validity of the duplicated loss component of the LDR was considered in *Rite Aid, supra.* Under the duplicated loss component of the LDR, Rite Aid had been disallowed a deduction for an economic loss on subsidiary stock solely because the stock loss could be duplicated by the subsidiary after it left the group. The Federal Circuit stated that the Secretary's authority to change the application of a Code provision to a consolidated group was limited to situations in which the change was necessary to address a problem created by the filing of a consolidated return. Because duplicated stock loss occurs and is allowable in the separate return setting, the court concluded that the duplicated loss component of the LDR was not addressing a problem arising from the filing of a consolidated return. Accordingly, the court held that the Secretary did not have the authority to change the Code rule allowing a deduction for the stock loss.

4. The Administrative Response to Rite Aid

In response to the *Rite Aid* decision, on February 19, 2002, the IRS announced that it would not continue to litigate the validity of the duplicated loss rule in § 1.1502–20. See Notice 2002–11 (2002–1 CB 526). On March 7, 2002, the IRS and Treasury Department promulgated § 1.1502–20T(i) (to suspend the application of the LDR) and § 1.337(d)–2T (to provide an interim rule addressing noneconomic stock loss). See TD 8984 (2002–1 CB 668), 67 FR 11034 (March 12, 2002). Concurrently with the promulgation of §§ 1.337(d)–2T and 1.1502–20T(i), the IRS issued Notice 2002–18 (2002–1 CB 644), announcing that loss duplication regulations would also be promulgated. Following the publication of TD 8984, the IRS and Treasury Department undertook a study of the issues underlying both noneconomic and duplicated loss on subsidiary stock.

In general, § 1.337(d)–2T disallowed stock loss and reduced stock basis (to value) upon the disposition or deconsolidation of subsidiary stock by a member of a consolidated group. However, under § 1.337(d)–2T(c)(2), loss disallowance and basis reduction were avoided to the extent the taxpayer could establish that the loss or basis ''is not attributable to the recognition of built-in gain on the disposition of an asset.'' Section 1.337(d)–2T(c)(2) defined the term ''built-in gain'' as gain that is ''attributable, directly or indirectly, in whole or in part, to any excess of value over basis that is reflected, before the disposition of the asset, in the basis of the share, directly or indirectly, in whole or in part.''

On March 14, 2003, the IRS and Treasury Department promulgated § 1.1502–35T as an interim measure to address the problem of loss duplication in consolidated groups. See TD 9048 (2003–1 CB 644), 68 FR 12287 (March 14, 2003). In the preamble to TD 9048, the IRS and Treasury Department announced that the issues addressed in § 1.1502–35T were still under study. The provisions of § 1.1502–35 are discussed in more detail in section D.1 of this preamble.

Further guidance on the interim rules was issued August 25, 2004, in the form of Notice 2004–58 (2004–2 CB 520). In Notice 2004–58, the IRS announced that it would accept the ''basis disconformity'' method as an alternative approach to determining whether stock

loss or basis was attributable to ''built-in gain'' within the meaning of § 1.337(d)–2T.

Under the basis disconformity method described in Notice 2004–58, stock loss or basis is treated as attributable to built-in gain to the extent of the least of (i) the net positive investment adjustment applied to the stock basis (disregarding distributions), (ii) the aggregate gain (net of directly related expenses) recognized on asset dispositions by the subsidiary, and (iii) the disconformity amount (generally, the amount by which the basis of the share exceeds the share's proportionate interest in the subsidiary's net inside asset basis; for this purpose, net inside asset basis is defined as the excess of the sum of the subsidiary's money, asset basis, loss carryforwards, and deferred deductions over its liabilities). Notice 2004–58 also requested comments on the general scope of *GU* repeal and on other approaches that could be adopted to safeguard the purposes of *GU* repeal in the consolidated return context.

5. The Legislative Response to Rite Aid

Congress responded to the *Rite Aid* opinion on October 22, 2004, in the American Jobs Creation Act (the AJCA), Public Law 108–357 (118 Stat. 1418 (2004)). In the AJCA, Congress added a sentence at the end of section 1502 of the Code, so that the section now reads:

> The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability. In carrying out the preceding sentence, the Secretary may prescribe rules that are different from the provisions of chapter 1 that would apply if such corporations filed separate returns.

In the legislative history to the AJCA, Congress stated that the Secretary is authorized to change the application of a Code provision when the Secretary determines it is necessary to clearly reflect the income tax liability of the group and each corporation in the group, both during and after the period of affiliation. See H.R. Conf. Rep. No. 108–755, 108th Cong., 2d Sess. 653 (2004). Congress thus rejected the suggestion in the *Rite Aid* opinion that the Secretary's authority to change the general application of the Code is limited to promulgating regulations that address problems created by the filing of a consolidated return.

In the AJCA legislative history, Congress also spoke to the proper scope of future regulations. Regarding the promulgation of regulations addressing noneconomic stock loss, Congress stated that ''presumptions and other simplifying conventions'' could be used to prevent the circumvention of *GU* repeal. See H.R. Conf. Rep. No. 108–755, fn. 595. In addition, Congress indicated two acceptable methods for addressing loss duplication by group members. The first would disallow subsidiary stock loss to the extent it duplicates losses that remain available to the group. The second would reduce the subsidiary's attributes in order to prevent the subsidiary from using losses outside the group, to the extent the losses duplicate stock loss. But Congress also stated its intention that the result of the *Rite Aid* decision is to be preserved. The IRS and Treasury Department interpret this statement to mean that regulations addressing loss duplication by consolidated groups must not disallow a deduction for an economic loss on subsidiary stock solely because the stock loss duplicates unrecognized or unabsorbed losses that later could be used outside the group.

6. Further Administrative Response to Rite Aid

On March 3, 2005, the IRS and Treasury Department finalized § 1.337(d)–2. See TD 9187 (2005–13 IRB 778), 70 FR 10319 (March 3, 2005). In TD 9187, the IRS and Treasury Department stated that the issues addressed in § 1.337(d)–2 were still under study and that an alternative approach would be proposed. On March 14, 2006, the IRS and Treasury Department finalized § 1.1502–35. See TD 9254 (2006–13 IRB 662), 71 FR 13008 (March 14, 2006). In TD 9254, the IRS and Treasury Department stated that both noneconomic and duplicated loss were still under study, and that regulations would be proposed adopting a singe integrated approach to addressing both issues. The results of that study and the proposed integrated approach are described below in sections D through H of this preamble.

B. Issues Considered in the Post-Rite Aid Study.

1. GU Repeal and Noneconomic Investment Adjustments Under the LDR

Section 337(d) generally directs the Secretary to prescribe regulations to prevent the circumvention of *GU* repeal and, in particular, section 337(d)(1) directs the Secretary to promulgate regulations to prevent the circumvention of *GU* repeal through the use of the consolidated return regulations. Congress' concern stems from the general operation of the investment adjustment system of § 1.1502–32.

The purpose of the investment adjustment system is to promote the clear reflection of the group's income. See § 1.1502–32(a)(1). One of the principal ways that the investment adjustment system promotes clear reflection is by preventing a subsidiary's items of income, gain, deduction and loss from giving rise to duplicative gain or loss on the subsidiary's stock. To that end, the investment adjustment system adjusts members' bases in shares of subsidiary stock to reflect such items once they have been taken into account by the group. See TD 8560 (1994–2 CB 200), 59 FR 41666 (August 15, 1994).

Example 1. Economic adjustment to stock basis prevents duplication. P, the common parent of a consolidated group, purchases all 100 outstanding shares of S common stock for $100 cash, taking a basis of $1 in each share. At the time, S owns one asset, A1, with a basis and value of $100. Later, the value of A1 increases to $150. S sells A1 to a nonmember for $150 and recognizes a $50 gain, which the P group takes into account. Under the investment adjustment system, P increases its basis in its S stock to reflect the $50 taken into account by the group. As a result, the basis of each share increases to $1.50, its fair market value. P can then sell all or any portion of its S stock for its fair market value without recognizing duplicative gain on the disposition.

The result in *Example 1* is that the group takes its economic gain into account only once, on the disposition of S's asset, and not again on the subsequent disposition of the S stock. Thus the group's income is clearly reflected and there is no circumvention of *GU* repeal.

The investment adjustment system is not a tracing regime. Rather, it is a presumptive regime based on certain operating assumptions. A principal assumption is that all of a subsidiary's items taken into account represent economic accruals (of gain or loss) to the group. Another principal assumption is that all such items accrue equally to all outstanding shares, at least within a class. When these assumptions correspond to the facts of a particular situation, as in *Example 1,* the investment adjustment system produces appropriate results: stock basis, which reflects only the investment in the stock, increases to reflect economic accrual (the group's return on its stock investment), and, as a result, stock basis can then shelter that return on the group's investment, protecting it from being taken into account again when the stock is sold.

The assumptions, however, do not correspond to the facts of all situations. For example, if stock of a subsidiary is purchased for its fair market value when the subsidiary holds appreciated assets, the items of income or gain generated when that appreciation is recognized do not represent an economic accrual on the group's investment (because the appreciation was already reflected in the basis of the stock). Nevertheless, the presumptive rules of the investment adjustment system treat such items as economic accruals and include them in the investment adjustment to be applied to the basis of the stock.

Example 2. Noneconomic adjustment to stock basis creates noneconomic stock loss. Assume the same facts as in *Example 1* except that P does not purchase the stock of S until the value of A1 has increased to $150. Accordingly, P purchases the stock for $150, taking a basis of $1.50 in each share. As in *Example 1,* when S sells A1, the investment adjustment system again increases P's basis in its S stock to reflect the $50 taken into account by the group. As a result, P's basis in each of its shares increases to $2, even though the fair market value of each share remains $1.50. If P were then to sell all or some portion of the S stock for its fair market value, P would recognize a $.50 loss on each share ($50 loss in the aggregate).

In this situation, a deduction for the stock loss would be inappropriate because neither the group nor its members have suffered any economic loss. If P were allowed to deduct that noneconomic loss, the deduction would offset the gain recognized on S's asset and, effectively, eliminate the corporate-level tax on the gain on S's asset. This is the circumvention of *GU* repeal that concerned Congress in 1986.

At the time Notice 87–14 was issued, the IRS and Treasury Department had identified the creation of noneconomic stock loss in situations similar to those illustrated in *Example 2.* Thus, Notice 87–14 referred specifically to investment adjustments attributable to the disposition of assets that, at the time of the acquisition of the subsidiary stock, had a fair market value in excess of adjusted basis. For that reason, § 1.337(d)–1, which implemented Notice 87–14, disallowed subsidiary stock loss unless the taxpayer could show that the loss was not attributable to the recognition of appreciation on assets owned, directly or indirectly, by a subsidiary when it became a member.

2. Duplicated Loss and the Clear Reflection of Group Income Under the LDR

In the study that followed the issuance of Notice 87–14, the IRS and Treasury Department also considered the issue of loss duplication by members of a consolidated group. The specific concern of the IRS and Treasury Department was the loss duplication that occurs when an economic loss is reflected in both a member's basis in subsidiary stock and in the subsidiary's assets or operations, and the loss is first recognized with respect to the stock.

Example 3. Duplication of loss. P forms S by contributing $110 to S in exchange for all 100 outstanding shares of S stock. S uses the cash to purchase an asset, A1. The value of A1 later declines to $10. If P were then to sell all or some portion of the S stock for its fair market value, P would recognize a $1 loss on each share.

In this situation, even though P would have recognized the group's economic loss on its disposition of the S stock, the loss continues to be reflected in the basis of A1. As a result, that loss would remain available for use by P (if the stock sale did not deconsolidate S) or S (if the stock sale deconsolidated S). Upon the disposition of A1, the group's single economic loss would thus be recognized and taken into account more than once by the group and its members or former members.

In contrast, if the duplicated loss had first been taken into account with respect to A1, the investment adjustment system would have prevented a duplicative benefit to the group and its members by reducing P's basis in S stock by the amount of the loss. In that case, the group would have enjoyed the tax benefit attributable to the loss, but that benefit would not remain available for another use by the group and its members or former members.

The IRS and Treasury Department concluded that the duplication of a group's tax benefit (represented by a single economic loss) distorts income without regard to whether the duplicated loss is taken into account first with respect to the subsidiary's stock or first with respect to the subsidiary's assets and operations. The IRS and Treasury Department further concluded that, even if the duplicated loss is used by a former member outside the group, that duplicative use distorts the income of the group and its members. Accordingly, the IRS and Treasury Department decided to promulgate regulations that would complement the investment adjustment system by addressing the stock-first recognition of a duplicated loss and that such regulations would apply to both deconsolidating and nondeconsolidating dispositions. Recognizing the administrative benefits of addressing both noneconomic and duplicated stock loss in a single integrated rule, the IRS and Treasury Department promulgated the LDR as a single rule with components directed at both.

The method adopted by the LDR to address loss duplication was the disallowance of stock loss (or reduction of stock basis) that duplicated unrecognized inside loss, such as that illustrated in *Example 3.* However, groups had several mechanisms available to recognize or preserve the inside loss and thereby avoid loss disallowance (by eliminating loss duplication). Inside losses could be recognized through an actual asset sale or a deemed asset sale under section 338(h)(10), and, following the sale, the subsidiary's unabsorbed losses would be available to the group. In addition, the LDR allowed the common parent to elect to reattribute the subsidiary's losses (to itself) under § 1.1502–20(g). If the group chose not to exercise those options, then the stock loss was denied, but the inside loss was preserved for a nonduplicative use by the subsidiary, in or out of the group.

At the time the LDR was promulgated, the duplication potential illustrated in *Example 3* was the principal form of loss duplication with which the IRS and Treasury Department were concerned. Thus it is the only form of loss duplication specifically addressed by the LDR. The anti-abuse rule in the LDR did, however, provide a limited mechanism for expanding the scope of that provision.

3. Noneconomic and Duplicated Loss Resulting from Investment Adjustments Allocated to Shares With Disparate Bases

Since the promulgation of the LDR, the IRS and Treasury Department have become increasingly concerned with the noneconomic and duplicated loss potential arising from the interaction of § 1.1502–32 and the disparate reflection of gain or loss in members' bases in individual shares of subsidiary stock.

As discussed in section B.1 of this preamble, the investment adjustment system is a presumptive regime that allocates a subsidiary's items of income, gain, deduction, and loss taken into account by the group. It operates in accordance with the assumption that all such items reflect economic accruals to all shares equally within each class. When its underlying assumptions correspond to the facts of a particular situation, the investment adjustment system produces appropriate results, as illustrated in *Example 1.* But when its underlying assumptions do not correspond to the facts of a situation because shares held by members have disparate bases, the general operation of

the investment adjustment system can give rise to both noneconomic and duplicated loss on individual shares of subsidiary stock.

Example 4. Noneconomic loss. P and M (a member of the P group) form S by contributing property to S in exchange for all 100 outstanding shares of S stock. P contributes A1, with a basis and value of $80, in exchange for 80 shares of S stock. M contributes A2, with a basis of $0 and a value of $20, to S in exchange for 20 shares of S stock. S then sells A2 for $20 and recognizes a $20 gain that is taken into account by the group. As a result, the basis of each share increases by $.20. P's basis in each of its shares is then $1.20 (or, $96 in the aggregate), and M's basis in each of its shares is then $.20 (or, $4 in the aggregate), even though the value of each share remains $1. P then sells all or some portion of its shares to X, a nonmember, and, under general principles of tax law, recognizes a $.20 noneconomic loss on each share, effectively eliminating up to $16 of the gain on A2.

Example 5(a). Duplicated loss, inside recognition precedes stock disposition. P forms S with $100 and receives all 50 shares of S common stock. S uses the $100 to buy A1, which then declines in value to $50. P contributes another $50 for a second 50 shares of common stock. S then sells A1 and recognizes a loss of $50 that is taken into account on the P group return. The absorption of the $50 loss results in a $.50 reduction to the basis of each share (original and newly issued). P then sells all or some portion of the original shares to X for $1 each (each with a basis of $1.50) and recognizes a $.50 loss on each share (up to $25 total). Although the $50 asset loss and the $25 stock loss both reflect an economic loss of the group, they are both reflecting the same loss. The group has actually experienced only $50 of economic loss. Therefore, the $.50 loss recognized on each of the original shares (up to $25 total) is duplicative.

Example 5(b). Duplicated loss, stock disposition precedes inside recognition. The facts are the same as in *Example 5(a),* except that, before S sells A1, P sells 20 of its original 50 shares to X for $20 (aggregate basis $40), recognizing a $20 loss that is taken into account on the P group return, and S remains a member of the group. S then sells A1, recognizing a $50 loss that is taken into account on the P group return. Although the $50 asset loss and the $20 stock loss both reflect an economic loss of the group, they are both reflecting the same loss. As in *Example 5(a),* the group has actually experienced only $50 of economic loss. Therefore, $20 of the recognized loss is duplicative. Alternatively, if P sold all its original 50 shares, P would recognize a $50 loss even though the entire $50 group loss would remain available to S for a duplicative use against its separate year income.

The IRS and Treasury Department recognize that, in each case where the disproportionate reflection of an item in a particular share causes an inappropriate stock loss, whether noneconomic or duplicated, that loss is offset by unrecognized gain in other shares. However, that gain can be deferred indefinitely or even eliminated by the group. Accordingly, the IRS and Treasury Department do not believe that the system is appropriately balanced in such cases.

The IRS and Treasury Department further recognize that these issues could be addressed by adopting a tracing-based approach to the allocation of investment adjustments. However, the complexity and burden of a tracing-based approach would render such an approach generally inadministrable for consolidated taxpayers and for the government. As a result, the system would be prone to error and, in practice, inconsistently applied. Moreover, the IRS and Treasury Department continue to believe that the assumptions on which the investment adjustment system is based are appropriate for typical commercial transactions, as the IRS and Treasury Department understand that typically subsidiaries have only common stock outstanding, that their stock is wholly owned by group members, and that members' bases in shares of subsidiary stock are uniform, as under the facts of *Example 1.* See section E.2 of the preamble of CO–30–92 (1992–2 CB 627), 57 FR 53634, 53639 (November 12, 1992).

Because a tracing-based approach to the allocation of investment adjustments would not be administrable, the IRS and Treasury Department are not considering revising the investment adjustment system to adopt such an approach. Instead, the IRS and Treasury Department have considered various presumptive approaches that could be adopted to mitigate the creation of noneconomic and duplicated loss when members hold subsidiary stock with disparate bases. The approaches considered and decisions reached are discussed in section E of this preamble.

4. Redetermination Events: Changes in the Extent That Unrecognized Gain or Loss Is Effectively Reflected in the Basis of Individual Shares

Because the investment adjustment system adjusts the basis of each share in accordance with its proportionate interest in S's assets and operations, the relationship between a share's basis and its allocable portion of unrecognized appreciation or depreciation determines the extent to which such amounts are effectively reflected in the basis of the share. This relationship, however, is not fixed at the time that stock is acquired. The reason is that there are many transactions, referred to here as redetermination events, that alter either the basis of a share or the interest it represents. These events generally occur in one of three types of situations.

a. *Stock basis is reallocated.*

The relationship between the basis of a share and the interest represented by the share can be altered whenever stock basis is reallocated among shares, including when it is allocated to shares of stock of other members.

Example 6. Intragroup spin-off. P forms S by contributing $100 to S in exchange for all the stock of S. S purchases two assets, A1 and A2, for $50 each. Subsequently, A1 appreciates to $75 and A2 depreciates to $25. In a transaction qualifying under sections 355 and 368(a)(1)(D), S transfers A2 to C in exchange for all of the C stock and S then distributes all the C stock to P. Under section 358 and § 1.358–2, P's basis in the S stock is allocated among the S and C stock in proportion to the value of the stock of S and C. As a result, P's basis in its S stock is $75 ($\frac{75}{100} \times \$100$) and P's basis in its C stock is $25 ($\frac{25}{100} \times \$100$). S sells A1 for $75, recognizing a $25 gain that is taken into account on the P group return. P's basis in its S stock increases by $25, from $75 to $100. P then sells its S stock for $75 and recognizes a $25 loss.

In this *Example 6,* after the reallocation of stock basis, P's basis in its S stock reflects the unrecognized appreciation on A1, just as P's basis in its S stock reflected unrecognized appreciation on A1 in *Example 2.* As a result, P's reallocated S stock basis protects the appreciation on A1 from being recognized as both asset gain and stock gain. Increasing P's basis in its S stock to reflect the recognition of S's gain on A1 is not only unnecessary, it inflates stock basis and thereby gives rise to either noneconomic loss or noneconomic reduction of gain when the stock is sold.

Basis reallocations, and the consequences described, can occur for a number of reasons, including, for example, under rules like § 1.1502–32(c)(4) (cumulative redetermination of investment adjustments) and § 1.1502–35(b) (basis redetermination to reduce disparity) and the corresponding provision in these proposed regulations.

b. *Capital transactions expand or contract the subsidiary's pool of assets.*

The relationship between the basis of a share and the nature of the interest represented by the share can also be altered by capital transactions that have no effect on the basis or value of outstanding shares, but that nevertheless alter the interest represented by those shares. Some common examples arise in the context of section 351 exchanges, even though, as illustrated in *Example 7(a),* a section 351 exchange in its simplest form cannot give rise to stock basis that reflects unrecognized appreciation.

Example 7(a). Contribution of appreciated asset in section 351 exchange. P forms S by contributing an asset, A1, to S in exchange for all 80 outstanding shares of S stock. The basis of A1 is $40 and its value is $80. S sells A1 and recognizes a $40 gain that is taken into account by the P group. As a result, P's aggregate basis in its S shares is increased by $40, from $40 to $80. Subsequently, P sells its S stock for $80, the stock's fair market value and recognizes $0 on the sale. The group is thus taxed once on its $40 economic gain.

In *Example 7(a),* P holds appreciated S stock and S holds an appreciated asset, but that appreciation is not reflected in either P's basis in its S stock or S's basis in its asset. Each share has a basis of $.50 and an interest in 1/80 of S's asset, A1, which has $40 of unrecognized appreciation (allocable $.50 to each share). If this relationship between P's basis in its S shares and the interest represented by the shares remains constant, as in *Example 7(a),* the investment adjustment system produces appropriate results. But if there is a change in that relationship, the underlying assumptions of the investment adjustment system may no longer correspond to the facts of the situation and, as a result, the general operation of the system could produce inappropriate results. Such changes can occur whenever S acquires property in exchange for additional shares of its stock.

Example 7(b). Contribution of appreciated asset in subsequent section 351 exchange creates disconformity in original shares. The facts are the same as in *Example 7(a),* except that, before A1 is sold, P contributes a second asset, A2, to S in exchange for an additional 20 shares of S stock. A2 has a basis of $0 and a value of $20. S sells both assets and recognizes a $60 gain that is taken into account by the P group. As a result, P's basis in its original shares increases by $48 ($.60 per share), from $40 to $88 (or, from $.50 to $1.10 per share), and P's basis in its new shares increases by $12, from $0 to $12 (or, from $0 to $.60 per share). P then sells 20 of its original shares (basis of $22) for $20, their fair market value, and recognizes a $2 loss.

In *Example 7(b),* P's basis in the original S stock reflected no unrecognized appreciation when the stock was issued. After the second contribution, however, P's basis in those shares reflects a portion of the unrecognized appreciation on A2. The reason is that each share represents an interest in S's entire pool of assets. When the pool changes, the nature of the interest represented by the shares changes, even though the share's basis and value remain constant. Thus, in *Example 7(b),* while each original share's basis ($.50) and value ($1) remain constant, the interest represented by each share changed from 1/80 of an asset with unrecognized appreciation of $40 (or, $.50 per share), to 1/100 of assets with unrecognized appreciation of $60 (or, $.60 per share). This shift causes the basis of each original share to reflect $.10 of unrecognized appreciation. When the gain is recognized, $.10 of the gain allocated to each original share under the investment adjustment system is a noneconomic increase in the share's basis. That increase will give rise to noneconomic stock loss or gain reduction. Although this (noneconomic) allocation of the (economic) item results in an offsetting stock gain on the basis of the new shares, that gain can be indefinitely deferred and even eliminated.

The principles that increase the reflection of unrecognized appreciation in the original shares in *Example 7(b)* can also cause the reflection of unrecognized appreciation in the basis of shares that are received in exchange for property that is not appreciated, including cash. Although such shares would have a substituted basis (which generally precludes the reflection of unrecognized appreciation, as illustrated in *Example 7(a)*), the reflection of unrecognized appreciation is prevented only if the shares represent, wholly and solely, the transferee's interest in its transferred property. If there are previously issued shares outstanding, or if other shares are issued in the exchange, the shares represent an interest in a pool of assets that includes more than the transferred assets. As a result, the interest represented by each such share may be significantly different from what it would be if the subsidiary held only the transferred property.

Example 7(c). Multiple transferors in single section 351 exchange. The facts are the same as in *Example 7(a),* except that, when P contributes A1 to S in exchange for 80 shares of S stock, M (another member in the group) also contributes $20 cash to S in exchange for 20 shares of S stock. S sells A1 for $80 and recognizes a $40 gain that is taken into account by the group. Accordingly, P's aggregate basis in its shares increases by $32 ($^{80}/_{100} \times$ $40), from $40 to $72, and M's aggregate basis in its shares increases by $8 ($^{20}/_{100} \times$ $40), from $20 to $28. M then sells its shares for $20, their fair market value, and recognizes an $8 noneconomic loss.

Similar changes in the extent to which unrecognized amounts are reflected in basis can occur whenever the subsidiary's pool of assets is increased or decreased by a capital transaction. The reason is that the interest represented by each share, and thus the relationship between a share's basis and the interest represented by the share, changes whenever the subsidiary's pool of assets changes. Such transactions include acquisitive reorganizations (if new shares are issued) and redemptions.

c. *Assets are acquired with a basis that reflects unrecognized appreciation.*

The relationship between the basis of a share and the nature of the interest represented by the share can also be altered by transactions in which S acquires assets with a basis that reflects unrecognized appreciation, such as stock of a new member. The reason is that, after the lower-tier acquisition, the S shares have an interest in unrecognized appreciation and the investment adjustment system will increase the basis of the S shares when those lower-tier items are recognized.

Example 8. Acquisition of lower-tier subsidiary with appreciated assets. P forms S by contributing $100 to S in exchange for all the stock of S. S then purchases all the stock of T for $100 when T holds one asset, A1, with a basis of $0 and a value of $100. T sells A1, recognizing a $100 gain that is taken into account on the P group return. As a result, both S's basis in its T stock and P's basis in its S stock are increased by $100, from $100 to $200. P then sells its S stock, recognizing a $100 loss.

The result is the same noneconomic loss illustrated in *Example 2*.

d. *Other redetermination events.*

The IRS and Treasury Department expect that other transactions and events can alter the extent to which unrecognized asset appreciation is reflected in stock basis. Accordingly, the preceding discussion is not intended to present an exhaustive list of possible redetermination events.

e. *Conclusions regarding redetermination events.*

The IRS and Treasury Department recognize that redetermination events occur as the result of bona fide business transactions engaged in frequently and routinely throughout the time a share is held by any member of the group, and that these transactions are typically not tax-structured transactions. Still, these events generate a significant potential for noneconomic stock loss or gain reduction that facilitates the circumvention of *GU* repeal. Accordingly, the IRS and Treasury Department believe that all such events, whether described in this preamble or not, must be taken into account in any model that is adopted to address the circumvention of *GU* repeal.

Nevertheless, the IRS and Treasury Department recognize, and are concerned that, the factual analysis necessary to identify all redetermination events for all members' shares would be an extensive, complex, difficult, and,

therefore, expensive undertaking and, as such, would impose a substantial burden on both taxpayers and the government. Moreover, the nature of the undertaking would make it prone to error and, as a result, the rule would be unevenly administered and similarly situated taxpayers would not be similarly treated.

The IRS and Treasury Department recognize that redetermination events can also create or increase the extent to which the basis of an individual share duplicates an inside loss. However, because duplicated loss is measured at the time that a stock loss is either recognized or preserved for later use, loss duplication rules by their operation account for redetermination events. Accordingly, regulations addressing loss duplication do not generally require specific provisions to address redetermination events.

C. Methods Considered To Implement GU Repeal

The IRS and Treasury Department considered a number of approaches to address the circumvention of *GU* repeal independently from the issue of loss duplication. The approaches fall into two broad categories: tracing-based and presumptive approaches.

1. Tracing-Based Methods

Under a tracing-based method, the extent to which a member can enjoy the benefit of subsidiary stock basis attributable to the recognition of an item of income or gain is determined by the extent to which the recognized item is reflected in the basis of the share and thus already protected from duplicative recognition on a later disposition of the stock. The IRS and Treasury Department continue to believe that tracing is a theoretically correct method for implementing *GU* repeal in the consolidated return setting and so considered various tracing-based proposals.

a. *Pure tracing*.

In general, a tracing approach would look solely to the connection between a subsidiary's recognized items and any appreciation reflected in stock basis in order to determine the extent to which the group will be allowed the benefit of stock basis attributable to those items. However, such an approach would require taxpayers to create and maintain (and the IRS to examine) records to establish:

- The identity of every ''tainted asset,'' that is, every asset held by the subsidiary and any lower-tier subsidiaries on every ''measuring date,'' which includes the date on which the member (or its predecessor) purchased the share and all subsequent dates on which the subsidiary has a redetermination event;
- The ''tainted appreciation,'' that is, the appreciation on each tainted asset held by the subsidiary and any lower-tier subsidiaries on each measuring date; and
- The extent to which tainted appreciation is recognized, whether as income or gain, and included in an adjustment to the basis of the share.

In addition, to fully benefit from a tracing regime, taxpayers would need to create and maintain similar records for tainted assets with unrecognized depreciation on a measuring date, because the recognition of that depreciation would be allowed to reduce the amount of recognized appreciation treated as tainted.

These records would have to be created and maintained for each share of stock of each subsidiary and each share of lower-tier subsidiary stock held by a subsidiary on each measuring date. In addition, these records would need to be created and maintained not just for subsidiaries, but for all corporations the stock of which is acquired by a member, because the information would be necessary if the corporation becomes a member at some later date.

In administering the various temporary and final regulations promulgated as loss limitation rules under § 1.337(d)–1 and § 1.337(d)–2, the IRS has found that taxpayers encounter substantial difficulty in attempting to satisfy these requirements.

To begin, taxpayers are generally unable to accurately identify all of a subsidiary's tainted assets. One reason is simply the vast number of assets implicated. Another reason is that many assets are accounted for in mass accounts and thus cannot be separately identified. Problems are exacerbated if appropriate records are not created contemporaneously; taxpayers have found this a particular concern when subsidiaries have been acquired with inadequate records.

Furthermore, the commonplace nature of many redetermination events makes it difficult to identify all such dates. For example, many taxpayers routinely issue stock when a member contributes cash or property to a subsidiary, even if the issuance of stock would not be required for section 351 to apply, and each such occurrence is a redetermination event.

Valuation also imposes significant financial and administrative burdens on both taxpayers and the government. These problems are exacerbated because the corporation's assets are not themselves the subject of an arms-length transaction and, in most cases, the date on which the assets are actually valued is long after the stock transaction.

The most problematic aspect of tracing, however, has typically been establishing the connection, or lack thereof, between items taken into account by the group and particular amounts of tainted appreciation. If much time has elapsed between a measuring date and the disposition of a tainted asset, or if an asset is held in a mass account, this can be difficult or even impossible. If tainted appreciation is recognized as income earned through the wasting or consumption of the appreciation, instead of as gain on the disposition of the asset, there are additional difficulties. In those cases, tracing is possible only if the tainted appreciation generates an identifiable stream of income. However, this is frequently not the case. For example, intangible assets, like patents or goodwill, are the source of significant tainted appreciation and they typically do not generate identifiable income streams.

i. *Conclusions regarding tracing*.

For all the reasons set forth in this preamble, the IRS and Treasury Department have again, as in 1990, concluded that tracing is not a viable method for preventing the circumvention of *GU* repeal in consolidation. This conclusion, while arguably based on theoretical concerns in 1990, is now based on several years of administering § 1.337(d)–2 (in both its temporary and final form) as a tracing regime. The IRS found that the difficulties encountered, by taxpayers and the government alike, in administering § 1.337(d)–2 as a tracing-based rule were overwhelmingly greater than those encountered in administering it as a presumption-based rule under the basis disconformity method permitted under Notice 2004–58. Accordingly, the IRS and Treasury Department are not proposing to adopt a tracing-based approach.

ii. *Tracing in other contexts*.

The IRS and Treasury Department recognize that tracing-based regimes are used to implement other provisions in the Code. For example, section 382(h), which prescribes the tax treatment of built-in items recognized by a corporation that has had an ownership change, and section 1374, which prescribes the tax treatment of built-in items recognized by an S corporation that was formerly a C corporation, both use tracing-based regimes. Further, the IRS and Treasury Department are proposing regulations implementing section 362(e)(2) in a consolidated return context that require certain items

to be traced. See section H of this preamble.

The tracing regimes appropriate for those sections, however, do not present compliance and administrative concerns of the scope and magnitude presented by a tracing regime appropriate for *GU* repeal in the consolidated setting for at least three reasons.

To begin, both sections 382(h) and 1374 apply only for a limited period of time—five years in the case of section 382(h) and ten years in the case of section 1374—and so whatever burden is imposed is more limited in nature.

More importantly, sections 382(h) and 1374 are generally concerned only with the unrecognized appreciation and depreciation in a pool of assets held by a corporation on a single date—the date the C corporation converts to an S corporation or the date the S corporation acquires assets of a C corporation in the case of section 1374, and the date a corporation has an ownership change in the case of section 382(h). Similarly, section 362(e)(2) is only concerned net unrecognized depreciation in a pool of assets on the date of the transaction to which section 362(e)(2) applies. But the ability to circumvent *GU* repeal using the consolidated return provisions can be created any time the subsidiary has a redetermination event. Thus, any rule implementing *GU* repeal in the consolidated context, unlike rules implementing sections 362(e)(2), 382(h), and 1374, must trace the pool of assets held on all measuring dates, and not just the pool of assets held when subsidiary stock is acquired (or when assets are transferred).

Finally, unlike regulations implementing *GU* repeal, regulations implementing those other sections do not need to take into account the changing relationship between the basis in a particular share of stock and the unrecognized appreciation and depreciation in the corporation's assets.

For these reasons, any tracing-based regime appropriately implementing *GU* repeal in the consolidated setting would be much more expansive and complex, and therefore much less administrable, than the tracing regimes appropriately implementing sections 382(h) or 1374 (or proposed to implement section 362(e)(2)).

b. *Modified tracing*.

The IRS and Treasury Department considered several approaches that could be adopted to modify a tracing model by limiting the extent to which tracing would be required, in order to mitigate the administrative burdens of a pure tracing model.

i. *Exclusion for items attributable to after-acquired assets*.

Several commentators have suggested an approach, generally called the ''after-acquired asset exception,'' which allows taxpayers to identify assets acquired after the acquisition of subsidiary stock, in order to treat any gain realized on those assets as economic to the group. In general, all other items of gain and income would be deemed to be noneconomic, that is, attributable to the recognition of appreciation that was already reflected in basis. Stock loss would be allowed only to the extent that stock basis was attributable to the amounts deemed economic to the group. In response to concerns raised by the IRS and Treasury Department about redetermination events, the proposal was modified to provide that only assets acquired after the latest measuring date would be treated as giving rise to economic amounts. The principal advantage of this approach is that it identifies some untainted items with no need for valuation.

To begin, the IRS and Treasury Department are concerned with the burden and error potential presented by the need to identify all redetermination events. Moreover, because these events can occur with considerable frequency in the ordinary course of business, it is unlikely that a great deal of time will typically elapse between the last redetermination date and the date of a stock disposition. Thus, the amount of gain recognized on an asset acquired and sold during such periods of time will not likely be significant. As a result, it appears unlikely that this approach would afford much relief to taxpayers (in terms of administrative burden or reducing the disallowance amount) or to the government (in terms of administrative burden).

Furthermore, in order to implement *GU* repeal appropriately, such an approach must take into account not only gains, but also losses, recognized on after-acquired assets. But the identification of such losses imposes an additional administrative burden that taxpayers have no incentive to facilitate. In any event, a requirement to take losses into account could be easily manipulated by the timing and structuring of redetermination events.

ii. *Exclusion for items recognized after prescribed period of time*.

Several commentators also suggested a tracing-based approach that would apply to investment adjustments taken into account only during a prescribed period of time following the acquisition of a share. The chief advantage to this approach is that, regardless how burdensome the administration of the rule, it would not extend indefinitely.

Like the proposed after-acquired-asset approach, however, this approach would need to take redetermination events into account. The tracing period would then begin again on the date of each redetermination event. Thus, like the after-acquired-asset exception, this approach is unlikely to afford much relief to taxpayers (in terms of administrative or tax burden) or the government (in terms of administrative burden) because the period for tracing may never close.

Moreover, the IRS and Treasury Department are concerned that such an approach does not adequately respond to *GU* repeal. The reason is that noneconomic investment adjustments circumvent *GU* repeal whenever they are taken into account. Thus, the IRS and Treasury Department continue to believe that, in the absence of any direction from Congress, such as in the case of section 1374, imposing time limits on the implementation of *GU* repeal would be inappropriate. See TD 8294.

iii. *Exclusion for basis conforming acquisitions*.

Commentators have also suggested adopting a tracing-based approach that excepted any stock acquired in either a section 351 exchange or a qualified stock purchase for which an election was made under section 338. The rationale for this approach is that, by operation of statute, the basis of stock acquired in these transactions can reflect no unrecognized appreciation.

The IRS and Treasury Department agree that, in certain circumstances, the structure of a stock acquisition will, by operation of law, preclude the reflection of unrecognized appreciation in stock basis. The IRS and Treasury Department are concerned, however, that many acquisitions under section 351 or section 338 actually do not preclude the reflection of unrecognized asset appreciation in stock basis. For example, if subsidiary stock is acquired in a section 351 exchange in multiple transactions or by multiple transferors, as illustrated in *Example 7(b)* and *Example 7(c)*, respectively, the basis of the shares received can reflect unrecognized appreciation. Similarly, because only 80 percent of the stock of a subsidiary need be acquired to elect section 338 treatment, the basis of up to 20 percent of a subsidiary's shares may reflect unrecognized appreciation. Moreover, even if the initial acquisition precludes the reflection of unrecognized gain, once there is a redetermination event, the form of the acquisition no longer prevents the reflection of

unrecognized appreciation in stock basis. Thus, very few, if any, such transactions would ultimately qualify for this exception.

Thus, like the two previously described approaches to modified tracing, this approach has the inaccuracy and burden associated with identifying redetermination dates and a limited potential for relief to either taxpayers or the government.

iv. *Conclusions regarding modified tracing.*

Each approach considered would increase the administrative burden significantly without significantly increasing precision or relief. Accordingly, the IRS and Treasury Department are not proposing to adopt any of these approaches.

2. Hybrid Tracing-Presumptive Model: Asset Tracing.

The IRS and Treasury Department also considered a hybrid tracing-presumption approach that would identify all assets held when a share is acquired and on each redetermination date thereafter (again, the ''tainted assets'') and then presume all items of income, gain, deduction, and loss traced to those assets to be tainted. The intent was to design an approach that would be more precise than either a modified tracing or purely presumptive approach, while being more administrable than a pure tracing-based approach. The chief advantages of this approach are that it may enhance precision and, like the after-acquired asset exception described in section C.1.b.i of this preamble, may eliminate any need for valuation.

However, like the modified tracing approaches described above, this approach would require the identification of all redetermination events. Furthermore, it would require the identification of all assets held at the time of each such event and the tracing of those assets to particular investment adjustments. Thus, it presents even more complexity, burden, and expense than the modified tracing regimes considered. Furthermore, the IRS and Treasury Department are concerned that this approach could be easily abused, either by the manipulation of redetermination dates or the use of intercompany transactions to make valuation elective. (That is, taxpayers could selectively engage in intercompany transactions so that, in effect, some assets would be valued and not others.)

Finally, the IRS and Treasury Department are not convinced that the approach in fact significantly enhances the precision of a pure presumptive model in light of the fact that there is no actual valuation (and therefore no actual determination that there was any gain reflected in stock basis).

For all these reasons, the IRS and Treasury Department concluded that the potential advantages of this hybrid tracing-presumptive approach are outweighed by its disadvantages. Accordingly, the IRS and Treasury Department are not proposing to adopt this approach.

3. Presumption-Based Models

Recognizing that even the hybrid tracing-presumptive model would present significant burden and imprecision, the IRS and Treasury Department considered various presumptive models that, like the LDR, would eliminate all elements of tracing. A principal advantage of such approaches is that they are readily administrable by both taxpayers and the IRS. Thus, the rules can apply uniformly and consistently, with the result that similarly situated taxpayers will be similarly treated, increasing the overall fairness of the system. The elimination of any tracing element, however, increases the importance of limitations, where appropriate, on the nature and amount of items treated as noneconomic to a share. The approaches considered are discussed in this section C.3 and in section C.4 of this preamble.

a. *Basis disconformity under Notice 2004–58.*

One model considered was the basis disconformity model described in Notice 2004–58, presently available as a method to avoid disallowance under § 1.337(d)–2. As noted in section A.4 of this preamble, the basis disconformity model treats as built-in gain (within the meaning of § 1.337(d)–2) the smallest of three amounts. The first is the basis disconformity amount (which identifies the minimum amount of built-in gain that could be reflected in the share), the second is the net positive adjustment amount (which identifies the actual amount of stock basis attributable to the consolidated return system), and the total gains on property dispositions (which responds to the definition of the term built-in gain in § 1.337(d)–2). A significant advantage of this approach is that both taxpayers and the IRS find it readily administrable with information that taxpayers are already required to maintain.

However, the Notice 2004–58 basis disconformity model, because it is an interpretation of the current loss limitation rule in § 1.337(d)–2, reflects limitations that inhibit the extent to which the rule addresses the circumvention of *GU* repeal and promotes the clear reflection of group income. For example, the model did not account for the consumption of unrecognized appreciation reflected in stock basis (the ''wasting asset'' problem). Thus, if unrealized gain reflected in stock basis was recognized as income (for example through a lease, instead of a disposition of the property), the resulting noneconomic stock loss was not disallowed under the current rule. In addition, the model did not address the problem of basis disparity. (See for example, *Example 4.*)

A more significant concern, however, is that the basis disconformity approach is underinclusive in that it can only address noneconomic stock loss to the extent of net appreciation reflected in stock basis, which is, by its nature, reduced by unrecognized depreciation reflected in basis. As a result, a potentially significant amount of noneconomic stock loss remained unaddressed, particularly in deconsolidating dispositions of subsidiary stock.

Example 9. Unrecognized loss reflected in stock basis. P purchases all the outstanding stock of S for $150. At the time, S owns one asset, A1, with a basis of $25 and value of $100, and one asset, A2, with a basis of $100 and a value of $50. S sells A1 to a nonmember for $100 and recognizes a $75 gain, which the P group takes into account. Under the investment adjustment system, P increases its basis in the S stock by $75, to $225, to reflect the $75 taken into account by the group. If P then sells the S stock for $150 (its fair market value), P will recognize a $75 loss. Under the basis disconformity approach, only $25, the excess of P's S stock basis ($225) over S's net inside asset basis ($100 cash plus S's $100 basis in A2, or, $200), of the $75 gain is treated as a noneconomic investment adjustment. Thus, although the entire loss is noneconomic, only $25 of that loss would be disallowed under this approach.

b. *Modified basis disconformity.*

The IRS and Treasury Department considered several modifications to the basis disconformity model, all of which were intended to address the underinclusivity of that model. One approach suggested by commentators would mitigate the wasting assets concern by first, for a prescribed period of time, treating the sum of all property gains and, up to the disconformity amount, all income as noneconomic (and thus included in the disallowance amount). After the prescribed time, all gains and income would be treated as noneconomic, but only to the extent of the disconformity amount. Other approaches considered reflected variations on this suggestion.

The IRS and Treasury Department recognize that the model described, and

any similar models, would be readily administrable, but are concerned that such a model would not adequately preserve the group's ability to deduct economic loss sustained by the group. The reason is that stock loss could be attributable to economic investment adjustments (adjustments attributable to the recognition of items of income and gain that were not reflected in stock basis) that were followed by economic loss (attributable to a decline in the value of the subsidiary's assets). For example, assume that P contributed an asset to S (basis and value of $10), the asset appreciated and S sold it for $100 (recognizing a $90 gain that increased P's basis in S stock to $100), S reinvested the $100 in an asset that declined in value to $10, and P then sold the stock for $10. P would recognize a $90 loss that would be disallowed because S had a $90 gain on the disposition of an asset. Yet the entire loss was an economic loss. As a result, the IRS and Treasury Department are concerned that the result in *Rite Aid* (that the group receive the tax benefit of its economic loss) would not be adequately protected.

Ultimately, the IRS and Treasury Department concluded that the basis disconformity model in Notice 2004–58 would not be modified, but that elements of the model would be incorporated in a new approach.

4. The Presumptions and Simplifying Conventions Adopted in These Proposed Regulations

a. *Loss limitation model.*

As discussed in section A.2 of this preamble, when the IRS and Treasury Department rejected a tracing approach in favor of the presumptive approach in 1990, the decision was made to balance the use of irrebuttable presumptions by adopting a loss limitation model. Under a loss limitation model, losses attributable to noneconomic investment adjustments are disallowed, but gain reduction (or elimination) attributable to noneconomic investment adjustments is not. The IRS and Treasury Department believed that allowing noneconomic gain reduction not only balanced the benefits and burdens of the presumptive approach, it also provided the considerable advantage of reducing gain duplication in consolidated groups.

Example 10. Noneconomic gain reduction, elimination of gain duplication. P purchases all the stock of S for $150 when S holds one asset, A1, with a basis of $100. S sells A1 for $150, recognizing $50 of gain. S uses the $150 proceeds from the sale of A1 to purchase A2. The value of A2 appreciates to $200, and P then sells its S stock for $200.

If the investment adjustment system did not adjust stock basis for items attributable to appreciation reflected in basis, P's basis in S stock would remain $150 and, when P sells the S stock, P would recognize a gain of $50 (reflecting the $50 appreciation in A2). When S sells A2, S would recognize the same $50 of economic gain a second time. However, because P's basis in S is increased by the $50 gain recognized on the sale of A1, P will recognize no gain or loss on its sale of S stock. The gain on A2 is therefore taxed once, when there is a recognition event with respect to A2.

These proposed regulations adopt a loss limitation model for the same reasons such a model was adopted in 1990, in the regulations promulgated under section 337(d) and the LDR (to balance the use of a presumptive approach).

However, the LDR, as well as §§ 1.337(d)–1 and 1.337(d)–2, applied the loss limitation model by disallowing loss recognized on the disposition of subsidiary stock and reducing basis on the deconsolidation of subsidiary stock. The IRS and Treasury Department recognize that the effect of a loss disallowance rule can be achieved by applying a basis reduction rule immediately before the disposition of loss stock. Modifying the loss limitation model to reduce basis in all cases simplifies the structure of the rule by avoiding the need for two distinct rules.

b. *Amount of basis reduction.*

The IRS and Treasury Department considered two basic approaches to determining the amount of basis reduction. One would be determined with reference to a share's adjusted basis and the other would be determined with reference to the disconformity between the share's basis and its allocable portion of the subsidiary's attributes.

i. *Adjusted purchase price cap.*

Under this approach, the basis of a transferred loss share would be reduced by the amount that the subsidiary's items increased the share's basis, but only to the extent of the adjusted purchase price. For purposes of this rule, the adjusted purchase price would be defined as the holder's original basis in the stock, adjusted to take into account all redetermination events. The rationale for this rule is that the adjusted purchase price represents the maximum amount of unrecognized gain that could be reflected in stock basis. However, this cap does not establish that, in fact, there was any appreciation reflected in stock basis and, therefore, it could prove to be substantially overinclusive.

The IRS and Treasury Department considered several rules that could be combined with the adjusted purchase price cap in order to mitigate its potential for overinclusiveness. One approach would combine this cap with the asset tracing model described in this preamble. Another approach would combine this cap with rules that treat income items as included in the basis reduction amount under a different rate (for example, using a declining percentage over time) or amount (for example, using an annual income cap, perhaps based on a percentage of the gross items). The IRS and Treasury Department ultimately concluded that the limitations either imposed unacceptable burdens (because of the need to identify redetermination dates and trace assets) or did not significantly increase the theoretical soundness of the approach, and that the potential for overinclusiveness prevented the approach from responding adequately to the Congressional mandate to preserve the result in *Rite Aid.*

ii. *Modified adjusted purchase price cap.*

To address the potential overinclusivity of the adjusted purchase price cap, the IRS and Treasury Department considered modifying the rule by reducing the cap by the basis of any tainted assets sold at a gain. The rationale for this modification is that the maximum potential amount of appreciation reflected in basis is reduced by the basis of tainted assets as they are sold. While this modification reduced the potential for overinclusiveness in a theoretically sound manner, it exacerbated the administrative difficulties by requiring not only the identification of all redetermination dates, but also of all assets held on such dates. Moreover, the IRS and Treasury Department ultimately concluded that the basic premise (that the limitation represented the maximum possible noneconomic income) remained an inadequate response to the Congressional directive that the group be allowed to deduct its economic loss.

iii. *Disconformity cap.*

This model would also reduce basis by the amount that the subsidiary's items increased the share's basis, but only to the extent of the disconformity amount. For this purpose, the disconformity amount would generally be the same as the basis disconformity amount described in Notice 2004–58. The rationale for this limitation is that the disconformity amount identifies the minimum amount of unrecognized appreciation actually reflected in the basis of a share of subsidiary stock at the relevant time. Thus, although the

amount of such appreciation could actually be considerably greater (as in *Example 9*), and could even be equal to the adjusted purchase price (assuming a subsidiary was purchased with no basis in any of its assets), it is not lower. Not only does the disconformity cap have the advantage of identifying an amount of appreciation actually reflected in stock basis, it allows for the computation of that amount with information taxpayers are already required to know. Additionally, it avoids the need to identify redetermination events because, by computing disconformity immediately before a transfer, this approach automatically takes the effect of all such events into account.

iv. *Modified disconformity cap.*

Because the use of a disconformity cap raises significant potential for underinclusivity, as illustrated in *Example 9,* the IRS and Treasury Department considered increasing the disconformity cap by the amount of unrecognized loss on any tainted assets held by the subsidiary. The rationale for this increase is that those losses could prevent an equal amount of recognized tainted appreciation from being treated as noneconomic. Thus, the rule would not undermine the theoretical foundation of the disconformity cap.

However, this approach would require the identification of redetermination dates, as well as the identification and valuation of all assets held on the last such date. Recognizing the imprecision inherent in this approach, the IRS and Treasury Department considered increasing the disconformity cap by only a discounted portion of those unrecognized losses. The IRS and Treasury Department concluded that this approach would introduce burden and imprecision much greater than the potential benefit obtained by increasing the cap on basis reductions, at least in the majority of commercially typical cases.

The IRS and Treasury Department also considered implementing this modification not as a general rule, but only as an anti-abuse rule, so that it would apply only in circumstances that indicated a significant amount of tainted income or gain might be sheltered by unrecognized loss on tainted assets. For example, such a rule could require an increase to the disconformity cap if there was a significant loss in stock, if the subsidiary recognized significant gain shortly before stock sale, or if the stock was held for only a short period of time before it was sold. The IRS and Treasury Department were concerned, however, that the increased uncertainty and burden introduced by such an approach could not be justified in light of the protections against manipulation that exist in the Code and other rules of law. For example, see sections 269, 362(e)(2), and 482, as well as various anti-avoidance and anti-abuse provisions in the regulations, including these proposed regulations.

v. *Disconformity cap with duplication rule.*

In considering the structural potential for underinclusivity in the disconformity cap, the IRS and Treasury Department observed that the recognition of noneconomic gains in excess of the disconformity amount causes the subsidiary's unrecognized losses to be expressed in stock basis. The facts of *Example 9* illustrate this point. In that example, P purchased S for $150 when S held A1 (basis $25, value $100) and A2 (basis $100, value $50). S sold A1 and recognized $75 gain, which increased P's basis in S to $225. P then sold the S stock and recognized a $75 loss. At the time of the stock sale, S's net asset basis was $200 (the $100 received for A1 and the basis of A2), which exceeds the value of the stock by $50. Thus, the basis disconformity amount is $25 (the excess of the $225 stock basis over the $200 net asset basis), and so (although there is a $75 recognized gain), only $25 is disallowed. However, at that point, S's $200 net asset basis exceeds S's $150 value by $50. The $50 of unrecognized loss on A2 is reflected in both P's basis in S stock and S's basis in its assets. That is, the loss on A2 has been duplicated. As a result, the underinclusivity of the disconformity cap can be measured and addressed as duplicated loss.

The IRS and Treasury Department recognize that addressing this loss as a duplicated loss allows taxpayers to accelerate the benefit of a subsidiary's unrecognized losses (that is, obtain the benefit of the loss without a recognition event with respect to its loss assets). However, this approach allows taxpayers the benefit of their economic loss while limiting any arguably excessive benefit to the ability to accelerate inside loss. In the end, loss duplication is prevented. (The IRS and Treasury Department have long recognized that it is appropriate for a group to offset recognized built-in gains and losses, see §§ 1.337(d)–1 and 1.337(d)–2, as promulgated in 1990 and again as temporary and final regulations following the *Rite Aid* decision).

vi. *Conclusion.*

In light of the concerns raised by any method that would reduce basis beyond the disconformity amount, the IRS and Treasury Department have concluded that the amount of basis reduction should be limited to the disconformity amount and that combining the disconformity cap with a loss duplication rule to address its underinclusivity provides the most appropriate balancing of interests. Under this approach, the group's economic loss is appropriately protected and neither the group nor its members will receive more than one benefit for the subsidiary's economic loss.

c. *Items applied to reduce basis.*

i. *Character of items applied to reduce basis.*

In general, the IRS and Treasury Department have concluded, and commentators have generally agreed, that all gains on property dispositions, as well as various gain equivalents, should be fully available to reduce basis under a presumptive rule.

Questions arose, however, regarding whether income items should also be fully available to reduce basis. The reasons for these questions center on the general difficulty of tracing income items (which is limited in the best of circumstances) and the observation that the likelihood of a particular income item being attributable to tainted appreciation generally decreases over time. Accordingly, the IRS and Treasury Department considered several proposals to limit both the amount and the rate of inclusion for income items.

All of these approaches would segregate income that could be traced to particular appreciation reflected in stock basis and treat those amounts in the same manner as items of gain. The net income remaining would be applied to reduce basis according to prescribed limits. For example, one proposal would apply net income to reduce basis for a prescribed period of time following a measuring date, but, after that time, net income would be so applied only according to a declining percentage.

The IRS and Treasury Department are concerned, however, that the approaches considered could be readily manipulated, for example, by converting gain into income that cannot be readily traced to particular assets or by delaying the recognition of income items until after the applicable time period. Therefore, any such rule would inappropriately influence the structure of business transactions and, at the same time, fail to provide adequate protection for *GU* repeal. In addition, the need to account for redetermination dates would add complexity and diminish the potential relief afforded under any such approach. Moreover, the IRS and Treasury Department identified no theoretical basis for any particular rule and were concerned that the increased

precision may be more perceived than real.

ii. *Capital transfers.*

Adjustments to reflect transfers of capital, whether contributions or distributions, are not adjustments attributable to the recognition of appreciation or depreciation. Accordingly, these adjustments do not increase or decrease the extent to which stock basis is noneconomic or facilitates the circumvention of *GU* repeal. For that reason, such amounts are not taken into account in determining the extent to which subsidiary stock basis is subject to reduction.

Commentators have suggested that the nature of an intercompany cancellation of indebtedness is similar to that of a capital contribution and thus should not be taken into account in determining basis reduction. The IRS and Treasury Department recognize that this may often be the case, but are concerned that, under some circumstances, this may not be the case. Because it will be administratively very difficult to identify situations in which intercompany cancellation of indebtedness is not similar to a capital contribution, and to distinguish intercompany cancellation of indebtedness from other arguably similar cases, these proposed regulations treat items related to intercompany cancellation of indebtedness like all other items of income or loss. However, the IRS and Treasury Department continue to study the issue and invite further comments.

d. *Netting of items from different tax periods.*

Under the LDR, there was no cross-year netting of investment adjustments. Positive investment adjustments were taken into account in determining the loss disallowance amount, negative investments were not. The IRS and Treasury Department have reconsidered whether items from different tax periods should be considered together in determining basis reduction.

The IRS and Treasury Department recognize that the particular circumvention of *GU* repeal at issue here is a product of the manner in which the investment adjustment system adjusts stock basis to reflect a subsidiary's amounts that are taken into account by the group. Thus, IRS and Treasury Department have concluded that the appropriate measure of the concern must take into account the net extent to which the basis of a share has been increased or decreased by the investment adjustment system. Whether a loss is taken into account in the same year in which a gain is taken into account or in a separate year does not change the net effect of the investment adjustment system. Thus, unlike the LDR, these proposed regulations allow netting of all investment adjustments made to a share for all periods.

e. *Summary and conclusions.*

Only a presumptive approach can eliminate the substantial administrative burdens imposed by the tracing-based and hybrid regimes discussed above. As a result, only a presumptive approach can be applied consistently among taxpayers and thus achieve the overall fairness necessary to these regulations. Importantly, if presumptions are rebuttable, the administrative burdens associated with a tracing system are not avoided. In fact, they are exacerbated, because taxpayers will feel it necessary to be prepared to establish, and the government will then need to be prepared to examine, returns using both systems. Accordingly, the proposed regulations reflect a presumptive approach that does not permit the rebuttal of its operating presumptions. As noted in section A.5 of this preamble, Congress has specifically sanctioned the use of presumptions and other simplifying conventions to address the circumvention of *GU* repeal.

To balance the use of irrebuttable presumptions, the proposed regulations adopt several provisions that are intended to enhance their overall fairness and theoretical soundness. First, the proposed regulations adopt the disconformity amount as the maximum amount of potential stock basis reduction. The reason, as discussed, is that only the disconformity amount both establishes the fact that the taxpayer had unrealized gain reflected in stock basis and identifies the minimum amount of such gain. Second, the proposed regulations include all items taken into account, from all years, in the determination of the basis reduction amount. Thus, basis is not reduced for certain amounts (such as capital transfers) that cannot be attributable to noneconomic investment adjustments. In addition, by presuming all items of income, gain, deduction and loss as attributable to appreciation or depreciation reflected in basis, the proposed regulations avoid the administrative and other concerns inherent in various tracing and hybrid approaches. Moreover, by presuming all items to be reflected in basis, the benefits and burdens inherent in the use of irrebuttable presumptions are fairly balanced between taxpayers and the government. Presuming all items of income and gain are noneconomic favors the fisc, while presuming all items of deduction and loss are noneconomic favors taxpayers.

D. Loss Duplication

The IRS and Treasury Department continue to believe that a group's income is distorted when the group enjoys more than one tax benefit from an economic loss. Further, the IRS and Treasury Department believe that a subsidiary's use of a group loss in a separate return year, after the group has already recognized the benefit of the loss, distorts the subsidiary's separate year income.

Moreover, the IRS and Treasury Department do not believe that the manner or order in which a group takes its losses into account affects the extent to which loss duplication is inappropriate. Thus, loss duplication is inappropriate and must be addressed whether arising in situations like that illustrated in *Example 3* (loss reflected in both stock and assets) or in *Example 5* (duplication attributable to disparate stock basis). In addition, loss duplication is inappropriate and must be addressed whether the group chooses to recognize loss first as an inside loss, on the subsidiary's assets and operations (which is addressed by § 1.1502–32), or as a stock loss (which is currently addressed, at least partially, by § 1.1502–35).

Accordingly, the IRS and Treasury Department have returned to a fundamental premise of the LDR and again concluded that a loss duplication rule that operates without regard to members' continued affiliation is a necessary complement to the investment adjustment system. The IRS and Treasury Department have also concluded that such a rule must also address the potential for loss duplication presented when loss is disproportionately reflected in the bases of individual shares.

Importantly, as noted in section A.5 of this preamble, Congress has indicated that it, too, views the prevention of loss duplication, including in deconsolidating stock dispositions, as an area that is appropriately addressed by regulation. See H.R. Conf. Rep. No. 108–755 at 652.

Therefore, the IRS and Treasury Department have reviewed the current rules and considered alternative approaches to address the duplication of loss.

1. Reconsideration of § 1.1502–35

Loss duplication is currently addressed in § 1.1502–35. That rule generally applies whenever there is a disposition of loss shares of subsidiary stock. To address the loss duplication problems arising when loss is disproportionately reflected in stock

basis, the rule first redetermines members' bases to reduce that disparity (to address the problems illustrated in *Example 5*). Different rules apply depending on the subsidiary's status as a group member following the stock disposition. If the subsidiary remains a member, the full blending rule of § 1.1502–35(b)(1) applies and all members' bases in shares of the subsidiary's stock are combined and then allocated evenly to preferred (to value) and then to common (equally). If the subsidiary ceases to be a member, the basis redetermination rule of § 1.1502–35(b)(2) applies and members' bases are redetermined to reduce loss on all members' shares. However, this rule only redetermines basis to the extent of items of deduction and loss included in negative adjustments applied to nonloss shares. As under the full blending rule, redetermination under this rule first reduces or eliminates loss on preferred shares and then equalizes members' bases in common shares.

The potential for loss duplication following the redetermination of members' bases is addressed only if the subsidiary remains a member of the group. In that case, stock loss (to the extent of loss duplication) is suspended, the suspended loss is reduced as the subsidiary's items of deduction and loss are taken into account, and any suspended loss remaining when the subsidiary ceases to be a member is allowed at that time. The regulation does not address the duplication of loss when the subsidiary ceases to be a member, other than to prevent the reimportation of duplicated losses back into the group.

The IRS and Treasury Department understand that certain administrability concerns have arisen under § 1.1502–35. For example, taxpayers have commented that the rules relating to the suspension of loss in nondeconsolidating dispositions and the treatment of reimported losses present substantial compliance issues. The experience of the IRS is consistent with those comments.

Moreover, the IRS and Treasury Department have reconsidered the appropriateness of allowing subsidiaries to duplicate group losses after the period of consolidation. Under this approach, former members can use group losses (that have already been used by the group) to offset their separate year income. This duplicative use of group losses distorts the former member's separate income. Under section 1502, consolidated return regulations are directed to promote the clear reflection of not only the income of a group, but also of its members, including former members. Accordingly, as in 1990, the IRS and Treasury Department have concluded that a group loss, once used by the group, should not be available to a former member for a second, duplicative use outside the group.

For these reasons, the IRS and Treasury Department propose to remove § 1.1502–35 and replace it with a more easily administered and more comprehensive approach to addressing loss duplication among members of a consolidated group.

2. Other Methods Considered for Addressing Loss Duplication

As discussed in section D of this preamble, the IRS and Treasury Department have concluded that loss duplication is an inappropriate distortion of income (of either a group or its members, including former members) regardless of the subsidiary's status after a transfer of its stock. Accordingly, these proposed regulations address loss duplication in both nondeconsolidating and deconsolidating stock transfers. Several approaches were considered.

a. *Disallowance of stock loss.*

As a general matter, the IRS and Treasury Department believe that disallowing duplicative stock loss better implements single entity principles because it results in the recognition of the subsidiaries' economic gain or loss on its assets and operations, instead of on its stock. However, to preserve the result in *Rite Aid*, stock loss could only be disallowed for nondeconsolidating transfers and additional rules would be necessary to address both the loss remaining in the group and the duplication of loss in deconsolidating transfers (which could not be subject to the loss disallowance rule). Thus, a rule implementing this approach would need to include a provision comparable to § 1.1502–35(c), which taxpayers and the IRS have found to present significant compliance issues. In addition, this approach would need to include a provision to address loss duplication in deconsolidating transfers.

b. *Loss duplication accounts.*

The IRS and Treasury Department also considered an approach that would allow stock loss, but identify the amount of loss duplication and create a suspended account to limit the deductibility of items as they are taken into account. One advantage of this approach is that it only requires one set of rules to address both nondeconsolidating and deconsolidating transfers. This approach also has the advantage of increasing the precision in identifying (and disallowing) losses that are actually duplicated.

However, unless the rule were to use presumptions to treat items as chargeable against the loss duplication account, it would present considerable tracing issues. In addition, this approach raises administrability issues comparable to those associated with the loss suspension regime in § 1.1502–35(c). These difficulties are exacerbated by the need to have the account follow the subsidiary, possibly through subsequent acquisitions, until the account is eliminated.

The IRS and Treasury Department are also concerned that, because this approach would reduce or eliminate duplication only when inside losses were recognized, taxpayers could avoid the effect of the rule by waiting until assets appreciated before disposing of them. To mitigate this concern, the rule could require the subsidiary to take into account the duplication account, either ratably over time or at some specified time, but this could give rise to income in the absence of any loss duplication.

c. *Attribute reduction.*

The IRS and Treasury Department also considered a presumptive rule that would identify the extent of duplicated loss and then reduce the subsidiary's attributes by that amount. This approach, like the loss duplication account, has the advantage of needing only one set of rules to govern both deconsolidating and nondeconsolidating transfers. It has the added advantage of being similar to regimes that are already familiar to taxpayers, such as the attribute reduction rules of sections 108 and 1017, and § 1.1502–28. Although attribute reduction could be based on valuation, like the rule in section 362(e)(2), the IRS and Treasury Department believe that mandatory valuation would present a significant administrative burden and expense for both taxpayers and the IRS.

d. *Conclusions.*

The IRS and Treasury Department have concluded that the complexity, administrative burden, and expense of the loss disallowance and the loss duplication account approaches outweighed their respective advantages. Accordingly, these proposed regulations adopt an attribute reduction rule. The IRS and Treasury Department recognize that the attribute reduction approach allows taxpayers to accelerate economic losses of the subsidiary, but believe that this approach best preserves the result in *Rite Aid* while addressing loss duplication. In general, the approach adopted operates as an irrebuttable presumption, to avoid the burden of

mandatory valuation in all cases, but taxpayers continue to have several mechanisms available to structure their transactions to permit valuation (for example, by using actual or deemed asset sales).

3. Gain Duplication

Notwithstanding the conclusions regarding duplication of loss, for the reasons set forth in the LDR preambles, the IRS and Treasury Department have tentatively concluded that adequate protections, and the incentive to use them, already exist to prevent the duplication of gain. See TD 8294, TD 8364 and TD 8984. For example, see sections 332, 336(e) (which is the subject of another current guidance project), and 338(h)(10). Accordingly, the duplication of gain is not addressed in these proposed regulations, except as a result of the adoption of a loss disallowance model. The IRS and Treasury Department continue to study the issues, however, and invite further comment. See section J of this preamble for further discussion of the issues on which comments are requested.

E. Noneconomic and Duplicated Loss From Investment Adjustment System

For all the reasons discussed in this preamble, IRS and Treasury Department believe that the approaches to noneconomic and duplicated loss that are adopted in these proposed regulations represent the best approach to the (original) noneconomic and duplicated loss concerns described in sections B.1 and B.2 of this preamble. However, those rules alone do not adequately address the problem of noneconomic and duplicated loss attributable to investment adjustments applied to shares of stock with disparate bases. This is the concern described in section B.3 of this preamble and illustrated in *Example 4* and *Example 5*, as well as *Example 7(b)* and *Example 7(c).*

The IRS and Treasury Department believe it is essential to address this concern. One reason is that stock basis would be inappropriately eliminated when, in cases like *Example 4*, there is noneconomic loss on one share because appreciated assets were contributed to a corporation in exchange for other shares. In those cases, the noneconomic loss should not be allowed, but a rule that only prevents that loss does not address the problem that there is insufficient basis on the shares received in the exchange. The result would be noneconomic gain on the sale of those shares. An equally important reason is that loss could otherwise be duplicated when, in cases like *Example 5*, loss is disproportionately reflected in the basis of some shares. Although regulations could prevent duplication in such cases (by eliminating inside loss to the full extent of duplicated stock loss), allowing a deduction for disproportionate stock loss in such cases permits the acceleration of a disproportionate amount of inside loss. To the extent that loss is disproportionately reflected in the basis of an individual share, acceleration is generally unwarranted and should be prevented to the extent possible. Accordingly, the IRS and Treasury Department have considered various approaches to mitigating these effects.

1. Revise Investment Adjustment System To Adopt a Tracing Approach

The IRS and Treasury Department recognize that one approach to this problem would be to revise the investment adjustment system so that it would allocate subsidiaries' items of income, gain, deduction, and loss to their shares in accordance with the actual reflection of those items in the each share's basis. This approach would be similar to the section 704(c) regime applicable to partnerships. However, this approach is a tracing model and, as discussed in section C of this preamble, the IRS and Treasury Department do not believe that tracing is administrable in the consolidated setting.

Moreover, as noted above, the IRS and Treasury Department continue to believe that the presumptive-based rules of § 1.1502–32 are not only administrable, but appropriate in the vast majority of cases because typically subsidiary stock is common stock owned entirely by members with uniform bases. Where subsidiaries have issued preferred stock, it is generally section 1504(a)(4) stock. In addition, the investment adjustment system contains some guidance for situations that do not reflect the general assumptions on which the rules are based (*for example*, the cumulative redetermination rule in § 1.1502–32(c)(4)). In such cases, tracing would be unnecessary. Moreover, the IRS and Treasury Department do not believe that typical commercial transactions generally require groups to alter a subsidiary's capital structure in a manner that would require tracing. Accordingly, the IRS and Treasury Department are not considering revising the investment adjustment system to implement a tracing regime.

2. Presumptive Approaches To Reduce Basis Disparity

The two presumptive approaches considered to reduce basis disparity were a full blending rule similar to that in § 1.1502–35(b)(1) and a rule that would redetermine investment adjustments made under § 1.1502–32, similar to the rule in § 1.1502–35(b)(2).

a. *Full basis blending.*

Under the full basis blending approach, all members' bases are aggregated and then allocated among members' shares in a manner that results in the elimination of loss on preferred shares and of basis disparity on all other shares, at least within each class. As a result, members' bases are aligned with the operating premises of the investment adjustment system.

Full basis blending not only mitigates the effects of previous noneconomic investment adjustments, addressing the concern illustrated in *Example 4* and *Example 5(a),* it also prevents the acceleration of disproportionate amounts of unrecognized loss, addressing the concern illustrated in *Example 5(b).*

A full basis blending rule is, however, a significant departure from the rules generally applicable under the Code. Commentators have suggested that this departure from generally applicable law may be more significant than is warranted in light of the extent to which the concerns can be addressed under the investment adjustment redetermination approach described in this preamble.

b. *Redetermination of Investment Adjustments Previously Made to Stock Basis.*

The investment adjustment redetermination approach is less a departure from Code provisions as it is a departure from the general operation of § 1.1502–32. In general, this approach would reallocate investment adjustments previously applied to members' bases in subsidiary stock with the goal of reducing, to the greatest extent possible, the disparity in members' bases in subsidiary stock. Thus, like the full blending approach, this approach would bring members' bases closer into alignment with the assumptions underlying the investment adjustment system. However, it would do so to a more limited extent than the full blending rule and in a manner that is less of a departure from general Code rules.

i. *Recomputation of individual investment adjustments.*

Presently, § 1.1502–35(b)(2) addresses duplicated loss by redetermining investment adjustments when there is a deconsolidating disposition of subsidiary stock. To achieve the greatest reduction in basis disparity possible, § 1.1502–35(b)(2) in effect deconstructs investment adjustments in order to remove negative items (that is, items of deduction and expense) from

adjustments to the bases of gain shares and then apply those items to reduce members' bases in loss shares. Taxpayers have raised concerns with the complexity and administrability of this approach. The IRS has observed compliance and audit difficulties with this approach.

Accordingly, the IRS and Treasury Department have reconsidered whether this general approach, redetermining investment adjustments, could be adopted in a simpler form. The principal method considered was a presumptive reallocation of entire investment adjustments (exclusive of distributions), instead of the individual items that comprise them. The approach is similar to that used in the cumulative redetermination rule of § 1.1502–32(c)(4). A significant advantage to this simplified approach is that it is readily administered with information that taxpayers are already required to know (§ 1.1502–32 already requires taxpayers to determine investment adjustments exclusive of distributions).

The IRS and Treasury Department recognize that this general approach, in whichever form adopted, does not address the acceleration illustrated in *Example 5(b)* to the extent that full blending would. However, this approach is less disruptive to the general determination of basis.

ii. *Reallocations to loss shares that are not transferred.*

Presently, § 1.1502–35(b)(2) reallocations can result in the reduction of any member's basis in a loss share of subsidiary stock. The IRS and Treasury Department have reconsidered whether reallocated investment adjustments should be applied to reduce loss on shares that are not transferred in the transaction.

The IRS and Treasury Department have concluded that reallocating investment adjustments to reduce the basis of only transferred loss shares better implements the loss disallowance model. The reason is that this approach allows subsidiary stock basis to remain intact until there is a taxable disposition, deconsolidation, or worthlessness of the share, thereby permitting that basis to enjoy the full protection of subsequent appreciation as long as it remains in the group and otherwise subject to the consolidated return system. This approach has the added benefit of affording the maximum potential to eliminate disparate reflection of loss on transferred shares because all the reallocations are directed to transferred shares. As a result, this approach reduces the amount of loss that can be accelerated (as illustrated in *Example 5(b)*).

iii. *Reallocations of positive and negative investment adjustments.*

Under the basis redetermination rule in § 1.1502–35(b)(2), only negative items are reallocated. However, the sole purpose of § 1.1502–35, and thus the basis redetermination rules in § 1.1502–35(b), is to address the duplication of loss. (The full blending approach of § 1.1502–35(b)(1) addresses noneconomic loss attributable to basis disparity as well as loss duplication, but only incidentally as a result of its broad operation.) The IRS and Treasury Department believe that, although it is appropriate for a rule addressing only loss duplication to reallocate just negative items (or negative investment adjustments), a rule addressing both noneconomic and duplicated loss must reallocate both negative and positive items (or investment adjustments). As illustrated in *Example 4* and *Example 5*, reallocations of both positive and negative amounts are necessary to prevent the noneconomic and duplicated stock loss that results from the disparate reflection of unrecognized gain and to do so without causing inappropriate results to taxpayers (specifically, noneconomic gain).

For the foregoing reasons, the IRS and Treasury Department have concluded that the reallocation of both positive and negative adjustments is appropriate and necessary to balance the use of a presumptive system. Accordingly, these proposed regulations provide for the reallocation of both positive and negative investment adjustments to minimize the potential over- and under-application of the noneconomic and duplicated loss rules.

Explanation of Provisions

F. Explanation of the Proposed Regulations

1. Overview

The proposed regulation consists of three principal rules that apply when a member transfers a loss share of subsidiary stock. The first rule redetermines members' bases in subsidiary stock by reallocating § 1.1502–32 adjustments (to adjust for disproportionate reflection of gains and losses in the bases of members' shares). The second rule reduces members' bases in transferred loss shares (but not below value) by the net positive amount of all investment adjustments applied to the bases of those shares, but only to the extent of the share's disconformity amount (to address noneconomic stock loss). The third rule reduces the subsidiary's attributes to prevent the duplication of a loss recognized on, or preserved in the basis of, transferred stock.

The three rules generally apply in the order described. If members transfer stock of multiple subsidiaries in one transaction, the basis redetermination and basis reduction rules apply first with respect to transfers of loss shares of stock of the subsidiaries at the lowest tier and then successively to transferred shares at each next higher tier. These rules are not applied at any tier until any gain or loss recognized (even if disallowed) on lower-tier transfers and any items resulting from lower-tier adjustments (whether required by the basis redetermination or basis reduction rule or otherwise) are taken into account and reflected in stock basis. After the basis redetermination and reallocation rules have applied with respect to all transferred loss shares, the attribute reduction rule applies with respect to the highest-tier transferred loss shares. The attribute reduction rule then applies successively with respect to transferred loss shares at each next lower tier.

For purposes of these proposed regulations, a transfer of stock includes any event in which gain or loss would be recognized (but for these proposed regulations), the holder of a share and the subsidiary cease to be members of the same group, a nonmember acquires an outstanding share from a member, or the share is treated as worthless. This rule allows the proposed regulations to prescribe one integrated set of rules that implement a loss limitation approach and that can be applied to all loss shares, regardless of the event giving rise to the application of the section.

2. The Basis Redetermination Rule

When a member transfers a share of subsidiary (S) stock and, after the application of all other provisions of the Code and regulations, the share is a loss share, this rule subjects all members' shares of S stock to redetermination.

Under the basis redetermination rule, investment adjustments (exclusive of distributions) that were previously applied to members' bases in S stock are generally reallocated in a manner that, to the greatest extent possible, first eliminates loss on preferred shares and then eliminates basis disparity on all shares. The rule moves both positive and negative adjustments, and so addresses both noneconomic and duplicated losses. Because it generally requires adjustments to be made to reduce disparity, it brings members' bases closer in line with the fundamental principals underlying the investment adjustment system. As a result, there is less likelihood for later

noneconomic or duplicated loss attributable to the investment adjustment system.

The rule operates by first removing positive investment adjustments (up to the amount of the loss) from the bases of transferred loss shares. Then, to the extent of any remaining loss on the transferred shares, negative investment adjustments are removed from shares that are not transferred loss shares and applied to reduce the loss on transferred loss shares. The positive adjustments removed from the transferred loss shares are allocated and applied only after the negative items have been reallocated. The reason is to preserve the most flexibility possible in reallocating positive adjustments, in order to minimize disparity to the greatest extent. Thus, the operation of these rules has the effect of removing basis from transferred loss shares and using it to reduce disparity in members' bases in S shares.

Redetermination is limited in several respects. First, because the premise of the rule is that the original allocation of an item did not represent the most economically appropriate allocation of the item, redeterminations under the rule are limited to allocations of investment adjustments that could have been made at the time an item was taken into account. Accordingly, no adjustments can be reallocated to shares that were not held by members in the year taken into account, as members' shares would not have been able to receive those adjustments in the original allocation.

A related limitation on reallocation is that an investment adjustment cannot be reallocated except to the extent that the full effect of the reallocation can be accomplished. Thus, an investment adjustment can not be reallocated to the extent the resulting basis has previously been taken into account (including at a higher tier). This rule guards against double benefits from an adjustment (for example, by not allowing positive adjustments to be moved from, or negative adjustments be moved to, shares after the item would have affected basis that was taken into account in recognizing gain or loss). It also guards against the loss of a benefit (for example, by not allocating positive adjustments to previously transferred shares that can no longer benefit from the basis).

The principle purpose of the rule is to reduce loss on transferred shares. However, because its secondary purpose is to decrease disconformity to the greatest extent possible, in certain fact patterns, the application of the rule will actually increase loss on some shares. Importantly, in no fact patterns will the application of the rule create gain on shares. Overall, the rule has no effect on the aggregate amount of gain or loss on members' bases in subsidiary stock.

In the basis reallocation rule, and in several other provisions of the proposed regulations, there is a direction to allocate items in a manner that reduces disparity to the greatest extent possible. The regulations do not, however, prescribe the manner in which such determinations are to be made. The IRS and Treasury Department intend that taxpayers have flexibility in choosing the methods and formulas to be employed in making these determinations and the IRS will respect any reasonable method or formula so employed.

The IRS and Treasury Department recognize that the redetermination of basis imposes a certain administrative burden. Thus, the rule contains two safe harbors that excuse taxpayers from reallocating basis in situations in which redetermination is deemed unnecessary. One safe harbor is for situations in which redetermination would have no ultimate effect on the basis of any share held by a member. This happens, for example, if only common stock is outstanding and there is no disparity in the bases of the shares. In such a case, any redetermination would result in the same bases the members' had before redetermination. The second safe harbor is for situations in which the group disposes of its entire interest in the subsidiary to an unrelated person in one or more fully taxable transactions. In such a case, the group recognizes all the gains and losses on the shares and so obtains no benefit from the disparate reflection of gain or loss. Transfers that are excepted from basis redetermination, like transfers of shares that remain loss shares after application of the rule, are then subject to the basis reduction rule.

3. The Basis Reduction Rule

If, after basis redetermination, any member's transferred share is a loss share (even if the share only became a loss share as a result of the application of the basis redetermination rule), the basis of that share is subject to reduction under this rule. This rule is intended to eliminate stock loss that is presumed noneconomic. It operates by reducing the basis of each transferred loss share (but not below value) by the lesser of the share's disconformity amount and its net positive adjustment.

A share's disconformity amount is the excess of its basis over its allocable portion of S's net inside attributes, determined at the time of the transfer. This amount identifies the net amount of unrealized appreciation reflected in the basis of the share. Because the disconformity amount is computed at the time of the transfer, the disconformity amount reflects the effects of all prior redetermination events.

The term net inside attributes is defined as the sum of S's loss carryovers, deferred deductions, cash, and asset basis, reduced by S's liabilities. This computation is used in both this basis reduction rule and the attribute reduction rule described in section F.4 of this preamble. Both rules do, however, have special provisions that modify the computation of net inside attributes if S holds lower-tier subsidiary stock. See sections F.3.a and F.4.a of this preamble for a discussion of rules relating to the stock of lower-tier subsidiaries for purposes of basis reduction and attribute reduction, respectively.

A share's net positive adjustment is computed as the greater of zero and the sum of all investment adjustments (excluding distributions) applied to the basis of the transferred loss share, including by reason of prior basis reallocations. All items of income, gain, deduction, and loss are included fully in the net positive adjustment amount. This rule identifies the extent to which basis has been increased by the investment adjustment provisions for items of income, gain, deduction and loss (whether taxable or not) that have been taken into account by the group.

a. *Special rules applicable when S holds stock of lower-tier subsidiary.*

For purposes of computing the disconformity amount, if S holds stock of a lower-tier subsidiary (S1) that was not transferred in the transaction, S's net inside attribute amount is computed by treating S's basis in S1 stock as ''tentatively reduced'' by the lesser of the S1 share's net positive adjustment and its disconformity amount. This reduction is made only for purposes of determining basis reduction to the S share, and has no other effect. The purpose of this adjustment is to prevent S1's recognized items from giving rise to noneconomic loss in S stock, for example, when S1 recognizes gain that is already reflected (indirectly) in P's basis in S shares. This problem is illustrated in *Example 8* (subsidiary holding lower-tier subsidiary stock with a basis that reflects lower-tier unrecognized appreciation).

When determining the disconformity amount of a share of subsidiary stock, no tentative reduction is made to the basis of lower-tier shares that were transferred in the transaction (without

regard to whether S retained the shares after the transaction, such as when S1 is transferred because S and S1 cease to be members of the same group but S continues to hold S1 stock). The reason is that the basis reduction rule applies directly to each transfer, starting with the lowest-tier transfer, and so any noneconomic loss in S stock that was attributable to S1's items has been eliminated by the time that the basis reduction rule applies to the S Stock. In addition, the tentative basis reduction rule does not apply to shares that are lower tier to any shares that were transferred in the transaction. The application of the rule to those shares is unnecessary because, when the basis reduction rule applied to S1, it eliminated any inappropriate effects from items that tiered up from subsidiaries that were lower tier to S1.

4. The Attribute Reduction Rule

If any transferred share remains a loss share after application of the basis reduction rule, the subsidiary's attributes (including the consolidated attributes attributable to the subsidiary) are subject to reduction. The attribute reduction rule addresses the duplication of loss by members of consolidated groups. This rule is intended to insure that the group does not recognize more than one loss with respect to a single economic loss regardless of whether the group chooses to dispose of the subsidiary stock before or after the subsidiary recognizes the loss with respect to its assets or operations.

Under this rule, S's attributes are reduced by the ''attribute reduction amount,'' which is computed as the lesser of the net stock loss and the aggregate inside loss. This amount reflects the total amount of unrecognized loss that is reflected in both the basis of the S stock and S's attributes. Net stock loss is the excess of the sum of the bases (after application of the basis reduction rule) of all S shares transferred by members in the same transaction over the value of such shares. S's aggregate inside loss is the excess of S's net inside attributes over the value of all of the S shares. Net inside attributes generally has the same meaning as in the basis reduction rule, subject to special rules for lower-tier subsidiaries (see section F.4.a of this preamble).

Unlike comparable provisions in § 1.1502–35 and the LDR, this rule does not limit its application to a share's proportionate interest in the subsidiary's aggregate inside loss. The reason is that when a member recognizes a stock loss, or preserves a stock loss for a later recognition (for example, when the share is retained but deconsolidated), the member enjoys (or preserves for later use) the benefit of the entire amount of that stock loss. If basis is uniform, the amount of stock loss will reflect a proportionate interest in the subsidiary's unrecognized loss. But if basis is disparate, the loss on a particular share can reflect any amount, even all, of the subsidiary's unrecognized loss. In either case, the potential loss duplication equals the entire amount by which the stock loss is duplicated in the subsidiary's attributes. Accordingly, the proposed regulations reduce attributes to that extent. This prevents the duplication (but not acceleration) of loss otherwise available in situations similar to *Example 5(b)* by reducing S's attributes by the entire amount by which the stock loss duplicates the aggregate inside loss.

A principal goal of this regulation is to address the issues of noneconomic and duplicated stock loss in a manner that is as readily administrable as possible, by taxpayers and the government. For that reason, the proposed regulations generally avoid imposing valuation requirements whenever possible. However, the proposed regulations do, to the extent possible, use readily available information to identify the location and amount of loss, to avoid knowingly creating gain. The order in which attributes are reduced reflects this principle.

After S's attribute reduction amount is determined, it is first applied to reduce or eliminate items that represent actual realized losses, such as operating loss carryovers, capital loss carryovers, and deferred deductions. If S's attribute reduction amount exceeds those items, the excess is then applied to reduce or eliminate the loss in the basis of property that is publicly traded (other than subsidiary stock, which is subject to special rules). The reason that the basis of publicly traded property, unlike that of other assets, is only reduced by the amount of loss reflected in the basis of the property is that such property can be readily and easily valued. Finally, if any attribute reduction amount remains after eliminating those attributes, it is applied to reduce or eliminate the basis in assets, other than publicly traded property (which then reflects no loss) and other than cash and equivalents (which also reflect no loss). This reduction is made proportionately according to the basis in each property.

The proposed regulations provide a special rule that applies to the extent a subsidiary has liabilities that have not been taken into account as of the time of the transfer. Under the general rule, if the attribute reduction amount exceeds attributes available for reduction, that excess attribute reduction amount has no further effect. However, a special rule applies if the attribute reduction amount exceeds the attributes available for reduction and the subsidiary has a liability that has not been taken into account. Typically this will happen when cash or other liquid assets are held to fund future expenses related to the liability. Because the assets held by S do not reflect attributes that can be reduced, loss can be duplicated later, when the liability is taken into account. To prevent the duplication of loss in such cases, the excess attribute reduction amount is suspended and applied to prevent the deduction or capitalization of payments later made by S or another person with respect to the liability.

a. *Special rules applicable when S holds stock of lower-tier subsidiary.*

When S holds stock of lower-tier subsidiaries, the attribute reduction amount is computed in a manner that identifies the maximum potential amount of loss duplication and attributes are reduced to that extent. However, the rule incorporates two restrictions to prevent excessive reduction of attributes that could otherwise result from this approach. These rules are set forth in this section 4.a.

First, to facilitate the computation of S's attribute reduction amount, all of S's shares of S1 stock are treated as a single share (generally referred to as the S1 stock). To identify the maximum potential duplication, the computation of the attribute reduction amount is made treating S's basis in S1 stock as its ''deemed basis'' in that stock. The proposed regulations define deemed basis as the greater of S's actual aggregate basis in the S1 shares (adjusted for any gain or loss recognized on a transfer of the S1 shares) and the S1 shares' allocable portion of S1's net inside attributes. For example, if P owns all the stock of S with a basis of $150, S owns all the stock of S1 with a basis of $100, and S1 owns an asset with a basis of $150. S's deemed basis in S1 stock is $150, the greater of $100 (S's actual basis in S1 stock) and $150 (the S1 shares' allocable portion of S1's net inside attribute amount), which is the maximum amount of inside loss that S can recognize. The proposed regulation uses deemed basis not only to identify the maximum potential amount of loss duplication ($150 in the example), but also to reduce attributes on the assumption that taxpayers will act in their best interest when deciding how lower-tier attributes will be recognized

(subject to certain limits discussed in this section F.4.a).

S's deemed basis in S1 stock is also used for purposes of allocating S's attribute reduction amount between S's S1 stock and S's other attributes. However, for this purpose, deemed basis is treated as reduced by certain amounts that, by their nature, do not reflect loss. These excluded amounts include the value of S1 shares transferred in the transaction and the portion of S1's cash, S1's cash equivalents, and the value of S1's publicly traded property (net of S1's liabilities) that is attributable to S's nontransferred shares of S1 stock. The excluded amounts also include the corresponding amounts with respect to all shares of stock of lower-tier subsidiaries. These modifications prevent nonloss assets from inappropriately increasing the allocation of attribute reduction to S1 stock.

The attribute reduction amount allocated to S's block of S1 stock is then apportioned and applied to reduce the bases of S's individual shares of S1 stock in a manner that, to the greatest extent possible, reduces disparity. This general rule is subject to two modifications. First, no allocated amount is apportioned to any transferred S1 share if gain or loss is recognized on the transfer of that share. The reason is that the recognition of gain or loss (even if not allowed) establishes that the basis of that share does not reflect (or no longer reflects) unrecognized loss. This modification thus directs attribute reduction to other shares that are the source of the potential duplication. The second modification is that no allocated amount that is apportioned to any transferred S1 share is to be applied to reduce the basis of the share below its value. This modification prevents attribute reduction from knowingly creating gain on such shares.

To fully implement the loss duplication rule, any portion of S's attribute reduction amount that is allocated to S1 stock, whether or not it is apportioned or applied to reduce the basis of any S1 shares, tiers down and becomes an attribute reduction amount of S1. The attribute reduction rules then apply to reduce S1's attributes in the same manner that they apply S's attribute reduction amount to reduce S's attributes. However, because the attribute reduction amount represents the maximum potential amount of duplication in the lower-tier subsidiary, the proposed regulations include two modifications to prevent the reduction of attributes beyond the amount necessary to eliminate duplicated loss.

The first modification is the conforming limit rule, which prevents the tier down of attribute reduction from reducing S1's net inside attributes below the sum of the value of the S1 shares transferred by members and the aggregate bases that members have in nontransferred S1 stock (after any reduction to those shares by the direct application of S's attribute reduction amount).

The second modification is the basis restoration rule. This rule applies after the attribute reduction rule has been applied with respect to all transfers and all resulting reductions (whether as a result of direct or tier-down attribute reduction) have been given effect. This rule reverses stock basis reductions made by the attribute reduction rule, but only to the extent necessary to conform inside (net inside attributes) and outside (stock) basis at each tier, taking into account the effect of any prior section 362(e)(2) transactions. Because net inside attributes can be a negative number, stock basis may be a negative number even after basis restoration. In such cases, the basis of the share will remain an excess loss account in the hands of the owning member after the transaction (the regulations specifically provide that the excess loss account created by this rule is not taken into account under § 1.1502–19). Basis restoration adjustments are made at each tier, but they do not give rise to any upper-tier adjustments.

With these two modifications, the attribute reduction rule can reduce lower-tier attributes in an amount that eliminates the full duplication potential reflected in S's basis in S1 stock and S1's net inside attributes without creating a noneconomic gain in the corresponding attribute.

b. *Election to reduce stock basis and/or reattribute loss.*

Finally, the attribute reduction rule contains an elective provision under which groups can reduce the potential for loss duplication and thereby reduce or completely avoid attribute reduction under these regulations. Under this rule, the common parent of a group can elect to reduce stock basis, reattribute attributes, or do some combination of basis reduction and attribute reattribution in order to prevent the reduction of attributes otherwise required under these proposed regulations. The total amount that can be the subject of the election is limited to the amount that S's attributes would otherwise be subject to reduction.

The election to reattribute attributes can only be made if S ceases to be a member of the P group as a result of the transfer. The reason is that the election is not intended to be merely a mechanism for changing location of items within a group (and its continuing members). The election can be made with respect to loss carryforwards and deferred deductions of S or any of S's lower-tier subsidiaries, but only to the extent and in the order that such attributes would otherwise have been reduced under the attribute reduction rule. However, P may only reattribute attributes of lower-tier subsidiaries that would otherwise be reduced as a result of tier-down attribute reduction to the extent that the reattribution does not create an excess loss account in the stock of any lower-tier subsidiary. When this election is made, P is treated as succeeding to the attributes as though it had acquired them in a section 381(a) transaction. Proposed regulations under § 1.1502–32 treat the reattributed attributes as absorbed and tiering up to reduce the basis of shares such that the full amount tiers up through the transferred S shares for which the election is made. This amount is allocated to shares in the chain with positive basis in a manner that reduces the disparity in the basis of the shares to the greatest extent possible. However, this amount is not allocated to any lower-tier subsidiary shares that were transferred in a transfer in which gain or loss was recognized. The IRS and Treasury Department recognize and are concerned with the potential complexity of this election and request comments regarding both the administrability and the benefit of the election, particularly as it relates to attributes of lower-tier subsidiaries.

Although the maximum amount of the election is computed by tentatively applying the attribute reduction rule to S, the election is actually given effect immediately before the application of the attribute reduction rule. Thus, to the extent loss duplication has not been eliminated by the election, the attribute reduction rules apply in their general manner.

5. Over-Ride Provisions

These proposed regulations contain two over-ride provisions. One, found in the general introductory provisions of the proposed regulation, requires that the provisions of these proposed regulations be interpreted and applied in accordance with their stated purposes. The other, an anti-abuse and anti-avoidance rule, provides that ''appropriate adjustments'' will be made if a taxpayer acts with a view to avoid the purposes of this section or use this section to avoid another rule of law. The anti-abuse rule includes several examples that illustrate general

principles. The examples are not intended to specify particular transactions that will be treated as abusive in all cases or to prevent the IRS from treating other transactions as abusive. This rule is an important safeguard to ensure that only transfers made in the ordinary course of business enjoy the benefits and avoid the burdens arising from the principles adopted in these proposed regulations.

6. Special Rules for Section 362(e)(2) Transactions

The IRS and Treasury Department recognize that adjustments made pursuant to section 362(e)(2) (see discussion in section H of this preamble) alter the extent to which comparisons of stock basis, net inside attributes, and value can identify both the amount of unrecognized appreciation reflected in stock basis and the amount of duplicated loss. For example, a reduction to asset basis under section 362(e)(2)(A) increases the disconformity amount of the shares received in the transaction subject to section 362(e)(2), but this amount does not represent unrealized appreciation reflected in stock basis. Further, the reduction to asset basis under section 362(e)(2)(A) decreases the amount of loss duplication that can exist with respect to the shares received in the transaction subject to section 362(e)(2). Similarly, if stock basis is reduced pursuant to an election under section 362(e)(2)(C), there is an increase in the subsidiary's net inside attribute amount that reduces the disconformity amount of all shares and increases aggregate inside loss, even though there has been neither a decrease in the amount of unrealized appreciation reflected in stock basis nor an increase in duplicated loss.

Accordingly, to adjust for distortions resulting from basis reduction under section 362(e)(2)(A), the proposed regulations adjust the disconformity amount of the shares received in the transaction to which section 362(e)(2) applied by an amount equal to the amount the basis of such shares would have been reduced had an election under section 362(e)(2)(C) been made. Further, for purposes of computing the attribute reduction amount on a transfer of any shares received in the section 362(e)(2) transaction, and applying the conforming limitation on the application of tier-down attribute reduction, the basis in such shares is reduced by an amount equal to the amount the basis of such shares would have been reduced had an election under section 362(e)(2)(C) been made Similarly, to adjust for distortions resulting from basis reduction under section 362(e)(2)(C), for purposes of computing any share's disconformity amount or the subsidiary's aggregate inside loss, and for purposes of determining any stock basis restoration, the proposed regulations reduce S's net inside attribute amount by an amount equal to the amount S's attributes would have been reduced under section 362(e)(2)(A) had no election under section 362(e)(2)(C) been made. Further, the regulations indicate that the special application of section 362(e)(2) to intercompany transactions must be taken into account, so these adjustments only apply to the extent section 362(e)(2) has actually resulted in some basis reduction.

The IRS and Treasury Department recognize that the computations in these proposed regulations may need to take other items into account. Accordingly, the proposed regulations provide that the Commissioner will make appropriate adjustments to account for changes in the relationship between stock basis and net inside attributes that are not the result of either § 1.1502–32 or these proposed regulations and that are not otherwise adjusted under these proposed regulations. In addition, the proposed regulations provide that taxpayers may seek a written determination regarding the treatment of comparable items or adjustments.

7. Special Rules Considered But Not Adopted

a. *Discounting of losses that are limited by section 382 or other provisions.*

The IRS and Treasury Department considered whether losses could be included in the computation of the net inside attribute amount at a reduced rate if their use was limited, for example, by section 382. Ultimately no administrable and precise method was identified for determining the extent to which losses could be considered properly excluded (or included at a reduced rate), except in the most extreme cases. Accordingly, the proposed regulations do not provide special rules for limited losses. As a result, losses are fully included in net inside attributes.

The IRS and Treasury Department recognize that this approach is extremely favorable to taxpayers as it reduces the disconformity amount (and thus the extent to which stock basis may be reduced) with the only potential cost being the elimination of the losses under the attribute reduction rule. The IRS and Treasury Department believe that this taxpayer-favorable result, when produced in the ordinary course of business, is not an inappropriate result as part of the overall balance reached by these regulations. Taxpayers that engage in transactions that have no bona fide purpose other than to acquire limited losses to avoid the purposes of the proposed regulations, however, will be subject to the anti-avoidance rule and the benefits of the transaction will be eliminated.

b. *Exceptions for basis conforming acquisitions.*

Practitioners had suggested that any proposed regulations addressing noneconomic loss contain an exception for transactions such as section 351 exchanges and acquisitions subject to a section 338 election. These proposed regulations do not explicitly contain such an exception. One reason is that such an exception would introduce the complexity and burden of identifying all redetermination events. A more important reason, however, is that such an exception is unnecessary under the basis disconformity model because, by measuring disconformity immediately before the transfer of loss shares, this rule automatically excludes situations from basis reduction when there is inside/outside conformity. Thus, the effect of this suggestion is accomplished and no special rules are necessary.

c. *Shadow account for reduced basis.*

The proposed regulations do not contain a mechanism, suggested by practitioners, for restoring basis to transferred shares that are retained by a member and later sold at a gain (for example, when a member retains S shares but S ceases to be a member). The IRS and Treasury Department are concerned that such a rule would add undue complexity to the regulatory scheme. Moreover, such a rule would be inconsistent with a fundamental principle underlying these proposed regulations, specifically, that a transfer (as defined in these proposed regulations) is the appropriate time for these proposed regulations to apply. Thus, the basis reduction rules do not permanently reduce the basis of lower-tier subsidiary stock unless the stock is transferred in the transaction. And, moreover, similar to the general application of other provisions of the Code and regulations, subsequent events should not reverse the effects of such application.

8. Effective Date

The proposed regulations would be applicable as of the date they are published as final regulations in the **Federal Register**.

G. Sections 1.337(d)–1, 1.337(d)–2, and 1.1502–35

Because proposed § 1.1502–36 addresses both noneconomic and duplicated loss on subsidiary stock, the IRS and Treasury Department are also proposing the removal of §§ 1.337(d)–1, 1.337(d)–2, and 1.1502–35, except to the extent necessary to address losses suspended under § 1.1502–35(c) and losses reimported under § 1.1502–35(g)(3).

Additionally, the IRS and Treasury Department intend to publish temporary regulations that will modify the anti-abuse provisions of § 1.1502–35. First, the temporary regulations will restate the loss reimportation rule as a principle-based rule. This change responds to comments received about the administrability of the current provision. Second, the temporary regulations will modify the loss reimportation rule to provide that a duplicated loss on subsidiary stock is subject to the loss reimportation rule even if the group deconsolidates the subsidiary before selling loss shares of the subsidiary stock. These modifications are reflected in these proposed regulations.

These proposed regulations also revise several regulations solely to reflect the removal of §§ 1.337(d)–1, 1.337(d)–2, and 1.1502–35 (other than with respect to loss suspension and loss reimportation), and the addition of § 1.1502–36.

The proposed regulations described in this section G would be applicable as of the date they are published as final regulations in the **Federal Register**.

H. Suspension of Section 362(e)(2) in Consolidation

1. Background

As part of the AJCA, Congress enacted section 362(e)(2) to address certain instances of loss duplication. Very generally, that provision provides that if loss property is transferred to a corporation in a section 351 exchange (or as a capital contribution or paid-in surplus), the transferee's aggregate basis in the assets will be limited to the properties' fair market value. However, section 362(e)(2) also permits the parties to elect to limit the basis of the stock received (or treated as received) in the exchange to its fair market value, so that the loss is preserved in the basis of the transferred property. Section 362(e)(2)(C). See REG–110405–05 (2006–48 IRB 1004), 71 FR 62067 (October 23, 2006), (''the 2006 proposal'') for a more detailed explanation of the general application of section 362(e)(2).

Practitioners have questioned whether it is necessary to apply section 362(e)(2) to intercompany transactions where there is a consolidated return rule addressing loss duplication. The IRS and Treasury Department recognize that loss duplication in consolidated groups is generally addressed by § 1.1502–32 (when losses are recognized on a subsidiary's assets or operations) and, currently, by § 1.1502–35 (or by this proposed § 1.1502–36 when it is finalized). In general, the IRS and Treasury believe that these regulations together address loss duplication in a manner that is most consistent with single entity principles. Nevertheless, the IRS and Treasury Department are concerned that, if section 362(e)(2) were not to apply to intercompany transfers, members of consolidated groups may be able to reduce gain under circumstances that separate taxpayers could not. Accordingly, the IRS and Treasury Department have tentatively concluded that section 362(e)(2) should be applied to intercompany transactions. However, the IRS and Treasury are concerned with the administrative burden imposed by section 362(e)(2) and are continuing to study whether its provisions should be applicable to such transfers. Comments are invited on this issue.

2. Suspension of Section 362(e)(2) for Intercompany Transactions.

Although the IRS and Treasury Department have tentatively concluded that section 362(e)(2) should remain applicable to transfers between members of a consolidated group, as noted, the IRS and Treasury Department are concerned with the significant complexity and administrative burden that section 362(e)(2) adds in the consolidated return context. For example, if an election is made to reduce stock basis under section 362(e)(2)(C), a portion of the items attributable to the transferred loss assets can produce duplicative reductions unless traced and treated as duplicative of the section 362(e)(2) reduction to stock basis.

Moreover, the IRS and Treasury Department recognize that basis reductions are not necessary in intercompany section 362(e)(2) transactions as long as duplication can effectively be eliminated by the general operation of the investment adjustment system. Accordingly, these proposed regulations would suspend application of section 362(e)(2) until the occurrence of a ''section 362(e)(2) application event,'' and then apply the principles of section 362(e)(2) only to the extent the investment adjustment system has not and can no longer effectively eliminate any remaining duplication. The IRS and Treasury Department expect that this suspension will often effectively eliminate the application of section 362(e)(2) to most intercompany transactions.

Nevertheless, in order to apply section 362(e)(2) upon the occurrence of a section 362(e)(2) application event, the group must determine the extent to which an intercompany transaction resulted in loss duplication that would have been prevented by section 362(e)(2), and track the extent to which this duplication is effectively eliminated while the transferor and the transferee are members. Accordingly, these proposed regulations require the group to identify the amount and location of basis in the transferred assets that would have been eliminated had section 362(e)(2)(A) applied at the time of the intercompany transaction. This is the amount of the net built-in loss that is duplicated as a result of the section 362(e)(2) transaction. The regulations refer to this amount of duplication as the ''section 362(e)(2) amount.''

The duplicated loss is reflected in both the transferor's basis in the transferee stock (or securities), and in the transferee's basis in the property received. The duplication is initially reflected in the basis of the transferee stock (or securities) to the extent the basis would have been reduced under section 362(e)(2)(C), if such an election was made and section 362(e)(2) was not suspended by these temporary regulations. The duplication is also initially reflected in the transferee's basis in the property received to the extent the basis of such property would have been reduced under section 362(e)(2)(A) if no election was made under section 362(e)(2)(C) and section 362(e)(2) was not suspended by these temporary regulations. Over time this amount can be reflected in other attributes of the transferee (such as unabsorbed losses) to the extent such attributes are attributable to the transferee's basis in the property received.

3. Elimination of the Section 362(e)(2) Amount

Because the investment adjustment system reduces stock basis as a subsidiary's attributes are taken into account, the duplication is eliminated to this extent, and the section 362(e)(2) amount must be eliminated to this extent. Further, if the basis of the stock (or securities) received in the intercompany section 362(e)(2) transaction is reduced as the result of a section 362(e)(2)(C) election, as a result of attribute reduction under these

proposed regulations, or is otherwise eliminated without the recognition of gain or loss, the duplication is similarly eliminated. Accordingly, these types of basis reductions result in an elimination of all or a portion of the section 362(e)(2) amount. The proposed regulations provide specific guidance regarding how much of any remaining section 362(e)(2) amount is reflected in the basis of the subsidiary's stock (or securities) or the subsidiary's attributes as the section 362(e)(2) amount is eliminated.

4. Application of Section 362(e)(2) to Intercompany Transactions

Upon the occurrence of a section 362(e)(2) application event, the regulations apply section 362(e)(2) only to the extent necessary. A section 362(e)(2) application event occurs when all or a portion of the duplicated amount can no longer be effectively eliminated by the operation of the investment adjustment system, and can involve either the stock (or securities) of the transferee or the assets transferred in the intercompany section 362(e)(2) transaction. Such an event is defined to include any transfer (as defined in proposed § 1.1502–36) of the transferee's stock received in the exchange, any satisfaction of a security received in the exchange, any transaction in which a nonmember acquires any of the transferred assets with substituted basis or succeeds to any attributes attributable to such basis, or any other transaction the result of which prevents all or a portion of any remaining section 362(e)(2) amount reflected in stock basis and attributes from being effectively eliminated by the operation of the investment adjustment system when taken into account.

Further, if the transferor and the transferee in the intercompany section 362(e)(2) transaction continue to be members of the same group (including as members of another group), the investment adjustment system can continue to effectively eliminate the duplication. Accordingly, these proposed regulations provide a subgroup exception implicit in the definition of section 362(e)(2) application events that allows the transferor and transferee to become members of a new group without triggering the application of section 362(e)(2). In such a case, the transferor and transferee will continue to track the section 362(e)(2) amount reflected in stock basis and attributes, and apply these provisions upon the occurrence of a section 362(e)(2) event.

Given the fact that section 362(e)(2) is applied in this context only to the extent necessary, the scope of its application varies slightly depending upon the type of section 362(e)(2) application event that occurs. If the application event involves a transaction in which a nonmember acquires some or all of the transferee's attributes that reflect a section 362(e)(2) amount, section 362(e)(2) applies to the extent such attributes reflect all or part of any remaining section 362(e)(2) amount. In such a case, the resulting reduction in attributes is applied to the attributes involved in the application event that reflect the section 362(e)(2) amount. If the application event involves all or part of the transferee stock (or securities) received in the section 362(e)(2) transaction, section 362(e)(2) applies to the extent such stock (or securities) reflect all or part of any remaining section 362(e)(2) amount. Further, in this case, the resulting reduction in attributes is applied to proportionately to the transferee's attributes that reflect the section 362(e)(2) amount (based on the relative section 362(e)(2) amount reflected). The reduction in the transferee's attributes is not a noncapital, nondeductible expense.

As is provided in section 362(e)(2)(C), the transferor and transferee may elect to reduce the basis in the transferee stock (or securities) received in the intercompany section 362(e)(2) transaction instead of reducing the transferee's attributes. Similar to the provisions of the proposed regulations under section 362(e)(2), the reduction in the basis of the transferee stock (or securities) received in the intercompany section 362(e)(2) transaction is equal to the amount of the reduction in the transferee's attributes absent the election. Further, if this election is made, the type of section 362(e)(2) application event dictates which shares (or securities) receive the basis reduction. If the application event involves a transaction in which a nonmember acquires some or all of the transferee's attributes, the reduction is applied proportionately to all of the transferee stock (or securities) held by members immediately before the application event (based on the relative section 362(e)(2) amount reflected). However, if the application event involves all or a part of the transferee stock (or securities) received in the intercompany section 362(e)(2) transaction, the reduction is applied proportionately to the stock (or securities) so involved (based on the relative section 362(e)(2) amount reflected). The reduction in the basis of the stock of the transferee as a result of this election is treated as a nondeductible basis recovery item.

Under the proposed regulations, the election to reduce stock basis (in lieu of attributes) under section 362(e)(2)(C) may be made for the intercompany transaction on either the group return for the year of the intercompany section 362(e)(2) transaction or the year in which the first section 362(e)(2) application event occurs. In either case, the election has effect only if and to the extent there is a section 362(e)(2) application event, is irrevocable once made, and applies to all section 362(e)(2) application events with respect to such intercompany section 362(e)(2) transaction (even if the application event occurs at a time when the transferor and transferee are members of another consolidated group).

5. Special Allocations Under § 1.1502–32

The proposed regulations also include a special allocation provision in § 1.1502–32 that requires all items taken into account by a group (including tier-ups of such amounts) that reflect a section 362(e)(2) amount to be allocated entirely to member's shares. In other words, such items are allocated as if any shares held by nonmembers were not outstanding. The reason for these special allocation rules is to prevent the general § 1.1502–32 allocation of items to dilute the elimination of duplication where shares of subsidiary stock are held by nonmembers.

6. Other Considerations

In the 2006 proposal, the IRS and Treasury Department proposed regulations that would provide that the tracing rules in § 1.358–2(a)(2) will not apply to stock received in a section 362(e)(2) transaction if the transferor and transferee elect to apply section 362(e)(2)(C). The IRS and Treasury requested comments regarding whether that treatment is appropriate. As noted in section H.4 of this preamble, these proposed regulations would allow the making of a section 362(e)(2)(C) election to be deferred until the year of the first section 362(e)(2) application event. The IRS and Treasury Department are aware of the potential difficulty and administrative burden associated with retroactively not applying the provisions of § 1.358–2(a)(2). The IRS and Treasury Department continue to study this issue, and invite comments regarding whether the proposed revision to § 1.358–2(a)(2)(viii) regarding section 362(e)(2)(C) elections should apply to intercompany transactions.

These proposed regulations would be applicable as of the date they are published as final regulations in the **Federal Register**.

I. Other Revisions to the Consolidated Return Regulations

The IRS and Treasury Department are also proposing various technical and administrative revisions to the consolidated return regulations.

1. Removal of § 1.1502–13(f)(6)(ii)

Section 1.1502–13(f)(6)(ii) prevents a member from recognizing gain on the qualified disposition of parent stock. However, § 1.1502–13(f)(6)(ii) only applies to dispositions of parent stock occurring prior to May 16, 2000. Thus, the provision has no current applicability. Nevertheless, gain on dispositions of parent stock occurring on or after May 16, 2000 may qualify to be prevented by § 1.1032–3, which has fewer conditions to its application than did § 1.1502–13(f)(6)(ii). To avoid confusion, the IRS and Treasury Department propose replacing the current provisions in § 1.1502–13(f)(6)(ii) (and references to that provision) with a reference to § 1.1032–3.

2. Modification of Exception to Definition of Deconsolidation in § 1.1502–19

Section 1.1502–19 provides rules for the determination and recapture of excess loss accounts. In general, an excess loss account is recaptured (taken into account) when there is a disposition of the stock to which the account relates. Section 1.1502–19(c) defines the term disposition for purposes of § 1.1502–19. Under that section, the term disposition includes transfers, cancellations, deconsolidations, and worthlessness. The term deconsolidation is defined in § 1.1502–19(c)(1)(ii).

In general, the termination of a consolidated group will give rise to the deconsolidation of the members of the group. However, § 1.1502–19(c)(3)(i)(A) provides that, if a group terminates because a member of another group has acquired 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, the members of the acquired group that become members of the acquiror's group are not treated as deconsolidated. Thus, there is no recapture of excess loss accounts in the shares of stock of subsidiaries of the acquired group that, after the acquisition, are held by a member of the acquiring group.

The exception to deconsolidation treatment in § 1.1502–19(c)(3)(i)(A) (and therefore to the recapture of excess loss accounts) is warranted because its conditions ensure that the consolidated return provisions will continue to apply to the members of the acquired group. Thus, the provisions of § 1.1502–19 are able to continue to regulate the determination and recapture of the excess loss accounts. However, for the continued application of the consolidated return provisions to the acquired group, it is only necessary that the acquiror be a member of a group following the acquisition. Its status prior to the acquisition is immaterial. The IRS and Treasury Department have therefore decided to revise the rule in § 1.1502–19(c)(3)(i)(A) to require only that the acquiror be a member of a group following the qualified acquisition.

Thus, under the proposed regulations, the exception to deconsolidation treatment provided in § 1.1502–19(c)(3)(i)(A) would be available when the acquisition is by a stand-alone corporation or a member of an affiliated, nonconsolidated group.

3. Clarification of ''Substantially All'' Standard in § 1.1502–19(c)(1)(iii)(A)

Section 1.1502–19(c)(1)(iii) defines the term ''worthless'' for purposes of excess loss account recapture (resulting in the inclusion of the excess loss account in income). The definition of worthlessness in § 1.1502–19(c)(1)(iii) is adopted for determining the time when subsidiary stock with positive basis may be treated as worthless (and therefore deductible). See § 1.1502–80(c).

Section 1.1502–19(c)(1)(iii)(A) generally provides that a share of subsidiary stock will be treated as worthless when substantially all the subsidiary's assets are treated as disposed of, abandoned, or destroyed for federal tax purposes. This provision prevents an excess loss account from being included in income (and a worthless stock deduction from being taken) until the subsidiary's activities have been taken into account by the group. As a result, the group's income is clearly reflected and single entity treatment is promoted.

The current regulations do not, however, define the term ''substantially all'' for purposes of § 1.1502–19(c)(1)(iii)(A). Particular concerns have arisen because the term is used in many other areas of tax law, most notably in the area of corporate reorganizations. Because different policies are operative in those areas, the thresholds appropriate in those areas are not necessarily appropriate for purposes of § 1.1502–19(c)(1)(iii)(A) and the consolidated return provisions that incorporate it.

The IRS and Treasury Department believe that the single entity purpose of these consolidated return provisions is best effected by treating a subsidiary's stock as worthless only once the subsidiary has recognized all items of income, gain, deduction, and loss attributable to its assets and operations. Accordingly, these proposed regulations clarify § 1.1502–19(c)(1)(iii)(A) by providing that stock of a subsidiary will be treated as worthless when the subsidiary has disposed of, abandoned, or destroyed (for Federal tax purposes) all its assets other than its corporate charter and those assets, if any, that are necessary to satisfy state law minimum capital requirements to maintain corporate existence.

4. Triangular Reorganizations That Are Also Group Structure Changes

Sections 1.1502–30 and 1.1502–31 provide special rules for determining the basis of stock following, respectively, a triangular reorganization and group structure change. The provisions both generally adopt net asset basis rules, but, in the case of a triangular reorganization, taxpayers can elect other rules in certain transactions. The regulations do not specify whether a group structure change that is also a triangular reorganization is subject to the basis rules applicable to group structure changes (under § 1.1502–31) or to triangular reorganizations (under § 1.1502–30). Because it is appropriate to conform the basis of the stock of the former common parent to its net asset basis in the case of any group structure change, the IRS and Treasury Department intend the rules of § 1.1502–31 to control the determination of stock basis when a transaction is a group structure change, without regard to whether the transaction is also a triangular reorganization. Accordingly, the proposed regulations add a rule to clarify that § 1.1502–31 governs the determination of basis in all cases to which it applies, even those that also qualify as triangular reorganizations.

5. Allocations of Investment Adjustments To Prevent or Minimize Excess Loss Accounts

Under § 1.1502–32(c)(2)(i), positive investment adjustments allocated to a member's shares of a class of common stock are allocated first to equalize and eliminate excess loss accounts and then equally to all the member's other shares in that class. In the case of a negative adjustment, that section provides for the reduction of a member's positive basis in shares of a class of common stock

before the creation or increase of an excess loss account in any such share. However, the current rule does not require that negative adjustments must be made first to equalize excess loss accounts before applying them equally to all shares. The proposed regulations add such a provision in order to better reflect the member's investment in its shares of subsidiary stock.

6. Expired Losses and Attribute Reduction Under § 1.1502–28.

Section 1.1502–32(b)(3)(ii)(C)(*2*) provides that, if the amount of a discharge of indebtedness exceeds the amount of the related attribute reduction under § 1.1502–28, that excess is treated as applying to reduce attributes to the extent of certain expired losses. In general, this section only applies to losses that expired without tax benefit, that were taken into account as noncapital, nondeductible expenses when they expired, and that would have been reduced had they not expired. The effect of this rule is to create a positive adjustment to the extent of the expired losses. The purpose of the rule, as stated in TD 8560, is to more fully integrate expired losses into the investment adjustment system.

As currently written, however, the rule does not explicitly state whether this special treatment of expired losses is available to all members' expired losses or only to the debtor-subsidiary's expired losses. Allowing such treatment for all members' expired losses is beyond the intended scope of relief and undermines the purpose of sections 108 and 1017, and § 1.1502–28. Accordingly, § 1.1502–32(b)(3)(ii)(C)(*2*) is revised to state explicitly that such treatment is intended only for the debtor-subsidiary's expired losses. The regulation is also revised to clarify that all available attributes, not just those of the debtor-subsidiary, must be reduced before this special rule for certain expired losses can apply.

7. Applicability of Other Rules of Law, Anti-Duplicative Adjustments Rules

Many of the consolidated return rules include provisions stating that other rules of law continue to apply. These provisions are generally unnecessary in light of § 1.1502–80(a), which provides that the provisions of the Code continue to apply to taxpayers filing a consolidated return unless specifically provided otherwise in the consolidated return regulations. However, these provisions often also contain statements that the consolidated return provisions modify other rules of law and that duplicative adjustments should not be made as a result of the consolidated return provisions. To simplify the regulations and remove any potential negative implication from the absence of such a provision in a particular provision, these proposed regulations incorporate all of these principles in § 1.1502–80(a) and remove similar provisions from other sections of the consolidated return regulations.

8. Retention of, and Nonsubstantive Revisions to, § 1.1502–80(c)

Section 1.1502–80(c) provides that subsidiary stock is not treated as worthless until the earlier of the time that the subsidiary ceases to be a member of the group and the time that the stock is worthless within the meaning of § 1.1502–19(c)(1)(iii). This rule, with its companion rule postponing the inclusion in income of excess loss accounts, prevents a group from recognizing any amount (whether loss or gain) on subsidiary stock until the subsidiary has taken into account all of its operating income, gain, deduction, and loss. Thus, the rule promotes single entity treatment by enabling the group to continue treating its investment in subsidiary stock as an investment in the subsidiary's assets and operations until the subsidiary has either taken all of its items into account or ceased to be a member of the group.

Following the *Rite Aid* decision, practitioners have submitted comments suggesting that § 1.1502–80(c) should be removed from the consolidated return regulations. The suggestion was based on the observation that § 1.1502–80(c) prevented inappropriate disallowance under the LDR and, since LDR no longer applies to stock dispositions, § 1.1502–80(c) is no longer necessary. While it is correct that there is no longer an LDR-based justification for the rule in § 1.1502–80(c), the LDR was neither the only nor the principal purpose for the rule. The principal purpose of the rule was, and is, to promote single entity treatment. And, with its companion rule governing the inclusion of excess loss accounts, this rule continues to do that.

In addition, the IRS and Treasury Department recognize that, to the extent a subsidiary's attributes would survive a worthlessness event (for example, when a subsidiary survives and is owned by its creditors following a bankruptcy), § 1.1502–80(c) benefits the group by postponing the time that the subsidiary's stock is treated as worthless. Because section 382(g)(4)(D) could subject S's losses to a zero section 382 limitation if P were to treat S's stock as worthless during bankruptcy, a court might prevent P from treating S's stock as worthless in an earlier year, effectively denying P any worthlessness deduction. See, *In re Prudential Lines, Inc.,* 928 F.2d 565 (2d Cir. 1991), *cert. denied,* 112 S.Ct. 82 (1991).

Accordingly, the IRS and Treasury Department have rejected the suggestion to remove § 1.1502–80(c). The proposed regulations do, however, revise the language of the current rule solely for the purpose of clarifying its operation. No substantive change is intended.

9. Effective Dates

The proposed regulations described in this section I would be applicable as of the date they are published as final regulations in the **Federal Register**.

J. Request for Comments

As described in this preamble, many approaches and combinations of approaches were considered with respect to both noneconomic and duplicated loss and, although the IRS and Treasury Department believe the approach adopted in these proposed regulations best responds to and balances the Congressional mandates, comments are requested concerning both the approach adopted in these proposed regulations and other possible approaches.

As noted in section D of this preamble, the IRS and Treasury Department are continuing to study, and invite comments on, the issue of gain duplication by consolidated groups. Comments are specifically requested concerning the circumstances under which gain duplication should be addressed and the mechanisms that could be adopted to do so. For example, comments could address whether a gain duplication rule could or should parallel the approach to loss duplication suggested in the proposed regulations, or whether some other approach would be more appropriate or administrable. Comments are also requested regarding limitations that may be necessary or appropriate to address concerns such as attribute churning and conversion. In addition, comments are requested concerning the noneconomic reduction of stock gain (that is, the appropriateness of the continued use of a loss disallowance model) and the reduction of noneconomic stock gain (that is, the reduction of basis through the absorption of built-in losses or net built-in losses), and the extent to which it would be appropriate to address gain duplication without addressing these issues.

As noted in section H of this preamble, the IRS and Treasury Department are continuing to study the application of section 362(e)(2) in the consolidated setting. Comments are

specifically requested concerning the general application of section 362(e)(2) to intercompany transactions, as well as the administrability and appropriateness of the proposed rules suspending the application of section 362(e)(2) to intercompany transactions and specially allocating items attributable to intercompany section 362(e)(2) transactions.

Although these regulations are generally proposed to be applicable when published as final regulations in the **Federal Register**, the IRS and Treasury Department invite comments regarding the extent to which it would be appropriate and desirable to allow taxpayers to elect to apply these provisions retroactively.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations primarily will affect affiliated groups of corporations that have elected to file consolidated returns, which tend to be larger entities. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f), this regulation has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed regulations and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal authors of these regulations are Theresa Abell and Phoebe Bennett of the Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

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

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

Section 1.1502–36 also issued under 26 U.S.C. 1502 * * *

Section 1.1502–36 also issued under 26 U.S.C. 337(d). * * *

§ 1.337(d)–1 [Removed]

Par. 2. Section 1.337(d)–1 is removed.

§ 1.337(d)–2 [Removed]

Par. 3. Section 1.337(d)–2 is removed.

Par. 4. Section 1.358–6 is amended by:

1. Revising paragraph (e).
2. Adding new paragraph (f)(3).

The revision and addition reads as follows:

§ 1.358–6 Stock basis in certain triangular reorganizations.

* * * * *

(e) *Cross-reference regarding triangular reorganizations involving members of a consolidated group.* For rules relating to stock basis adjustments made as a result of a triangular reorganization in which P and S, or P and T, as applicable, are, or become, members of a consolidated group, see § 1.1502–30. However, if a transaction is a group structure change, even if it is also a triangular reorganization, stock basis adjustments are determined under § 1.1502–31.

* * * * *

(f) * * *

(3) *Special rule for triangular reorganizations involving members of a consolidated group.* Paragraph (e) of this section shall apply to all transfers on or after the date these regulations are published as final regulations in the **Federal Register**.

Par. 5. Section 1.1502–13 is amended by:

1. Revising paragraphs (a)(4), (f)(6)(ii), and (j)(5)(i)(A).
2. Adding new paragraph (e)(4).
3. Revising the last sentence of paragraph (f)(6)(iv)(A).
4. Removing the second sentence in paragraph (f)(6)(v).
5. Adding a new last sentence to paragraph (l)(1).

The revisions and additions read as follows:

§ 1.1502–13 Intercompany transactions.

(a) * * *

(4) *Application of other rules of law.* See § 1.1502–80(a) regarding the general applicability of other rules of law and a limitation on duplicative adjustments.

* * * * *

(e) * * *

(4) *Intercompany section 362(e)(2) transactions*—(i) *Purpose and scope.* This paragraph (e)(4) provides simplifying rules for intercompany transactions that are subject to section 362(e)(2) (intercompany section 362(e)(2) transactions). The purpose of this paragraph (e)(4) is to suspend the application of section 362(e)(2) during the period of time that the duplication resulting from the intercompany section 362(e)(2) transaction (the section 362(e)(2) amount, as defined in paragraph (e)(4)(ii)(A) of this section) can effectively be eliminated by the operation of the investment adjustment provisions of § 1.1502–32. The amount and location of this duplication is identified and tracked while in the consolidated group. When this duplication can no longer effectively be eliminated by the investment adjustment provisions, the principles of section 362(e)(2) apply to the extent necessary to eliminate all or a portion of any remaining section 362(e)(2) amount (as defined in paragraph (e)(4)(ii)(B) of this section) reflected in B's attributes or stock. For purposes of this paragraph (e)(4), any reference to B stock received in an intercompany section 362(e)(2) transaction refers to B stock or B securities received (or deemed received) without the recognition of gain or loss.

(ii) *Identification and elimination of section 362(e)(2) amount*—(A) *Section 362(e)(2) amount.* The *section 362(e)(2) amount* is the amount of duplication resulting from an intercompany section 362(e)(2) transaction, and is equal to the amount by which B's basis in the assets received in an intercompany section 362(e)(2) transaction would have, but for the application of this paragraph (e)(4), been eliminated under section 362(e)(2)(A) (absent an election under section 362(e)(2)(C)). Such amount is initially reflected in both the basis of the B stock received in the transaction and B's basis in the assets received. Each share of B stock initially reflects the section 362(e)(2) amount to the extent the basis would have been reduced under section 362(e)(2)(C) if such an

election was made and this paragraph (e)(4) did not apply. B's basis in each asset received initially reflects the section 362(e)(2) amount to the extent the basis in such asset would have been reduced under section 362(e)(2)(A) if no election was made under section 362(e)(2)(C) and this paragraph (e)(4) did not apply. However, over time the section 362(e)(2) amount may be reflected in B's basis in assets, deferred items, or other unabsorbed losses (B's attributes).

(B) *Remaining section 362(e)(2) amount.* The *remaining section 362(e)(2) amount* is the portion of the section 362(e)(2) amount that has not been eliminated.

(C) *Elimination of section 362(e)(2) amount*—(*1*) *Elimination caused by reduction in B's attributes.* The section 362(e)(2) amount is eliminated as B's attributes that reflect the section 362(e)(2) amount are taken into account by the group (including as a result of attribute reduction under paragraph (e)(4)(iv) of this section, or § 1.1502–36(d) to the extent it did not reduce the basis in B stock that reflects the section 362(e)(2) amount). The portions of B's attributes that reflect a section 362(e)(2) amount are generally taken into account by the group proportionately. However, because any reduction in B's attributes under paragraph (e)(4)(iv) of this section is applied to reduce attributes that reflect the section 362(e)(2) amount, the section 362(e)(2) amount is eliminated to the extent of the full amount of such reduction. If the section 362(e)(2) amount is eliminated because B's attributes that reflect the section 362(e)(2) amount are taken into account, each share of B stock received in the intercompany section 362(e)(2) transaction that is held by a member is treated as proportionately reflecting the remaining section 362(e)(2) amount (based on the section 362(e)(2) amount reflected before the elimination).

(*2*) *Elimination caused by reduction in basis in B stock.* The section 362(e)(2) amount is also eliminated to the extent the basis in B stock that reflects the section 362(e)(2) amount is reduced under paragraph (e)(4)(v) of this section, is reduced under § 1.1502–36(d), or is otherwise is eliminated (other than under § 1.1502–32) without the recognition of gain or loss. The portion of the basis in a share of B stock that reflects a section 362(e)(2) amount is so reduced or eliminated before any other portion of the basis in such a share. If the section 362(e)(2) amount is eliminated as provided in this paragraph (e)(4)(ii)(C)(*2*), each of B's attributes that reflected the section 362(e)(2) amount is treated as proportionately reflecting the remaining section 362(e)(2) amount (based on the section 362(e)(2) amount reflected before the elimination).

(iii) *Section 362(e)(2) application event.* A section 362(e)(2) application event is any transaction or event that results in—

(A) A transfer (within the meaning of § 1.1502–36(f)(11)) of any of the B stock that was received in the intercompany section 362(e)(2) transaction;

(B) Any satisfaction (actual or deemed) of a security received in an intercompany section 362(e)(2) transaction without the recognition of gain or loss;

(C) Any nonmember holding an asset with a substituted basis that reflects all or a portion of the remaining section 362(e)(2) amount or succeeding to an attribute that reflects all or a portion of the remaining section 362(e)(2) amount; or

(D) Any other transaction the result of which prevents all or a portion of any remaining section 362(e)(2) amount reflected in stock basis or attributes from being effectively eliminated by the operation of the investment adjustment provisions of § 1.1502–32 when taken into account.

(iv) *General rule.* In the case of an intercompany section 362(e)(2) transaction, no adjustment to B's attributes shall be made under section 362(e)(2) until immediately before a section 362(e)(2) application event (as defined in paragraph (e)(4)(iii) of this section). At that time, unless an election is made under paragraph (e)(4)(v) of this section, B reduces its attributes that reflect the remaining section 362(e)(2) amount as provided in this paragraph (e)(4)(iv).

(A) *Amount of reduction.* If the application event involves B's attributes that reflect all or a portion of the remaining section 362(e)(2) amount, the amount of the reduction is equal to the remaining section 362(e)(2) amount reflected in the attributes so involved. If the application event involves all or a portion of the B stock received in the intercompany section 362(e)(2) transaction, the amount of the reduction is equal to the remaining section 362(e)(2) amount reflected in the B stock so involved.

(B) *Application of reduction.* If the application event involves B's attributes that reflect all or a portion of the remaining section 362(e)(2) amount, the reduction is applied to reduce each attribute so involved by the full amount of the remaining section 362(e)(2) amount reflected in each such attribute. If the application event involves all or a portion of the B stock received in the intercompany section 362(e)(2) transaction, the reduction is applied proportionately (based on the remaining section 362(e)(2) amount reflected in each attribute prior to reduction) to all of B's attributes that reflect the remaining section 362(e)(2) amount.

(C) *Effect of the reduction.* Any reduction to B's attributes under this paragraph (e)(4)(iv) is not a noncapital, nondeductible expense described in § 1.1502–32(b)(2)(iii).

(v) *Election to reduce the basis in B stock.* In lieu of reducing B's attributes as provided in paragraph (e)(4)(iv) of this section, S and B may elect to reduce the basis in the B stock received in the intercompany section 362(e)(2) transaction as provided in this paragraph (e)(4)(v).

(A) *Amount of reduction.* The basis in the B stock is reduced by an amount equal to the amount B would otherwise be required to reduce its attributes under paragraph (e)(4)(iv) of this section.

(B) *Application of reduction.* If the application event involves B's attributes that reflect all or a portion of the remaining section 362(e)(2) amount, the reduction is applied proportionately (based on the remaining section 362(e)(2) amount reflected in the B stock prior to reduction) to all of the B stock received in the intercompany section 362(e)(2) transaction that is held by members immediately before the application event. If the application event involves all or a portion of the B stock received in the intercompany section 362(e)(2) transaction, the reduction is applied proportionately (based on the remaining section 362(e)(2) amount reflected in the B stock prior to reduction) to the B stock so involved. Any reduction in the basis of the B stock under this paragraph (e)(4)(v) is applied immediately before the section 362(e)(2) application event.

(C) *Effect of the reduction.* Any reduction to the basis of the B stock under this paragraph (e)(4)(v) is a nondeductible basis recovery item described in § 1.1502–32(b)(3)(iii)(B).

(D) *Election.* The election is made in the manner described in regulations implementing section 362(e)(2). The election must be made for an intercompany section 362(e)(2) transaction on or with the group return for either the year in which the intercompany section 362(e)(2) transaction or the first section 362(e)(2) application event occurs. The election is irrevocable and applicable for all section 362(e)(2) application events with respect to such intercompany section 362(e)(2) transaction (even if the event occurs while S and B are members

of another consolidated group). If the election is made on or with the return for the year of the intercompany section 362(e)(2) transaction, it has effect only if and to the extent there is a remaining section 362(e)(2) amount when there is a section 362(e)(2) application event.

(vi) *Examples.* The application of this paragraph (e)(4) is illustrated by the following examples:

Example 1. Section 362(e)(2) amount reflected in asset basis. (i) *Facts.* P owns the sole outstanding share of S stock. S owns Asset 1 with a basis of $100 and a value of $20. On January 1, year 1, S contributes Asset 1 to newly formed B in exchange for 10 shares of B stock in a transaction to which section 351 applies. At the end of year 1, B's only item is a $10 depreciation deduction with respect to Asset 1, which gives rise to a $10 loss that is absorbed by the group. On January 1, year 2, S sells all 10 shares of B stock for $18. After applying and giving effect to all generally applicable rules of law, S's basis in each share of B stock is $9 (the original $10 basis reduced by $1 loss attributable to the depreciation on Asset 1). No election is made under section 362(e)(2)(C).

(ii) *Suspension of section 362(e)(2) in year 1.* S's contribution of Asset 1 to B is an intercompany transaction to which section 362(e)(2) applies. Under the general rules of section 362(e)(2)(A), B's basis in Asset 1 would be reduced by $80 to its value, $20. However, as described in this paragraph (e)(4), the transfer is an intercompany section 362(e)(2) transaction and therefore, under paragraph (e)(4)(iv) of this section, no adjustment is made under section 362(e)(2) until there is a section 362(e)(2) application event. The $80 reduction that B would have had in its basis in Asset 1 is a section 362(e)(2) amount described in paragraph (e)(4)(ii)(A) of this section. This amount is reflected ratably in S's basis in the 10 shares of B stock, and in B's basis in Asset 1. There is no section 362(e)(2) application event in year 1 and so there is no section 362(e)(2) adjustment in year 1.

(iii) *Application of section 362(e)(2) on sale of B stock.* S's sale of the B stock is a transfer within the meaning of § 1.1502–36(f)(11) and therefore a section 362(e)(2) application event under paragraph (e)(4)(iii)(A) of this section. Accordingly, under paragraphs (e)(4)(iv)(A) and (e)(4)(iv)(B) of this section, because the section 362(e)(2) application event was caused by the transfer of B stock received in the intercompany section 362(e)(2) transaction, B must reduce its basis in Asset 1 that reflects the remaining section 362(e)(2) amount by an amount equal to the remaining section 362(e)(2) amount reflected in the B stock involved in the application event. Because S sold all of the B stock received in the intercompany section 362(e)(2) transaction and this stock reflects all of the section 362(e)(2) amount, B must reduce its basis in Asset 1 by the full amount of the remaining section 362(e)(2) amount immediately before the application event. Although there was originally an $80 section 362(e)(2) amount, $8 of that amount ($80/$100 × $10) was eliminated under paragraph (e)(4)(ii)(C)(*1*) of this section when the loss attributable to the depreciation deduction on Asset 1 was absorbed in year 1. Thus, at the time of the sale, the remaining section 362(e)(2) amount is only $72 ($80 less $8), and B's basis in Asset 1 is reduced by such amount, to $18. Under paragraph (e)(4)(iv)(C) of this section, the reduction in the basis of Asset 1 is not a noncapital, nondeductible expense described in § 1.1502–32(b)(2)(iii) and so has no effect on S's basis in its B shares. See § 1.1502–36 for additional rules relating to loss on shares of subsidiary stock.

Example 2. Section 362(e)(2) amount reflected in unabsorbed loss. (i) *Facts.* The facts are the same as in *Example 1*, except that during year 1 B sells Asset 1 to an unrelated nonmember for $20, and recognizes an $80 loss that is not absorbed by the group.

(ii) *Suspension of section 362(e)(2) in year 1.* As in paragraph (ii) of *Example 1,* S's contribution of Asset 1 to B is an intercompany section 362(e)(2) transaction, the section 362(e)(2) amount is $80, and there is no section 362(e)(2) adjustment in year 1. This amount is reflected ratably in S's basis in the 10 shares of B stock, and initially in B's basis in Asset 1. Further, because the $80 loss recognized on the sale of Asset 1 is not absorbed by the group, at the end of year 1 the remaining section 362(e)(2) amount is $80, reflected ratably in S's basis in the 10 shares of B stock, and in B's unabsorbed $80 loss.

(iii) *Application of section 362(e)(2) on sale of B stock.* As in paragraph (iii) of *Example 1*, S's sale of the 10 shares of B stock is a section 362(e)(2) application event that involves all of the B stock received in the intercompany section 362(e)(2) transaction. Accordingly, immediately before the application event, B must reduce the unabsorbed loss carryover that reflects the remaining section 362(e)(2) amount by an amount equal to the remaining section 362(e)(2) amount reflected in the B stock involved in the application event, $80 (all of the remaining section 362(e)(2) amount). The reduction of the loss carryover is not a noncapital, nondeductible expense described in § 1.1502–32(b)(2)(iii) and so has no effect on S's basis in its B shares. See § 1.1502–36 for additional rules relating to loss on shares of subsidiary stock.

Example 3. Section 362(e)(2) amount reflected in unabsorbed loss, partial application. (i) *Facts.* The facts are the same as in *Example 2,* except that on January 1, year 2, S only sells two shares of the B stock to an unrelated nonmember for $4.

(ii) *Suspension of section 362(e)(2) in year 1.* S's contribution of Asset 1 to B is an intercompany section 362(e)(2) transaction, the section 362(e)(2) amount is $80, and there is no section 362(e)(2) adjustment in year 1. This amount is reflected ratably in S's basis in the 10 shares of B stock, and initially in B's basis in Asset 1. Further, because the $80 loss recognized on the sale of Asset 1 is not absorbed by the group, at the end of year 1 the remaining section 362(e)(2) amount is $80, reflected ratably in S's basis in the 10 shares of B stock, and in B's unabsorbed $80 loss.

(iii) *Application of section 362(e)(2) on sale of B stock.* S's sale of two of the shares of B stock is a section 362(e)(2) application event that involves two shares of the B stock received in the intercompany section 362(e)(2) transaction. Accordingly, immediately before the application event, B must reduce the unabsorbed loss carryover that reflects the remaining section 362(e)(2) amount by an amount equal to the remaining section 362(e)(2) amount reflected in the B stock involved in the application event, $16 ($8 of the remaining section 362(e)(2) amount reflected in each share). The loss carryover is reduced from $80 to $64. This reduction is not a noncapital, nondeductible expense described in § 1.1502–32(b)(2)(iii) and so has no effect on S's basis in its B shares. Additionally, under paragraph (e)(4)(ii)(C)(*1*) of this section, $16 of the remaining section 362(e)(2) amount is eliminated, and, thereafter, the $64 remaining section 362(e)(2) amount is ratably reflected in S's basis in the remaining 8 shares of B stock and in B's $64 loss carryover. Because no election is made under section 362(e)(2)(C) in the year of the intercompany section 362(e)(2) transaction or in the year of the stock sale, the first section 362(e)(2) application event, no such election can be made with respect to the remaining shares received in the intercompany section 362(e)(2)(C) transaction. See § 1.1502–36 for additional rules relating to loss on shares of subsidiary stock.

(iv) *Application of section 362(e)(2) on sale of B stock, section 362(e)(2)(C) election.* If S and B elect under paragraph (e)(4)(v) of this section to reduce S's basis in the B stock received in the intercompany section 362(e)(2) transaction, under paragraph (e)(4)(v)(A) of this section S will reduce its basis in the B stock by $16 (an amount equal to the amount that B would otherwise be required to reduce its loss carryover, or the remaining section 362(e)(2) amount reflected in the two shares of B stock sold). Under paragraph (e)(4)(v)(B) of this section, this $16 reduction is applied proportionately to the two shares of B stock sold immediately before the application event, reducing the basis of each share to $2. The reduction in the basis of the two B shares sold is a nondeductible basis recovery item described in § 1.1502–32(b)(3)(iii)(B), and will effect P's basis in its share of S stock. Additionally, under paragraph (e)(4)(ii)(C)(*2*) of this section, $16 of the remaining section 362(e)(2) amount is eliminated, and, thereafter, the $64 remaining section 362(e)(2) amount is ratably reflected in S's basis in the remaining 8 shares of B stock and in B's $80 loss carryover. S recognizes no gain or loss on the sale of these two shares of B stock. Under paragraph (e)(4)(v)(D) of this section, S and B's election to reduce S's basis in the B stock is irrevocable and applicable to all future section 362(e)(2) application events with respect to this intercompany section 362(e)(2) transaction, such as subsequent dispositions of B stock to an unrelated nonmember.

Example 4. Section 362(e)(2) amount reflected in unabsorbed loss, subgroup exception. (i) *Facts.* The facts are the same as in *Example 3,* except that S does not sell any shares of B stock, and on January 1, year 2, P sells the sole share of the S stock to P1, the

common parent of another consolidated group.

(ii) *Suspension of section 362(e)(2) in year 1.* S's contribution of Asset 1 to B is an intercompany section 362(e)(2) transaction, the section 362(e)(2) amount is $80, and there is no section 362(e)(2) adjustment in year 1. This amount is reflected ratably in S's basis in the 10 shares of B stock, and initially in B's basis in Asset 1. Further, because the $80 loss recognized on the sale of Asset 1 is not absorbed by the group, at the end of year 1 the remaining section 362(e)(2) amount is $80, reflected ratably in S's basis in the 10 shares of B stock, and in B's unabsorbed $80 loss.

(iii) *No section 362(e)(2) application event on sale of S stock.* P's sale of the S stock is not an application event described in paragraph (e)(4)(iii) of this section. Further, because S and B continue to be members of the same consolidated group, there is no transfer (within the meaning of § 1.1502–36(f)(11)) of the 10 shares of B stock. Accordingly, there is no application event and, under paragraph (e)(4)(iv) of this section, no section 362(e)(2) adjustment is required. However, adjustments will be required if a section 362(e)(2) application event occurs at a time when there is a remaining section 362(e)(2) amount.

* * * * *

(f) * * *

(6) * * *

(ii) *Gain stock.* For dispositions of P stock occurring before May 16, 2000, see § 1.1502–13(f)(6)(ii) as contained in 26 CFR part 1 in effect on April 1, 2000. For dispositions of P stock occurring on or after May 16, 2000, see § 1.1032–3.

* * * * *

(iv) * * * (A) * * * If P grants M an option to acquire P stock in a transaction meeting the requirements of § 1.1032–3, M is treated as having purchased the option from P for fair market value with cash contributed to M by P.

* * * * *

(j) * * *

(5) * * * (i) * * *

(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

* * * * *

(l) * * * (1) * * * Paragraphs (a)(4), (e)(4), (f)(6)(ii), (f)(6)(iv)(A), and (j)(5)(i)(A) of this section apply to all transfers on or after the date these regulations are published as final regulations in the **Federal Register**.

* * * * *

Par. 6. Section 1.1502–19 is amended by:

1. Revising paragraphs (a)(3), (c)(1)(iii)(A), and (c)(3)(i)(A).

2. Adding a new last sentence to paragraph (h)(1).

The revisions and addition reads as follows:

§ 1.1502–19 Excess loss accounts.

(a) * * *

(3) *Application of other rules of law.* See § 1.1502–80(a) regarding the general applicability of other rules of law and a limitation on duplicative adjustments. In addition, for purposes of this section, the definitions in § 1.1502–32 apply.

* * * * *

(c) * * *

(1) * * *

(iii) * * *

(A) All of S's assets (other than its corporate charter and those assets, if any, necessary to satisfy state law minimum capital requirements to maintain corporate existence) are treated as disposed of, abandoned, or destroyed for Federal income tax purposes (for example, under section 165(a) or § 1.1502–80(c), or, if S's asset is stock of a lower-tier member, the stock is treated as disposed of under this paragraph (c)). An asset of S is not considered to be disposed of or abandoned to the extent the disposition is in complete liquidation of S under section 332 or is in exchange for consideration (other than in satisfaction of indebtedness);

* * * * *

(3) * * * (i) * * *

(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

* * * * *

(h) * * * (1) * * * Paragraphs (a)(3), (c)(1)(iii)(A), and (c)(3)(i)(A) of this section apply to all transfers on or after the date these regulations are published as final regulations in the **Federal Register**.

* * * * *

§ 1.1502–20 [Removed]

Par. 7. Section 1.1502–20 is removed.

Par. 8. Section 1.1502–21 is amended by:

1. Removing the last sentence of paragraph (b)(1).

2. Removing paragraph (b)(3)(v).

3. Revising paragraphs (b)(2)(ii)(A), (b)(2)(iv)(B)(*2*), (h)(6), and (h)(8).

4. Adding new paragraph (h)(1)(iii).

The revisions and addition reads as follows:

§ 1.1502–21 Net operating losses.

* * * * *

(b) * * *

(2) * * *

(ii) *Special rules*—(A) *Year of departure from group.* If a corporation ceases to be a member during a consolidated return year, net operating loss carryovers attributable to the corporation are first carried to the consolidated return year, then are subject to reduction under section 108 and § 1.1502–28 (regarding discharge of indebtedness income that is excluded from gross income under section 108(a)), and then are subject to reduction under § 1.1502–36 (regarding transfers of loss shares of subsidiary stock). Only the amount that is neither absorbed nor reduced under section 108 and § 1.1502–28 or under § 1.1502–36 may be carried to the corporation's first separate return year. For rules concerning a member departing a subgroup, see paragraph (c)(2)(vii) of this section.

* * * * *

(iv) * * *

(B) * * *

(*2*) *Special rules*—(*i*) *Carryback to a separate return year.* If a portion of the CNOL attributable to a member for a taxable year is carried back to a separate return year, the percentage of the CNOL attributable to each member, as of immediately after such portion of the CNOL is carried back, is recomputed pursuant to paragraph (b)(2)(iv)(B)(*2*)(*v*) of this section.

(*ii*) *Excluded discharge of indebtedness income.* If during a taxable year a member realizes discharge of indebtedness income that is excluded from gross income under section 108(a) and such amount reduces any portion of the CNOL attributable to any member pursuant to section 108 and § 1.1502–28, the percentage of the CNOL attributable to each member as of immediately after the reduction of attributes pursuant to sections 108 and 1017, and § 1.1502–28, shall be recomputed pursuant to paragraph (b)(2)(iv)(B)(*2*)(*v*) of this section.

(*iii*) *Departing member.* If during a taxable year a member that had a separate net operating loss for the year of the CNOL ceases to be a member, the percentage of the CNOL attributable to each member as of the first day of the following consolidated return year shall be recomputed pursuant to paragraph (b)(2)(iv)(B)(*2*)(*v*) of this section.

(*iv*) *Reduction of attributes for stock loss.* If during a taxable year a member does not cease to be a member of the group and any portion of the CNOL attributable to any member is reduced pursuant to § 1.1502–36, the percentage of the CNOL attributable to each member immediately after the reduction of attributes pursuant to § 1.1502–36 shall be recomputed pursuant to paragraph (b)(2)(iv)(B)(*2*)(*v*) of this section.

(*v*) *Recomputed percentage.* The recomputed percentage of the CNOL attributable to each member shall equal the unabsorbed CNOL attributable to the member at the time of the recomputation divided by the sum of the unabsorbed CNOL attributable to all of the members at the time of the recomputation. For purposes of the preceding sentence, a CNOL that is reduced pursuant to section 108 and § 1.1502–28, or under § 1.1502–36, or that is otherwise permanently disallowed or eliminated, shall be treated as absorbed.

(*vi*) *Examples.* For purposes of the examples in this section, unless otherwise stated, all groups file consolidated returns, all corporations have calendar taxable years, the facts set forth the only corporate activity, value means fair market value and the adjusted basis of each asset equals its value, all transactions are with unrelated persons, and the application of any limitation or threshold under section 382 is disregarded. * * *

* * * * *

(h) * * * (1) * * *

(iii) Paragraphs (b)(2)(ii)(A) and (b)(2)(iv)(B)(*2*) of this section apply to taxable years the original return for which the due date (without regard to extensions) is on or after the date these regulations are published as final regulations in the **Federal Register**.

* * * * *

(6) *Certain prior periods.* Paragraphs (b)(1), (b)(2)(iv)(A), (b)(2)(iv)(B)(*1*), and (c)(2)(vii) of this section shall apply to taxable years for which the due date of the original return (without regard to extensions) is after March 21, 2005. Sections 1.1502–21T(b)(1), (b)(2)(iv), and (c)(2)(vii), as contained in 26 CFR part 1 revised as of April 1, 2004, shall apply to taxable years for which the due date of the original return (without regard to extensions) is on or before March 21, 2005, and after August 29, 2003. For taxable years for which the due date of the original return (without regard to extensions) is on or before August 29, 2003, see paragraphs (b)(1), (b)(2)(ii)(A), (b)(2)(iv), and (c)(2)(vii) of this section and § 1.1502–21T(b)(1) as contained in 26 CFR part 1 revised as of April 1, 2003.

* * * * *

(8) *Losses treated as expired under § 1.1502–35(f)(1).* For rules regarding losses treated as expired under § 1.1502–35(f) on and after March 10, 2006, see § 1.1502–21(b)(3)(v) as contained in 26 CFR part 1 in effect on April 1, 2006. For rules regarding losses treated as expired before March 10, 2006, see § 1.1502–21T(h)(8) as contained in 26 CFR part 1 in effect on April 1, 2005.

Par. 9. Section 1.1502–30 is amended by:

1. Revising paragraph (b)(4).
2. Adding a new second sentence to paragraph (c).

The revision and addition reads as follows:

§ 1.1502–30 Stock basis after certain triangular reorganizations.

* * * * *

(b) * * *

(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.

* * * * *

(c) * * * However, paragraph (b)(4) of this section applies to reorganizations occurring on or after the date these regulations are published as final regulations in the **Federal Register**.

* * * * *

Par. 10. Section 1.1502–31 is amended by:

1. Revising paragraph (a)(2).
2. Adding a new last sentence to paragraph (h)(1).

The revision and addition reads as follows:

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

(a) * * *

(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.

* * * * *

(h) * * * (1) * * * In addition, paragraph (a)(2) of this section applies to group structure changes that occurred on or after the date these regulations are published as final regulations in the **Federal Register**.

* * * * *

Par. 11. Section 1.1502–32 is amended by:

1. Revising paragraphs (a)(2), (b)(3)(ii)(C)(*2*), (b)(3)(iii)(C), (b)(3)(iii)(D), (c)(1), (c)(2)(i), the first sentence in paragraph (c)(2)(ii)(A) introductory text, the first sentence in paragraph (c)(3), and the first sentence in paragraph (c)(4)(i) introductory text.
2. Adding new paragraph (h)(9).

The revisions and addition read as follows:

§ 1.1502–32 Investment adjustments.

(a) * * *

(2) *Application of other rules of law.* See § 1.1502–80(a) regarding the general applicability of other rules of law and a limitation on duplicative adjustments.

* * * * *

(b) * * *

(3) * * *

(ii) * * *

(C) * * *

(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.

* * * * *

(iii) * * *

(C) *Loss suspended under § 1.1502–35(c).* For losses suspended by § 1.1502–35(c) prior to the date these regulations are published as final regulations in the **Federal Register**, see 1.1502–32(b)(3)(iii)(C) as contained in 26 CFR part 1 revised as of April 1, 2006.

(D) *Reimported losses disallowed under § 1.1502–35.* Any loss or deduction the use of which is disallowed pursuant to § 1.1502–35(b) (other than duplicating items that are carried back to a consolidated return year of the group), and with respect to which no waiver described in paragraph (b)(4) of this section is filed, is treated as a noncapital, nondeductible expense incurred during the taxable year that such loss would otherwise be absorbed. For losses or deductions disallowed under § 1.1502–35(g)(3)(iii) prior to the date these regulations are published as final regulations in the **Federal Register**, see 1.1502–32(b)(3)(iii)(D) as contained in 26 CFR part 1 revised as of April 1, 2006.

* * * * *

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

(ii) *Special allocations in the case of certain loss transfers and reallocations of investment adjustments subject to prior use limitation*—(A) *Losses attributable to transfers subject to section 362(e)(2)–(1) In general.* If a nonmember holds shares of S stock, any amounts that directly or indirectly reflect a section 362(e)(2) amount (as defined in § 1.1502–13(e)(4)(ii)(A)) are allocated to members' shares of S stock under the general principles of this paragraph (c), except that such allocations are made as though the shares of S stock held by nonmembers were not outstanding.

(*2*) *Example.* The application of this paragraph (c) is illustrated by the following example:

Example. (i) *Facts.* P owns four of the five outstanding shares of the stock of M. X, a nonmember, owns the remaining outstanding share of M stock. On January 1, year 1, M contributes Asset 1 to S, a newly formed subsidiary, in exchange for five shares of S stock in a transaction to which section 351 applies. At the time of the transfer, M's basis in Asset 1 is $100 and its value is $20. At the end of year 1, S's only item is a $10 depreciation deduction with respect to Asset 1, which gives rise to a $10 loss that is absorbed by the group. At the beginning of year 2, M sells one of its S shares to X for $3.60, and M and S elect to reduce M's basis in the S stock under § 1.1502–13(e)(4)(v) by the amount of the remaining section 362(e)(2) amount ($72) (computed in paragraph (iii)(C) of this *Example*) reflected in the share. See, § 1.1502–13(e)(4). Accordingly, M's basis in the S share is reduced by $14.40 (the portion of the $72 remaining section 362(e)(2) amount reflected in the share (computed in paragraph (iii)(C) of this *Example*)), to $3.60. M recognizes no gain or loss on the sale of the S share. At the end of year 2, S's only item is an additional $10 depreciation deduction with respect to Asset 1, which gives rise to an additional $10 loss that is absorbed by the group. At the end of year 2, M's only item is a $14.40 nondeductible basis recovery item resulting from the election to reduce its basis in the S share. See § 1.1502–13(e)(4)(v)(C).

(ii) *Application of section 362(e)(2) and § 1.1502–13(e)(4) to the transfer of Asset 1.* M's contribution of Asset 1 to S is a transaction described in section 362(e)(2). Under the general rules of section 362(e)(2)(A), S's basis in Asset 1 would be limited to its value ($20) and would thus be reduced by $80, from $100 to $20. However, the transfer is an intercompany section 362(e)(2) transaction and therefore, under § 1.1502–13(e)(4)(iv), no adjustment is made to S's basis in Asset 1 under section 362(e)(2) until there is a section 362(e)(2) application event (within the meaning of § 1.1502–13(e)(4)(iii)). There is no section 362(e)(2) application event in year 1 and so there is no section 362(e)(2) adjustment in year 1. The $80 reduction that S would have had in its basis in Asset 1 is a section 362(e)(2) amount described in § 1.1502–13(e)(4)(ii)(A). This $80 section 362(e)(2) amount is initially reflected ratably ($16 per share) in M's basis in each of the five shares of S stock received in the transaction, and in S's basis in Asset 1. Further, under § 1.1502–13(e)(4)(ii)(C)(*1*), the section 362(e)(2) amount reflected in an attribute is generally eliminated proportionately as the attribute is taken into account. Accordingly, $8 ($80/$100 × $10) of the year 1 Asset 1 depreciation deduction is attributable to the section 362(e)(2) amount.

(iii) *Treatment of year 1 item.* (A) *Allocation of item among shares of S stock.* Although no adjustment is made under section 362(e)(2) during year 1, if any shares of S stock are held by nonmembers, any items taken into account that are attributable to the section 362(e)(2) amount must be specially allocated under the rules of this paragraph (c)(1)(ii). Because M owns all the shares of S stock, the special allocation rules of this paragraph (c)(1)(ii) have no application to the allocation of S's depreciation deduction to M's shares. Accordingly, the entire $10 of depreciation on Asset 1 is included in the remaining adjustment to the S shares under the general rules in paragraphs (c)(2) through (c)(4) of this section. As a result, $2 is allocated to, and decreases the basis in, each share of S stock held by M from $20 to $18.

(B) *Allocation of tiered-up item among shares of M stock.* Under paragraph (a)(3)(iii) of this section, adjustments to M's basis in S stock tier up and are taken into account in determining adjustments to higher-tier stock. However, because X, a nonmember, holds a share of M stock, any portion of the tiering-up adjustment that is attributable to a section 362(e)(2) amount is specially allocated under this paragraph (c)(1)(ii). In this case, $8 of the adjustment to M's basis in S stock ($^{80}/_{100}$ × $10) is attributable to a section 362(e)(2) amount and thus $8 of the tiered-up adjustment is indirectly attributable to a section 362(e)(2) amount. As a result, $8 of the tiered-up adjustment must be allocated as though X's share of M stock was not outstanding. Accordingly, $2 (¼) of the $8 of the tiered-up adjustment is allocated to each of P's four shares of M stock and no portion of that amount is allocated to X's share of M stock. However, the remaining $2 of the tiered-up adjustment not attributable to a section 362(e)(2) amount is included in the remaining adjustment allocated to all outstanding shares under the general rules in paragraphs (c)(2) through (c)(4) of this section. Thus, $.40 (⅕) of the $2 of the tiered-up adjustment is allocated to each outstanding share. (Although $.40 is allocated to X's share of M stock, that allocation does not affect X's basis in the share because X is not a member of the group. See paragraph (c)(1)(iv) of this section.) The allocation of the tiered up year 1 item is thus:

Item	Allocation	
	P's shares of M stock (⅘)	X's share of M stock (⅕)
Tiered-up section 362(e)(2) amount ($8 of the $10 depreciation on Asset 1)	$8.00 ($2.00 per share)	N/A.
Tiered-up non-section 362(e)(2) amount ($2 of the $10 depreciation on Asset 1)	$1.60 ($.40 per share)	$.40 ($.40 per share).
Total allocation	$9.60 ($2.40 per share)	$.40 ($.40 per share).

(C) *Remaining section 362(e)(2) amount.* After the year 1 items have been taken into account, the remaining section 362(e)(2) amount with respect to the S shares is $72 ($80 less $8 eliminated due to Asset 1 depreciation being taken into account). Under § 1.1502–13(e)(4)(ii)(C)(*1*), this $72 remaining section 362(e)(2) amount is reflected proportionately in the five S shares held by M, or $14.40 per share.

(iv) *Treatment of year 2 items.* (A) *Elimination of a portion of the section 362(e)(2) amount.* Under § 1.1502–13(e)(4)(ii)(C)(*2*), S's remaining section 362(e)(2) amount is eliminated to the extent of the reduction in M's basis in the S stock under § 1.1502–13(e)(4)(v). Accordingly, S's remaining section 362(e)(2) amount is reduced by $14.40, to $57.60. This remaining section 362(e)(2) amount is reflected proportionately in the four remaining S shares held by M, or $14.40 per share.

(B) *Allocation of item among shares of S stock.* Because X owns a share of S stock in year 2, the special allocation rule in paragraph (c)(1)(ii) of this section applies to the allocation of the portion of the year 2 depreciation deduction attributable to a section 362(e)(2) amount. Under that rule, $6.40 (57.60/90 × $10) of the item attributable to a section 362(e)(2) amount must be allocated as though only the four shares of S stock held by M were outstanding. Accordingly, $1.60 (¼) of the $6.40 of the $10 depreciation deduction is allocated to each of M's four shares of S stock and no portion of that amount is allocated to X's share of S stock. However, the remaining $3.60 of the $10 depreciation deduction not attributable to a section 362(e)(2) amount is included in the remaining adjustment allocated to all outstanding shares under the general rules in paragraphs (c)(2) through (c)(4) of this section. Thus, $.72 (⅕) of the $3.60 of the $10 depreciation deduction is allocated to each outstanding S share. (Although $.72 is allocated to X's share of S stock, that allocation does not affect X's basis

in the share because X is not a member of the group. See paragraph (c)(1)(iv) of this section.) The allocation of S's year 2 item is thus:

Item	Allocation	
	M's shares of S stock (4/5)	X's share of S stock (1/5)
Section 362(e)(2) amount ($6.40 of the $10 depreciation on Asset 1)	$6.40 ($1.60 per share)	N/A.
Non-section 362(e)(2) amount ($3.60 of the $10 depreciation on Asset 1)	$2.88 ($.72 per share)	$.72 ($.72 per share).
Total allocation:	$9.28 ($2.32 per share)	$.72 ($.72 per share).

(C) *Adjustments to the basis of shares of M stock.* The adjustment to the basis of M stock includes two items: M's $14.40 nondeductible basis recovery item resulting from the reduction in M's basis in the S stock under § 1.1502–13(e)(4)(v); and $9.28 tiered-up adjustment from the adjustment made to its basis in the S stock. The full amount of the $14.40 nondeductible basis recovery item, and $6.40 of the $9.28 tiered-up adjustment is attributable to the section 362(e)(2) amount. Therefore $20.80 ($14.40 plus $6.40) must be allocated entirely to P's shares of M stock. Accordingly, $5.20 (1/4) of the $20.80 is allocated to each of P's four shares of M stock. The remaining $2.88 of the tiered-up adjustment not attributable to a section 362(e)(2) amount is included in the remaining adjustment allocated to all outstanding shares under the general rules in paragraphs (c)(2) through (c)(4) of this section. Thus, approximately $.58 (1/5) of the $2.88 of the tiered-up adjustment is allocated to each outstanding share. (Although approximately $.58 is allocated to X's share of M stock, that allocation does not affect X's basis in the share because X is not a member of the group. See paragraph (c)(1)(iv) of this section.) The allocation of M's year 2 items is thus:

Item	Allocation	
	P's shares of M stock (4/5)	X's share of M stock (1/5)
.		
Nondeductible basis recovery ($14.40 reduction in S stock basis)	$14.40 ($3.60 per share)	N/A.
Tiered-up section 362(e)(2) amount ($6.40 of the $9.28 tiered-up adjustment)	$6.40 ($1.60 per share)	N/A.
Tiered-up non-section 362(e)(2) amount ($2.88 of the $9.28 tiered-up adjustment)	$2.30 (approx. $.58 per share).	$.58 (approx. $.58 per share).
Total allocation:	$23.10 (approx. $5.78 per share).	$.58 (approx. $.58 per share).

(D) *No duplicative adjustments to the basis of shares of M stock.* A portion of the $2.88 of the tiered-up adjustment not attributable to a section 362(e)(2) amount duplicates a portion of the $14.40 nondeductible basis recovery item resulting from the reduction in M's basis in the S stock under § 1.1502–13(e)(4)(v). Consequently, under § 1.1502–80(a), such portion of the tiered-up adjustment is not applied to reduce P's basis in its shares of M stock. The election to reduce M's basis in the S stock eliminated $14.40 of the remaining section 362(e)(2) amount. Accordingly, at the S level, $1.60 ($14.40/$90 × $10) of the Asset 1 year 2 depreciation deduction is associated with this amount. This portion was allocated to all outstanding shares of S stock under the general rules in paragraphs (c)(2) through (c)(4) of this section ($.32 per share ($1.60/5)). At the M level, $1.28 (4 × $.32) of the tiered-up non-section 362(e)(2) amount reflects depreciation on this $14.40 of Asset 1 basis. So, at the M level, approximately $.26 ($1.28/5) of this tiered-up amount is allocated to each outstanding share. This approximately $.26 per share amount would duplicate a portion of the $14.40 nondeductible basis recovery item if it is applied to reduce P's basis in the M shares. Accordingly, although approximately $5.78 of the items are allocated to each M share held by P, P's basis in each share of M stock is only reduced by approximately $5.52 ($5.78 less $.26).

(B) *Losses reattributed pursuant to an election under § 1.1502–36(d)(6).* If a member transfers (within the meaning of § 1.1502–36(f)(11)) loss shares of S stock and the common parent elects under § 1.1502–36(d)(6) to reattribute S attributes, the resulting noncapital, nondeductible expense is allocated to all loss shares of S stock transferred by members in the transaction in proportion to the loss in the shares, and such amount tiers up to any higher tiers under the general rules of this section. If lower-tier subsidiary attributes that would otherwise be reduced as a result of tier-down attribute reduction under § 1.1502–36(d)(5)(ii)(D) are reattributed, the resulting noncapital, nondeductible expense is allocated to the shares of the lower-tier subsidiary (and any tier up of such amount is allocated to the shares of higher tier subsidiaries) that will cause the full amount of this expense to be applied to reduce the basis of the loss shares of S stock transferred by members in the transaction. However, this noncapital, nondeductible expense (and any tier up of such amount) is not allocated to shares (other than S shares) transferred in a transfer in which gain or loss was recognized. Further, this noncapital, nondeductible expense (and any tier up of such amount) is allocated among lower-tier shares with positive basis in a manner that reduces the disparity in the basis of the shares to the greatest extent possible. The tier up of this amount is allocated to the loss shares of S stock transferred by members in the transaction in proportion to the loss in the shares, and such amount tiers up to any higher tiers under the general rules of this section. For example, suppose 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, the tier up of this amount is allocated entirely to the S1 shares held by S (excluding the S1 shares sold), and the tier up of this amount is allocated to the loss shares of S stock sold by M2. This amount then tiers up from M2 to M1 and P, and from M1 to P under the general rules of this section.

(C) *Reallocations of investment adjustments subject to prior use limitation.* If the reallocation of an investment adjustment under § 1.1502–36(b)(2) is subject to the limitation in § 1.1502–36(b)(2)(iii)(B)(*2*) due to prior use, no amount of such reallocation (including as a tiered-up amount) shall be allocated to any share whose prior use resulted in the application of the limitation.

(iii) *Remaining adjustment.* The *remaining adjustment* is that portion of the adjustment 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) that is 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 to the extent 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 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 generally is allocated equally to each share within the class. However, if a member has an excess loss account in shares of a class of common stock at the time of a positive remaining adjustment, the portion of the adjustment allocable to the member with respect to the class is allocated first to equalize and eliminate that member's excess loss accounts and then to increase equally its basis in the shares of that class. Similarly, any negative remaining adjustment is allocated first to reduce the member's positive basis in shares of the class before creating or increasing its excess loss account. After positive basis is eliminated, any remaining portion of the negative adjustment is allocated first to equalize, to the greatest extent possible, and then to increase equally, the member's excess loss accounts in the shares of that class. 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. * * *

* * * * *

(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. * * *

* * * * *

(4) *Cumulative redetermination*—(i) *General rule.* A member's basis in each share of S'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) and (c)(1)(iii) of this section (adjustments for specially allocated losses and remaining adjustments, respectively) 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 S's shares. * * *

* * * * *

(h) * * *

(9) *Allocations of investment adjustments, including adjustments attributable to certain loss transfers; certain conforming amendments.* Paragraphs (a)(2), (b)(3)(ii)(C)(*2*), (b)(3)(iii)(C), (b)(3)(iii)(D), (c)(1), (c)(2)(i), (c)(2)(ii)(A), (c)(3), and (c)(4)(i) of this section are applicable on or after the date these regulations are published as final regulations in the **Federal Register**.

* * * * *

Par. 12. Section 1.1502–33 is amended by:

1. Revising paragraph (a)(2).
2. Adding a new last sentence to paragraph (j)(1).

The revision and addition reads as follows:

§ 1.1502–33 Earnings and profits.

(a) * * *

(2) *Application of other rules of law.* See § 1.1502–80(a) regarding the general applicability of other rules of law and a limitation on duplicative adjustments.

* * * * *

(j) * * * (1) * * * However, paragraph (a)(2) of this section applies with respect to determinations of the earnings and profits of a member in consolidated return years beginning on or after the date these regulations are published as final regulations in the **Federal Register**.

* * * * *

Par. 13. Section 1.1502–35 is amended by:

1. Revising paragraphs (a), (b), and (h).
2. Removing and reserving paragraphs (f) and (g).
3. Adding new paragraph (l).

The revisions and addition read as follows:

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

(a) *Losses on subsidiary stock transferred or deconsolidated prior to the date that these regulations are published as final regulations in the* **Federal Register**. If a member disposed of a loss share of stock of a subsidiary (S), or if S ceased to be a member (deconsolidated) when any member held loss shares of S stock, and if the disposition or deconsolidation occurred prior to the date that these regulations are published as final regulations in the **Federal Register**, see § 1.1502–35, as contained in 26 CFR part 1, revised as of April 1, 2006. For transfers and deconsolidations on or after the date that these regulations are published as final regulations in the **Federal Register**, see § 1.1502–36.

(b) *Anti-loss reimportation rule applicable on or after the date that these regulations are published as final regulations in the* **Federal Register**—(1) *Conditions for application.* This paragraph (b) applies when—

(i) A member of a group (the selling group) recognized and was allowed a loss with respect to a share of stock of S, a subsidiary or former subsidiary in the selling group;

(ii) 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

(iii) 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 becomes directly or indirectly 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) (reimported items).

(2) *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 (b)), 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.

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

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

(ii) The determination of whether a loss is duplicative is made under the principles of § 1.1502–35, as contained in 26 CFR part 1, revised as of April 1, 2006; and

(iii) The reduction of a reimported item (other than duplicating items that are carried back to a consolidated return year of the group) is a noncapital, nondeductible expense within the meaning of § 1.1502–32(b)(2)(iii).

(4) *Period of applicability.* The provisions of this paragraph (b) apply to a reimported item if its related stock loss is recognized on or after the date that these regulations are published as final regulations in the **Federal Register**. The provisions of this paragraph (b) (other than paragraph (b)(1)(i)) also apply to a reimportation event if its related stock loss is recognized on or after March 7, 2002, and is recognized in either a disposition (described in paragraph (g)(3)(i)(A) of this section, as contained in 26 CFR part 1, revised as of January 1, 2007) or a disposition otherwise subject to this section. For prior law, see paragraph (g)(3) of this section, as contained in 26 CFR part 1, revised as of January 1, 2007.

* * * * *

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

* * * * *

(l) *Effective date.* Paragraphs (a), (b), and (h) of this section apply with respect to stock transfers, deconsolidations of subsidiaries, determinations of worthlessness, and stock dispositions on or after the date these regulations are published as final regulations in the **Federal Register**. For rules applicable prior to the date these regulations are published as final regulations in the **Federal Register**, see § 1.1502–35 as contained in 26 CFR part 1 in effect on April 1, 2007.

§ 1.1502–35T [Removed]

Par. 14. Section 1.1502–35T is removed.

Par. 15. Section 1.1502–36 is added to read as follows:

§ 1.1502–36 Loss on subsidiary stock.

(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 *loss share*.

(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 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 giving effect to all applicable rules of law other than this section, the share is a loss share. Paragraph (b) of this section applies first to require certain redeterminations of all members' bases in shares of S stock. If the transferred share is a loss share after any basis redetermination required by paragraph (b) of this section, paragraph (c) of this section applies to require certain reductions in M's basis in the transferred loss share. If the transferred share is a loss share after any reduction required by paragraph (c) of this section, paragraph (d) of this section applies to require certain reductions in S's attributes. Paragraphs (e), (f), and (g) of this section provide general operating rules (predecessor/successor rules, effects of prior section 362(e)(2) transactions), definitions, and an anti-abuse rule, respectively.

(ii) *Stock of multiple subsidiaries transferred in the transaction*—(A) *Order of application*—(*1*) *Transferred shares in lowest tier.* If shares of stock of more than one subsidiary are transferred in a transaction and no transferred shares of stock of the lowest-tier subsidiary (S2) are loss shares, any gain recognized with respect to the S2 shares immediately adjusts members' bases in subsidiary stock under the principles of § 1.1502–32. However, if any of the transferred S2 shares are loss shares, first paragraph (b) of this section and then paragraph (c) of this section apply with respect to the S2 shares. After giving effect to any adjustments required under paragraphs (b) and (c) of this section, gain or loss is computed on all transferred S2 shares. Any adjustments under paragraphs (b) and (c) of this section, any gain or loss recognized on transferred S2 shares (whether allowed or disallowed), and any other related or resulting adjustments are then applied to adjust members' bases in subsidiary stock under the principles of § 1.1502–32.

(*2*) *Application of paragraphs (b) and (c) of this section to higher-tier stock.* After giving effect to any lower-tier adjustments described in paragraph (a)(3)(ii)(A)(*1*) of this section, transfers in the next higher tier in which shares are transferred, and then in each next higher tier successively, are subject to the treatment described in paragraph (a)(3)(ii)(A)(*1*).

(*3*) *Application of paragraph (d) of this section.* After paragraphs (b) and (c) of this section have been applied with respect to all transferred loss shares and after giving effect to all adjustments (whether required by paragraphs (b) and (c) of this section, by the recognition of gain on a transfer, or otherwise), paragraph (d) of this section applies with respect to the highest-tier shares that are then transferred loss shares. Paragraph (d) then applies with respect to transferred loss shares in each next lower tier successively.

(B) *Example.* The rules of this paragraph (a)(3) are illustrated by the following example:

Example. M owns all the outstanding shares of S stock and one of the two outstanding shares of S2 stock, S owns all the outstanding shares of S1 stock, and S1 owns the other outstanding share of S2 stock. As part of one transaction, M sells all the S shares and its S2 share, and S1 sells its S2 share. The sales are to unrelated individuals, S and S1 do not elect to file a consolidated return after the transaction, the S and S1 shares are loss shares and the S2 shares are gain shares. Each share is transferred within

the meaning of this section, the S and S2 shares because S and S2 cease to be owned by M, and M and S1, respectively, as a result of taxable dispositions, and the S1 shares because S and S1 cease to be members of the same group. This section applies to the transfer of the S and S1 (loss) shares, but not to the transfer of the S2 (gain) shares. Accordingly, immediately before the transaction, after giving effect to other rules of law, the following occurs. First, the gain recognized on the transferred S2 shares tiers up to adjust members' bases in all upper-tier subsidiary shares under the principles of § 1.1502–32. Then, if S's transferred S1 shares are still loss shares, paragraphs (b) and (c) of this section apply to those shares. The loss on the S1 shares is not recognized in the transfer (because there is no taxable disposition of the shares) and so only the adjustments to the bases of the S1 shares required by paragraphs (b) and (c) of this section tier up to adjust M's basis in the S stock. Then, if M's transferred shares of S stock are still loss shares, paragraphs (b) and (c) of this section apply with respect to those shares. If, after giving effect to any adjustments under paragraphs (b) and (c) of this section, any of the S shares are still loss shares, paragraph (d) of this section applies with respect to the transfer of those shares. If any transferred S1 shares are still loss shares after the application of paragraph (d) of this section with respect to the transfer of S shares, paragraph (d) applies with respect to the transfer of the S1 shares.

(4) *Other rules of law and coordination with deferral and disallowance provisions.* 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. For example, if M sells loss shares of S stock to another member in an intercompany transaction, every member's bases in shares of S stock and all of S's attributes may be adjusted under this section even though M's loss is deferred under §§ 1.267(f)–1 and 1.1502–13, and S remains a member. See § 1.1502–80(a) regarding 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 and X is a nonmember 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 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 loss disallowance or deferral provision of the 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 are intended to prevent the operation of the investment adjustment system from creating noneconomic or duplicated loss when members hold S shares with disparate bases, and they operate by reallocating previously applied investment adjustments. The provisions of this paragraph (b) 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) *Exemptions from basis redetermination*—(A) *No potential for redetermination.* Notwithstanding the general rule in paragraph (b)(2) of this section, basis redetermination will not be required if redetermination would not result in a change to any member's basis in any share of S stock. For example, if S has only one class of stock outstanding and there is no disparity in members' bases in S shares, no member's basis would be changed by the application of this paragraph (b). Accordingly, under this paragraph (b)(1)(ii)(A), no redetermination would be required. Similarly, if S has preferred and common stock outstanding, there is no gain or loss on any member's preferred shares, and there is no disparity in members' bases in the common stock, no member's basis would be changed by the application of this paragraph (b). Accordingly, under this paragraph (b)(1)(ii)(A), no redetermination would be required.

(B) *Disposition of entire interest.* Notwithstanding the general rule in paragraph (b)(2) of this section, basis redetermination will not be required if, within the group's taxable year in which the transfer occurs, every share of S stock held by a member is transferred to a nonmember in one or more fully taxable transactions.

(iii) *Transfers of stock of subsidiaries at multiple tiers.* If stock of subsidiaries at multiple tiers is transferred in a transaction, see paragraph (a)(3)(ii) of this section regarding the order of application of this section.

(iv) *Investment adjustment.* For purposes of this paragraph (b), the term *investment adjustment* means the adjustment for items described in § 1.1502–32(b)(2), excluding § 1.1502–32(b)(2)(iv) (distributions). The term includes all such adjustments reflected in the basis of the share, whether originally applied directly by § 1.1502–32 or otherwise. The term therefore includes investment adjustments reallocated to the share, and it does not include investment adjustments reallocated from the share, whether pursuant to this section or any other provision of law. It also includes the proportionate amount of investment adjustments reflected in the basis of a share after the basis is apportioned among shares, for example in 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 adjustments are made in accordance with the following:

(i) *Decreasing the bases of transferred loss shares*—(A) *Removing positive investment adjustments from transferred loss shares.* M's basis in each of its transferred loss shares of S 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 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.* 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 and applying negative investment adjustments to the transferred loss share from shares held by members that are not transferred loss shares. Reductions under this paragraph (b)(2)(i)(B) are made 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.

(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 are reallocated and applied to increase, but not above value, members' bases in gain shares of S preferred stock.

(B) *Common stock.* Any positive investment adjustments removed from transferred loss shares and not applied to S preferred shares are then

reallocated and applied to increase members' bases in shares of S common stock. Reallocations are made to shares of 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.

(iii) *Operating rules*—(A) *In general.* Reallocations are made in a manner that reduces basis disparity among shares of preferred stock and among shares of common stock to the greatest extent possible (that is, causes the ratio of the basis to the value of each member's share to be as equal as possible).

(B) *Limits on reallocation*—(*1*) *Restriction to outstanding shares.* Investment adjustments can only be reallocated to shares that were held by members in the period to which the adjustment is attributable.

(*2*) *Limitation by prior use of allocation*—(*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, notwithstanding the general rule, 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 prior intercompany transaction.) 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, but the basis of that share would not change as a result of the reallocation (for example, because the reallocation would be among shares that are all lower-tier to the share with the previously used basis), the investment adjustment may be reallocated. See § 1.1502–32(c)(1)(ii)(C) regarding special allocations applicable if the reallocation of an investment adjustment is limited under this paragraph (b)(2)(iii)(B)(*2*).

(*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 paragraph (b) of this section applies and requires a reallocation of the year 1 positive investment adjustment.

(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 (including the tiered up $.50) was used in determining the gain on the sale. Accordingly, $.50 of the $10 investment adjustment originally allocated to the S share that tiered-up to the M share was previously used and therefore cannot be reallocated in a manner that would (if it were the original allocation) affect the basis of the sold share. Thus, taking into account the special allocations in § 1.1502–32(c)(1)(ii)(C), up to $9.50 of the adjustment to M's transferred S share could be allocated to P's shares of S stock (leaving $.50 on M's transferred S share, all of which would be treated as tiered up to P's transferred M share). Alternatively, all $10 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, if it were the original adjustment, would have caused any amount to be reflected in the basis of the transferred 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 P sold, would have been reflected in P's basis, and would have been used in determining the gain or loss on the sale. Accordingly, taking into account the special allocations in § 1.1502–32(c)(1)(ii)(C), up to $9.50 of the $10 adjustment to P's transferred S share could be allocated to M's shares of S stock (all of which would tier up to P's 19 retained M shares). Alternatively, all $10 could be reallocated to P's other S shares.

(C) *Order of reallocation.* In general, reallocations are 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 reduces basis disparity to the greatest extent possible.

(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, P has owned two assets, Asset 1 and Asset 2. On January 1, year 1, P receives four shares of S common stock (the Block 1 shares) in exchange for Asset 1, which has a basis and value of $80. The exchange qualifies under section 351 and, therefore, under section 358, P's aggregate basis in the Block 1 shares is $80 ($20 per share). On July 1, year 1, P receives another share of S common stock (the Block 2 share) in exchange for Asset 2, which has a basis of $0 and value of $20. This exchange also qualifies as a section 351 exchange and, under section 358, P's basis in the Block 2 share is $0. P's Block 1 and Block 2 shares are the only outstanding shares of S stock. On October 1, year 1, S sells Asset 2 for $20. On December 31, year 1, P sells one of its Block 1 shares for $20. After applying and giving effect to all generally applicable rules of law (other than this section), P's basis in each Block 1 share is $24 (P'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, P's basis in its Block 2 share is $4 (P'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)). P's sale of the Block 1 share is a transfer of a loss share and therefore subject to the provisions of this section.

(B) *Basis redetermination under this paragraph (b).* Under this paragraph (b), P'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 P's basis in the transferred loss share, but not below value, by removing positive investment adjustments applied to the basis of the share. Accordingly, P'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. No further reduction to the basis of the share is required under this paragraph (b) because the basis of the share is then equal to 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 P's bases in its S shares in a manner that reduces basis disparity 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 P's sale of the Block 1 share is no longer a transfer of a loss share after the application of this paragraph (b), paragraphs (c) and (d) of this section do not apply.

(ii) *Redetermination to prevent 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, P 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 1, S sells Asset 1 for $20, recognizing a $60 loss that is absorbed by the group. On December 31, year 1, P sells one of its Block 1 shares for $5. After applying and giving effect to all generally applicable rules of law (other than this section), P's basis in each Block 1 share is $8 (P'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)). P's basis in its Block 2 share is an excess loss account of $7 (its original basis of $5 reduced by $12, the share's portion of the loss recognized on Asset 1). P's sale of the Block 1 share is a transfer of a loss share and therefore subject to the provisions of this section.

(B) *Basis redetermination under this paragraph (b).* Under this paragraph (b), P'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, P's basis in the transferred Block 1 share is reduced, but not below value, by reallocating negative investment adjustments from shares that are not transferred loss shares. In total, there were $48 of negative investment adjustments applied to shares that are not transferred loss shares. Accordingly, P'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 shares that are not transferred loss shares in a manner that reduces basis disparity 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 P's sale of the Block 1 share is no longer a transfer of a loss share after the application of this paragraph (b), paragraphs (c) and (d) of this section do not apply.

(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 1, P sells all its shares of S stock for $25. Under paragraph (b)(1)(ii)(B) of this section, this paragraph (b) does not apply to redetermine P's basis in its S shares because every S share held by a member is transferred to a nonmember in a fully taxable transaction. However, the sale of the Block 1 shares is a transfer of loss shares and therefore subject to paragraphs (c) and (d) of this section. 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.

Example 2. Redetermination increases basis of transferred loss share. (i) *Facts.* On January 1, year 1, P owns all 10 outstanding shares of S common stock. Five of the shares have a basis of $20 per share (the Block 1 shares) and five of the shares have a basis of $10 per share (the 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. On December 31, year 2, S sells one Block 1 share and one Block 2 share to X for $10 per share. After applying and giving effect to all generally applicable rules of law (other than this section), P's basis in each Block 1 share is $25 (P'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 P's basis in each Block 2 share is $15 (P's original $10 basis increased by $5). P's sale of the Block 1 and Block 2 shares is a transfer of loss shares and therefore subject to the provisions of this section.

(ii) *Basis redetermination under this paragraph (b).* Under this paragraph (b), P'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 P'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 Block 1 share is reduced by $5, from $25 to $20. The basis of the Block 2 share is also reduced by $5, from $15 to $10. (Although the 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 to 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 P's bases in its S shares in a manner that reduces basis disparity to the greatest extent possible. Accordingly, of the $10 positive investment adjustments to be reallocated, $6 is reallocated and applied to the basis of the 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), P's basis in each retained Block 1 share is $25, P's basis in the transferred Block 1 share is $20, and P's basis in each Block 2 share is $16.

(iii) *Application of paragraph (c) of this section.* After the application of this paragraph (b), P'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 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, paragraph (c) of this section reduces P's basis in the transferred Block 2 share (by the lesser of its net positive adjustment and its disconformity amount, or $6, from $16 to $10, its value).

(iv) *Application of paragraph (d) of this section.* After the application of paragraph (c) of this section, P'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 P'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. 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 have a $100 annual, cumulative preference as to dividends (per share). 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	975	1025	710	550	400	375	250	215	100
Value	1000	1000	375	375	375	375	375	375	375	375

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 loss is absorbed by the group and the resulting negative adjustment of $1000 is allocable entirely to the common stock. See § 1.1502–32(c)(1).

In year 2, S has $700 of ordinary income and a $100 ordinary loss. Also, on October 1, year 2, S declares a dividend of $200 ($100 with respect to each of the preferred shares). Thus, there is a net positive investment adjustment for year 2 of $400. See § 1.1502–32(b)(2). Under § 1.1502–32(c)(1), a negative adjustment of $100 is first allocated to each of the preferred shares to reflect the dividend declaration. Then, $400 of the $600 remaining adjustment (the adjustment computed without taking distributions into account) is allocated $200 to each of the preferred shares to reflect their entitlement to dividends accruing in year 1 and year 2. See § 1.1502–32(c)(3). (The year 2 investment adjustment to each preferred share is therefore a positive $100.) Finally, under § 1.1502–32(c)(2), the remaining $200 of the investment adjustment is allocated to the common stock, equally to all outstanding shares. After applying and giving effect to all generally applicable rules of law (other than this section), 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	975	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
Adjusted basis	1350	1075	925	610	450	300	275	150	115	0
Value	1100	1100	275	275	275	275	275	275	275	275
Unrecognized gain/(loss)	(250)	25	(650)	(335)	(175)	(25)	0	125	160	275

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 the provisions of 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 shares.* First, paragraph (b)(2)(i)(A) of this section applies to reduce M's basis in PS1 and P's basis in CS2, but not below value, by removing the positive investment adjustments applied to the bases of the shares. Accordingly, M's basis in PS1 is reduced by $200 (the investment adjustment applied to the share without regard to the distribution), from $1350 to $1150, and P's basis in CS2 is reduced by $25, from $610 to $585.

(B) *Reallocating negative investment adjustments from 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 negative investment adjustments applied to 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 basis disparity to the greatest extent possible. The remaining loss on PS1 is $50, 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 adjustments made to all common shares other than CS2). Thus, $50 of negative investment adjustments are reallocated to the basis of PS1 and $310 of negative investment adjustments are reallocated to the basis of CS2, reducing each to its value ($1100 and $275, respectively). The negative investment adjustments are reallocated from the shares that are not transferred loss shares in a manner that reduces basis disparity to the greatest extent possible. Accordingly, of the $360 reallocated negative investment adjustments, $125 is reallocated from each of CS7 and CS8, and $110 is reallocated from CS6. As a result, the basis of CS6 increases to $260, the basis of CS7 increases to $240, and the basis of CS8 increases to $125.

(C) *Increasing basis by reallocated positive investment adjustments.* Under paragraph (b)(2)(ii)(A) of this section, the $225 of positive investment adjustments removed from the transferred loss shares are then reallocated and applied to increase the basis of preferred shares, but not above value. Accordingly $25 of that amount is reallocated to PS2, increasing its basis from $1075 to $1100, its value. The remaining $200 is allocated among the common shares in a manner that reduces basis disparity to the greatest extent possible. Accordingly, of the $200 positive investment adjustment that is reallocated to common shares, $150 is reallocated to CS8, $35 is reallocated to CS7, and $15 is reallocated to CS6, increasing the basis of each to $275.

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

	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	1075	925	610	450	300	275	150	115	0
Removing positive adjustments from transferred loss shares	−200	.....	.....	−25	.....	.....	.....	.....	.....	.....
Reallocating negative adjustments	−50	.....	.....	−310	.....	.....	.....	+110	+125	+125
Applying positive adjustments removed from transferred shares	.....	+25	.....	.....	.....	.....	.....	+15	+35	+150
Basis after redetermination	1100	1100	925	275	450	300	275	275	275	275
Value	1100	1100	275	275	275	275	275	275	275	275
Gain/(loss)	0	0	(650)	0	(175)	(25)	0	0	0	0

(iii) *Application of paragraphs (c) and (d) of this section.* Because M's sale of PS1 and P's sale of CS2 are no longer 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 adjustments made to PS1 give rise to a $250 nondeductible basis recovery item (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 reduce 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 in order to prevent noneconomic stock loss and thereby promote the clear reflection of the group's income. The effect of these rules is to limit the reduction to M's basis in the S share to the amount of net unrealized appreciation reflected in the share's basis immediately before the transfer. 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*—(i) *In general.* If M transfers a share of S stock and, after the application of paragraph (b) of this section, the share is a loss share, M's basis in the share is reduced, but not below value, by the lesser of—

(A) The share's net positive adjustment (see paragraph (c)(3) of this section); and

(B) The share's disconformity amount (see paragraph (c)(4) of this section).

(ii) *Transactions that adjusted stock or asset basis.* See paragraph (e)(2) of this section for special rules that may apply if a prior transaction, such as an exchange subject to section 362(e)(2), adjusted the basis in any share of S stock or S's attributes in a manner that altered a share's disconformity amount.

(iii) *Transfers of stock of subsidiaries at multiple tiers.* If stock of subsidiaries at multiple tiers is transferred in a transaction, see paragraph (a)(3)(ii) of this section regarding the order of application 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)(iv) of this section.

(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 time immediately before the transfer, taking into account all applicable rules of law other than this section (except as specifically provided otherwise in this section). 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 (for this purpose, S's basis in any share of lower-tier subsidiary stock is S's basis in that share, adjusted to reflect any gain or loss recognized in the transaction and any other related or resulting adjustments), reduced by the amount of S's liabilities. See paragraph (f) of this section for definitions of the terms ''allocable portion'', ''deferred deduction'', ''liability'', and ''loss carryover''. 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.

(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 increased noneconomic loss on S stock (as a result of S1's recognition of items that are indirectly reflected in members' bases in S stock).

(ii) *General rule for nontransferred shares of lower-tier subsidiary.* Solely for purposes of determining the disconformity amount of a share of S stock, S's basis in a 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, computed under the principles of paragraphs (c)(3) and (c)(4) of this section, respectively.

(iii) *Multiple tiers of nontransferred shares.* If S directly or indirectly owns non-transferred 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 successively to determine the tentatively reduced basis of nontransferred shares of stock of subsidiaries at each next higher tier that is lower tier to S. The tentative reductions are treated as noncapital, nondeductible expenses that tier up under the principles of § 1.1502–32, tentatively reducing the basis of stock and the net positive adjustments of subsidiaries 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) does not apply with respect to stock of any other subsidiary (S2) to the extent it is lower tier to the transferred S1 share. However, the tentative basis reduction rule may apply to S2 stock for purposes of computing the disconformity amount of the transferred S1 share. The purpose of this rule is to prevent tentative adjustments under this paragraph (c)(6) to the extent that this paragraph (c) has already applied to shares of subsidiary stock, without regard to whether the basis of those shares was reduced under this paragraph (c).

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

Example. (i) *Facts.* P owns the sole outstanding share of S stock, S owns the sole outstanding share of S1 stock, S1 owns the sole outstanding share of S2 stock, S2 owns the sole outstanding share of S3 stock, and S3 owns the sole outstanding share of S4 stock. The S and S1 shares are loss shares, and the S3 share is a gain share. In one transaction, P 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 S2 sells the S3 share to an unrelated individual. S1 and S2 elect to file a consolidated return following the transaction, as do S3 and S4.

(ii) *General applicability of section.* The transaction is a transfer of the S and S3 shares (by reason of the sales) and of the S1 share (because S and S1 cease to be members of the same group). The transfer of the S3 share is not a transfer of a loss share and so this section does not apply to that transfer. This section does, however, apply to the transfer of the S and S1 loss shares. Under paragraph (a)(3)(ii)(A) of this section, the application of this section begins with the application of paragraph (b) to the transfer of the loss share stock of S1, the lowest-tier subsidiary the stock of which is transferred in the transaction.

(iii) *Application of paragraphs (b) and (c) to transfer of S1 stock.* First, the gain recognized on the transfer of S3 tiers up to adjust the basis of each upper-tier share. Then, because the transferred S1 share is still a loss share under these facts, paragraph (b) of this section applies to S's transfer of S1 stock. However, no adjustment is required under paragraph (b) of this section because redetermination would change no member's basis in a share (members hold only one share of S1 stock). See paragraph (b)(1)(ii)(A)

of this section. The S1 share is still a loss share and so it is then subject to the provisions of this paragraph (c). In determining basis reduction under this paragraph (c), the disconformity amount of the S1 share is computed by treating S1's basis in S2 stock as tentatively reduced under this paragraph (c)(6). In determining the disconformity amount of the S1 share, this tentative reduction rule has no application with respect to S2's basis in the S3 share (because the S3 share is transferred in the transaction) or with respect to S3's basis in the S4 share (because the S4 stock is lower tier to the transferred S3 share). After the application of this paragraph (c) to the transfer of the S1 share, paragraph (b) of this section applies to P's transfer of the S share if the share is still a loss share.

(iv) *Application of section to transfer of S stock.* First, assuming the S share has remained a loss share, paragraph (b) of this section applies to P's transfer of S stock. However, no adjustment is required under paragraph (b) of this section, either because there is no potential for redetermination (members hold only one share of S stock) or because P transfers the group's entire interest in S to a nonmember in a fully taxable transaction. See, respectively, paragraphs (b)(1)(ii)(A) and (b)(1)(ii)(B) of this section. The transferred share is still a loss share and therefore subject to the provisions of this paragraph (c). In determining the disconformity amount of the S share, S's net inside attributes are determined by taking into account S's actual basis in the S1 stock. The tentative reduction rule of this paragraph (c)(6) does not apply to S's basis in the S1 share because the S1 share is transferred in the transaction. All other shares are lower tier to the transferred S1 share and are therefore not subject to tentative reduction for purposes of determining the disconformity amount of the S 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 gain taken into account by members with respect to all transferred gain shares of S stock, provided that—

(A) The gain and loss shares are transferred in the same transaction; and

(B) The gain is taken into account in the year 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.* P owns the only two outstanding shares of S common stock. Share A has a basis of $54 and Share B has a basis of $100. In the same transaction, P sells the two S shares to X for $60 each. P realizes a gain of $6 on Share A and a loss of $40 on Share B. P's sale of Share B is a transfer of a loss share and therefore subject to the provisions of this section. (No adjustment is required under paragraph (b) of this section because P transfers the group's entire interest in S to a nonmember in a fully taxable transaction. See paragraph (b)(1)(ii)(B) of this section.) The transfer is then subject to the provisions of this paragraph (c). However, for this purpose, P treats its basis in Share B as reduced by the $6 gain taken into account with respect to Share A. Thus, solely for purposes of computing the basis reduction required with respect to P's basis in Share B, P's basis in Share B is treated as $94 ($100 less $6). If, after the application of this paragraph (c), the sale of Share B is still a transfer of a loss share, then the transfer is subject to paragraph (d) of this section. (Although the basis of Share B is not reduced by gain for purposes of paragraph (d) of this section, paragraph (d)(3)(i)(A) of this section applies netting principles to limit adjustments under paragraph (d) of this section.)

(ii) *Allocation of gain amount to determine net loss.* The facts are the same as in paragraph (i) of this *Example*, except that, in addition to Share A and Share B, a third share of S stock, Share C, is outstanding. P's basis in Share C is $80. P sells all three shares of S stock to X for $60 each. P's sales of Share B and Share C are transfers of loss shares and therefore subject to the provisions of this section. (No adjustment is required under paragraph (b) of this section because P transfers the group's entire interest in S to a nonmember in a fully taxable transaction. See paragraph (b)(1)(ii)(B) of this section.) The transfer is then subject to the provisions of this paragraph (c). However, for this purpose, P 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 × $6) is treated as allocated to Share B and $2 of gain ($20/$60 × $6) is treated as allocated to Share C. Accordingly, P 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 reduced by gain for purposes of paragraph (d) of this section, paragraph (d)(3)(i)(A) of this section applies netting principles to limit adjustments under paragraph (d) of this section.)

(iii) *Disposition of stock with deferred gain.* The facts are the same as in paragraph (i) of this *Example*, except that P sells the gain share to a member. Under § 1.1502–13, P'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 P's loss recognized on Share B.

(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, P 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. On December 31, year 1, P sells its S share for $100. After applying and giving effect to all generally applicable rules of law (other than this section), P's basis in the S share is $140 (P's original $100 basis increased under § 1.1502–32 to reflect the $40 gain recognized on the sale of Asset 1). P's sale of the S share is a transfer of a loss share and therefore subject to the provisions of this section.

(B) *Application of paragraph (b) of this section.* No adjustment is required under paragraph (b) of this section, either because redetermination would change no member's basis in a share (members hold only one share of S stock) or because P transfers the group's entire interest in S to a nonmember in a fully taxable transaction. See, respectively, paragraphs (b)(1)(ii)(A) and (b)(1)(ii)(B) of this section. After the application of paragraph (b) of this section, P's sale of the S share is still a transfer of a loss share and therefore subject to this paragraph (c).

(C) *Basis reduction under this paragraph (c).* Under this paragraph (c), P's basis in the S share is reduced, but not below value, 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 applied to the basis of the share, computed without taking distributions into account. There are no distributions. The only investment adjustment to 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, the basis in the share is reduced by $40, from $140 to $100, immediately before the sale.

(D) *Application of paragraph (d) of this section.* Because P's sale of the S share is no longer a transfer of a loss share after the application of this paragraph (c), paragraph (d) of this section does not apply.

(ii) *Appreciation recognized as income (instead of 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, P sells the S share for $140. Because P'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 distributes a $10 dividend before the end of year 1. As a result, the value of the share decreases and P sells the share for $90. After applying and giving effect to all generally applicable rules of law (other than this section), P's basis in the S share is $130 (P's original $100 basis increased by $30 under § 1.1502–32 (the net of the $40 gain recognized on the sale of Asset 1 and the $10 dividend declared and distributed)). P's sale of the S share is a transfer of a loss share and therefore subject to the provisions of this section.

(B) *Application of paragraph (b) of this section.* No adjustment is required under paragraph (b) of this section, either because there redetermination would change no member's basis in a share (members hold only one share of S stock) or because P transfers the group's entire interest in S to a nonmember in a fully taxable transaction. See, respectively, paragraphs (b)(1)(ii)(A) and (b)(1)(ii)(B) of this section. After the application of paragraph (b) of this section, P's sale of the S share is still a transfer of a loss share and therefore subject to this paragraph (c).

(C) *Basis reduction under this paragraph (c).* Under this paragraph (c), P's basis in the S share is reduced, but not below value, 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 applied to the basis of the share, computed without taking distributions into account). 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 the sum of S's money ($30, the $40 sale proceeds minus the $10 distribution) and S's basis in Asset 2 ($60), or $90. 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, the basis in the share is reduced by $40, from $130 to $90, immediately before the sale.

(D) *Application of paragraph (d) of this section.* Because P's sale of the S share is no longer a transfer of a loss share after the application of this paragraph (c), paragraph (d) of this section does not apply.

Example 2. Loss of appreciation reflected in basis. (i) *Facts.* On January 1, year 1, P 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 P sells its S share for $60. After applying and giving effect to all generally applicable rules of law (other than this section), P's basis in the S share remains $100. P's sale of the S share is a transfer of a loss share and therefore subject to the provisions of this section.

(ii) *Application of paragraph (b) of this section.* No adjustment is required under paragraph (b) of this section, either because redetermination would change no member's basis in a share (members hold only one share of S stock) or because P transfers the group's entire interest in S to a nonmember in a fully taxable transaction. See, respectively, paragraphs (b)(1)(ii)(A) and (b)(1)(ii)(B) of this section. After the application of paragraph (b) of this section, P's sale of the S share 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), P's basis in the S share ($100) is reduced immediately before the sale, but not below value ($60), by the lesser of the share's net positive adjustment and disconformity amount. There were no adjustments to P'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 P'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).

(iv) *Application of paragraph (d) of this section.* After the application of this paragraph (c), P'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, P 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. Also in year 1, the value of Asset 2 declines and S sells Asset 2 for $20. On December 31, year 1, P sells its S share for $60. After applying and giving effect to all generally applicable rules of law (other than this section), P's basis in the S share is $100 (P's original $100 basis, unadjusted under § 1.1502–32 because the $40 gain recognized on the sale of Asset 1 offsets the $40 loss on the sale of Asset 2). P's sale of the S share is a transfer of a loss share and therefore subject to the provisions of this section.

(B) *Application of paragraph (b) of this section.* No adjustment is required under paragraph (b) of this section, either because redetermination would change no member's basis in a share (members hold only one share of S stock) or because P transfers the group's entire interest in S to a nonmember in a fully taxable transaction. See, respectively, paragraphs (b)(1)(ii)(A) and (b)(1)(ii)(B) of this section. After the application of paragraph (b) of this section, P's sale of the S share is still a transfer of a loss share and therefore subject to this paragraph (c).

(C) *Basis reduction under this paragraph (c).* Under this paragraph (c), P's basis in the S share ($100) is reduced immediately before the sale, but not below value ($60), 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 P'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), P'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 neither P nor S sells anything 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. On December 31, year 3, P sells its S share for $100. After applying and giving effect to all generally applicable rules of law (other than this section), P's basis in the S share is $140 (P's original $100 basis increased under § 1.1502–32 to reflect the $40 gain recognized on the sale of Asset 3 in year 3).

(B) *Application of paragraph (b) of this section.* No adjustment is required under paragraph (b) of this section, either because redetermination would change no member's basis in a share (members hold only one share of S stock) or because P transfers the group's entire interest in S to a nonmember in a fully taxable transaction. See, respectively, paragraphs (b)(1)(ii)(A) and (b)(1)(ii)(B) of this section. After the application of paragraph (b) of this section, P's sale of the S share is still a transfer of a loss share and therefore subject to this paragraph (c).

(C) *Basis reduction under this paragraph (c).* Under this paragraph (c), P's basis in the S share ($140) is reduced immediately before the sale, 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, immediately before the sale.

(D) *Application of paragraph (d) of this section.* Because P's sale of the S share is no

longer a transfer of a loss share after the application of this paragraph (c), paragraph (d) of this section does not apply.

(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.* P 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. On December 31, year 1, P sells the S share for $100. After applying and giving effect to all generally applicable rules of law (other than this section), P's basis in the S share is $140 (P's original $100 basis increased under § 1.1502–32 to reflect the $40 gain recognized on the sale of Asset 1). P's sale of the S share is a transfer of a loss share and therefore subject to the provisions of this section.

(B) *Application of paragraph (b) of this section.* No adjustment is required under paragraph (b) of this section, either because redetermination would change no member's basis in a share (members hold only one share of S stock) or because P transfers the group's entire interest in S to a nonmember in a fully taxable transaction. See, respectively, paragraphs (b)(1)(ii)(A) and (b)(1)(ii)(B) of this section. After the application of paragraph (b) of this section, P's sale of the S share is still a transfer of a loss share and therefore subject to this paragraph (c).

(C) *Basis reduction under this paragraph (c).* Under this paragraph (c), P's basis in the S share ($140) is reduced immediately before the sale, 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 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 the sum of S's money ($60 from the sale of Asset 1) and S's basis in Asset 2 ($60), or $120. 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 $140 over $120, or $20. 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, immediately before the sale.

(D) *Application of paragraph (d) of this section.* After the application of this paragraph (c), P's sale of the S share is still a transfer of a loss share, and, accordingly, subject to paragraph (d) of this section. Paragraph (d) of this section reduces the basis of Asset 2 by $20 because the loss is duplicated.

(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). Because the net positive adjustment includes items of income (and not just gain), the analysis of the application of this paragraph (c) is the same here as in paragraph (i)(C) of this *Example 4.* Furthermore, the analysis of the application of this paragraph (C) would also be the same if the $60 loss carryover were subject to a section 382 limitation from a prior ownership change, and if, instead, it would subject to the limitation in § 1.1502–21(c) on losses carried from separate return limitation years. However, under each alternative fact pattern, paragraph (d) of this section reduces the loss carryover by $20 because the loss is duplicated.

(iii) *Liabilities.* The facts are the same as in paragraph (i)(A) of this *Example 4*, except that S borrows $100 before P 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 cash)) plus S's basis in Asset 2 ($60), minus 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, P 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. On December 31, year 1, P sells one of its shares, Share 1, for $20. After applying and giving effect to all generally applicable rules of law (other than this section), P's basis in its Share 1 is $40 (P's original $20 basis increased by $20 under § 1.1502–32 to reflect the share's allocable portion of the $100 gain recognized on the sale of Asset). P's sale of Share 1 is a transfer of a loss share and therefore subject to the provisions of this section.

(ii) *Application of paragraph (b) of this section.* No adjustment is required under paragraph (b) of this section because redetermination would change no member's basis in a share (S has only one class of stock outstanding and there is no disparity in the basis of the shares). See paragraph (b)(1)(ii)(A) of this section. After the application of paragraph (b) of this section, P'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), P's basis in Share 1 ($40) is reduced immediately before the sale, but not below value ($20), 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 basis ($40) over its allocable portion of S's net inside attribute amount. S's net inside attribute amount is the sum of S's money ($100 from the sale of the asset), and Share 1's allocable portion of S's net inside attribute amount is $20 (⅕ × $100). Thus, Share 1's disconformity amount is the excess of $40 over $20, or $20. The lesser of the share's net positive adjustment ($20) and its disconformity amount ($20) is $20. Accordingly, the basis in the share is reduced by $20, from $40 to $20, immediately before the sale.

(iv) *Application of paragraph (d) of this section.* Because P's sale of Share 1 is no longer a transfer of a loss share after the application of this paragraph (c), paragraph (d) of this section does not apply.

Example 6. Liabilities. (i) *In general.* (A) *Facts.* On January 1, year 1, P 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 distributes $60 to P and earns $20. The value of Asset declines to $60 and, on December 31, year 1, P sells the S share for $20. After applying and giving effect to all generally applicable rules of law (other than this section), P's basis in the S share is $60 (P's original $100 basis decreased under § 1.1502–32 by $40 (the net of the $60 distribution and the $20 income earned)). P's sale of the S share is a transfer of a loss share and therefore subject to the provisions of this section.

(B) *Application of paragraph (b) of this section.* No adjustment is required under paragraph (b) of this section, either because redetermination would change no member's basis in a share (members hold only one share of S stock) or because P transfers the group's entire interest in S to a nonmember in a fully taxable transaction. See, respectively, paragraphs (b)(1)(ii)(A) and (b)(1)(ii)(B) of this section. After the application of paragraph (b) of this section, P's sale of the S share is still a transfer of a loss share and therefore subject to this paragraph (c).

(C) *Basis reduction under this paragraph (c).* Under this paragraph (c), P's basis in the S share ($60) is reduced immediately before the sale, 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 computed without taking the distribution into account). 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 minus the $60 distribution plus the $20 income earned)) plus S's basis in Asset ($0), minus 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, immediately before the sale.

(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 required by 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 P 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 becomes worthless under section 165(g), taking into account the provisions of § 1.1502–80(c). After applying and giving effect to all generally applicable rules of law (other than this section), P's basis in the S share is $60 (P'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 earned). The investment adjustment for year 5 is $0 ($60 tax exempt income from the excluded COD applied to reduce attributes minus $60 noncapital, nondeductible expense from the reduction of S's portion of the CNOL). Under paragraph (f)(11)(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(g), taking into account the provisions of § 1.1502–80(c). Accordingly, P transfers a loss share of S stock on December 31, year 5, and the transfer is therefore subject to the provisions of this section.

(B) *Application of paragraph (b) of this section.* No adjustment is required under paragraph (b) of this section because redetermination would change no member's basis in a share. See paragraph (b)(1)(ii)(A) of this section. After the application of paragraph (b) of this section, P's transfer of the S share is still a transfer of a loss share and therefore subject to this paragraph (c).

(C) *Basis reduction under this paragraph (c).* Under this paragraph (c), P's basis in its S share ($60) is reduced immediately before the sale, 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 computed without taking the distribution into account). 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 (S's basis in Asset). (The attribute reduction required under sections 108 and 1017 and § 1.1502–28 is given effect before the application of this section; therefore, S's portion of the CNOL was 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 P loses the $60 distributed in year 1 and the loss is not absorbed by the group. 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 applying and giving effect to all generally applicable rules of law (other than this section), P's basis in the S share at the end of year 5 is $100 (P's original $100 basis decreased under § 1.1502–32 by $40 at the end of year 1 and then increased under § 1.1502–32 by $40 at the end of year 5 ($100 tax exempt income from the excluded COD applied to reduce attributes minus $60 noncapital, nondeductible expense from the reduction of S's portion of the CNOL). Under paragraph (f)(11)(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(g), taking into account the provisions of § 1.1502–80(c). Accordingly, P transfers a loss share of S stock on December 31, year 5, and the transfer is therefore subject to the provisions of this section.

(B) *Application of paragraph (b) of this section.* No adjustment is required under paragraph (b) of this section because redetermination would change no member's basis in a share. See paragraph (b)(1)(ii)(A) of this section. After the application of paragraph (b) of this section, P's transfer of the S share is still a transfer of a loss share and therefore subject to this paragraph (c).

(C) *Basis reduction under this paragraph (c).* Under this paragraph (c), P's basis in the S share ($100) is reduced immediately before the sale, 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 computed without taking the distribution into account ($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 (S's basis in Asset). 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, P'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.* P owns the sole outstanding share of S stock with a basis of $160. S owns two assets, Asset A 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 1, with a basis of $20 and value of $60. In year 1, S1 sells Asset 1 to X for $60, recognizing $40 of gain. On December 31, year 1, P sells its S share to Y, a member of another consolidated group, for $160. After applying and giving effect to all generally applicable rules of law (other than this section), P's basis in the S share is $200 (P's original $160 basis increased under § 1.1502–32 by $40 (to reflect the tiering up of the increase to S's basis in S1 under § 1.1502–32 by $40 (to reflect the gain recognized on S1's sale of Asset 1)). P's sale of the S share is a transfer of a loss share and therefore subject to the provisions of 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)(11) of this section.)

(ii) *Application of paragraph (b) of this section.* No adjustment is required under paragraph (b) of this section, either because redetermination would change no member's basis in a share (members hold only one share of S stock) or because P transfers the group's entire interest in S to a nonmember in a fully taxable transaction. See, respectively, paragraphs (b)(1)(ii)(A) and (b)(1)(ii)(B) of this section. After the application of paragraph (b) of this section, P's sale of the S share is still a transfer of a loss share and therefore subject to this paragraph (c).

(iii) *Basis reduction under this paragraph (c).* (A) *In general.* Under this paragraph (c), P's basis in the S share ($200) is reduced immediately before the sale, 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, if any, of the basis of the share ($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 A ($100) plus 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 by S1's year 1 positive $40 investment adjustment), for purposes of computing the S share's disconformity amount, S's basis in the S1 share is tentatively reduced by the lesser of the S1 share's net positive adjustment and its 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, if any, of its basis ($100) over its allocable portion of S1's net inside attribute amount. S1's net inside attribute amount is $60 (its cash received on the sale of Asset 1) and it is

entirely attributable to S's S1 share. The S1 share's disconformity amount is therefore 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 basis in its S1 share is tentatively reduced by $40, from $100 to $60.

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

(D) *Amount of reduction.* P'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, P's basis in the S share is reduced by $40, from $200 to $160, immediately before the sale.

(E) *Effect on S's basis in its S1 share.* The transaction has no effect on S's basis in the S1 share. Thus, S owns the S1 share with a basis of $100, S's original $60 basis in the share plus the $40 adjustment for the gain recognized on the sale of Asset 1 in year 1.

(iv) *Application of paragraph (d) of this section.* Because P's sale of the S share is no longer a transfer of a loss share after the application of this paragraph (c), paragraph (d) of this section does not apply.

(d) *Attribute reduction to prevent duplication of loss*—(1) *In general.* The rules of this paragraph (d) reduce S's attributes to the extent they duplicate a net loss on shares of S stock transferred by members in a single transaction. This rule furthers single entity principles by preventing S 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. This rule applies without regard to whether S ceases to be a member after the transfer of its shares.

(2) *Attribute reduction rule*—(i) *General.* If a transferred share is a loss share after the application of paragraph (c) of this section, S's attributes are reduced by S's attribute reduction amount. 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.

(ii) *Transfers of stock of subsidiaries at multiple tiers.* If stock of subsidiaries at multiple tiers is transferred in a transaction, this paragraph (d) (other than paragraph (d)(6) to the extent necessary to make the election to reattribute attributes) applies only after paragraphs (b) and (c) of this section have applied with respect to all transfers of loss shares. See paragraph (a)(3)(ii) of this section regarding the order of application of this section.

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

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

(B) S's aggregate inside loss (see 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 (taking into account any adjustments required under paragraphs (b) and (c) of this section, any gain or loss recognized at lower tiers, and any other related or resulting adjustments); over

(B) The aggregate value of those shares.

(iii) *Aggregate inside loss*—(A) *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) *Transactions that adjusted stock or asset basis.* See paragraph (e)(2) of this section for special rules that may apply if a prior transaction, such as an exchange subject to section 362(e)(2), adjusted the basis in any share of S stock or S's attributes in a manner that altered the potential for loss duplication.

(v) *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*—(i) *Attributes available for reduction.* S's attributes available for reduction under this paragraph (d) are—

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

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

(C) *Category C.* Deferred deductions;

(D) *Category D.* Basis in publicly traded property (other than stock of a subsidiary), but only to the extent of the amount, if any, that each such property's basis exceeds its value; and

(E) *Category E.* Basis of assets excluding—

(*1*) Money and cash equivalents, and

(*2*) The basis of publicly traded property (other than stock of a subsidiary).

(ii) *Rules of application*—(A) *In general.* S's attribute reduction amount is allocated and applied to reduce the attributes in each category in the order that the categories are set forth in paragraph (d)(4)(i) of this section. If the amount to be allocated and applied to any category equals or exceeds the amount of attributes in the category, the attributes in that category are reduced to zero and any excess is then allocated and applied to the attributes in the next category. If the amount to be allocated and applied is less than the amount of attributes in any category other than Category A or Category B, it is allocated and applied proportionately to all attributes in the category based on the amount of each attribute. If the amount to be allocated and applied to attributes in Category E exceeds the amount of attributes in that category, then—

(*1*) To the extent of any liabilities of S (or a lower-tier subsidiary) that are not taken into account for tax purposes before the transfer, such excess is suspended and allocated and applied proportionately to reduce any amounts that would be deductible or capitalizable as a result of such liabilities later being taken into account by S or another person; solely for purposes of this paragraph (d)(4)(ii)(A)(*1*), *liability* means any liability or obligation that 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; and

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

(B) *Order of reduction of loss carryovers.* With respect to attributes in Category A and Category B, the attribute reduction amount is applied first to reduce losses carried from the first taxable year in which a loss carryover arose, and then to reduce loss carryovers that arose in each next successive year.

(C) *Time and effect of attribute reduction.* In general, the reduction of attributes is effective immediately before the transaction in which there is a transfer of a loss share of S stock. If the reduction to a member's basis in a share of S stock exceeds the basis of that share, the excess is an excess loss account to which the member owning the share succeeds (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)(ii)(D) 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). Accordingly, such reductions have no effect on the basis of stock of upper-tier subsidiaries.

(5) *Special rules applicable if S holds stock of a lower-tier subsidiary (S1) immediately before a transfer of loss shares of S stock*—(i) *Computation of S's attribute reduction amount.* For purposes of determining S's attribute reduction amount under paragraph (d)(3) of this section—

(A) *Single share.* All of S's shares of S1 stock held immediately before the transaction (whether or not transferred in, or held by S immediately after, the transaction) are treated as a single share (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.* If S owns (directly or indirectly) stock of subsidiaries in multiple tiers (whether or not transferred in, or held by S, directly or indirectly, immediately after, the transaction), S's deemed basis in such stock is determined first with respect to shares of stock of the lowest-tier subsidiary or subsidiaries. Deemed basis is then determined with respect to the basis of stock of subsidiaries in each next higher tier.

(ii) *Allocation and application of S's attribute reduction amount*—(A) *Allocation of attribute reduction amount between S1 stock and other assets.* For purposes of allocating S's attribute reduction amount, S's basis in S1 stock is treated as equal to its deemed basis in the S1 stock (determined under paragraph (d)(5)(i)(B) of this section), reduced by—

(*1*) The value of S's transferred shares of S1 stock,

(*2*) The excess of the sum of S1's money, S1's cash equivalents, the value of S1's publicly traded property (other than stock of a subsidiary) and S1's transferred shares of lower-tier subsidiary (S2) stock, and all corresponding S2 amounts (net of S2's liabilities) that are allocable to S1's nontransferred shares of S2 stock, over the total amount of S1's liabilities, to the extent that such excess is allocable to S's nontransferred shares of S1 stock, and

(*3*) The corresponding amounts with respect to shares of stock of all lower tier subsidiaries.

(B) *Application of attribute reduction amount to S's S1 stock.* The attribute reduction amount allocated to S's S1 stock (the allocated amount) is apportioned among, and applied to reduce S's bases in, S's individual S1 shares in accordance with the following—

(*1*) No allocated amount is apportioned to a share of transferred S1 stock if gain or loss is recognized on its transfer;

(*2*) The allocated amount is apportioned among all of S's other shares of S1 stock in a manner that, when applied to those shares, reduces the disparity in S's bases in the S1 shares to the greatest extent possible;

(*3*) The allocated amount that is apportioned to any S1 share transferred in a transfer in which no gain or loss was recognized is applied only to the extent necessary to reduce the bases of that share to, but not below, the value of the share; and

(*4*) The allocated amount that is apportioned to S1 shares not transferred in the transaction is applied to reduce the basis of such shares without limitation.

(C) *Further effects of allocated amount.* Any portion of the allocated 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, as provided in paragraph (d)(5)(ii)(D) of this section, such amounts continue to be part of the allocated amount for purposes of the tier down rule in paragraph (d)(5)(ii)(D) of this section.

(D) *Tier down of attribute reduction amount*—(1) *General rule.* The portion of S's attribute reduction amount that is allocated to S1 stock (the allocated amount) is an attribute reduction amount of S1. Thus, subject to the basis conforming limitation in paragraph (d)(5)(ii)(D)(*2*) of this section, the allocated amount applies to reduce S1's attributes under the provisions of this paragraph (d). The allocated amount is an attribute reduction amount of S1 that must be allocated to S1's assets even if its application to S's basis in S1 stock is limited under paragraph (d)(5)(ii)(B) of this section and even if its application to S1's attributes is limited under paragraph (d)(5)(ii)(D)(*2*) of this section.

(*2*) *Conforming limitation on reduction of lower-tier subsidiary's attributes.* Notwithstanding the general rule in paragraph (d)(5)(ii)(D)(*1*) of this section, and subject to any modification in paragraph (e)(2) of this section, the application of S's attribute reduction amount to S1's attributes (the tier down amount) is limited such that, when combined with any attribute reduction amount computed with respect to a transfer of S1 stock, the total amount of reduction to S1's attributes does not exceed the excess of—

(i) The portion of S1's net inside attributes that is allocable to all S1 shares held by members immediately before the transaction; over

(ii) The sum of the value of all S1 shares transferred by members in the transaction and the sum of all members' bases in any other shares of S1 stock held immediately before the transaction (after any reduction under this section, including this paragraph (d)).

(iii) *Stock basis restoration.* After this paragraph (d) has applied with respect to all shares of subsidiary stock transferred in the transaction, basis is restored under this paragraph (d)(5)(iii). In general, under this paragraph (d)(5)(iii), reductions otherwise required under paragraph (d)(5)(ii)(B) of this section are reversed to the extent necessary to restore members' bases in subsidiary stock to conform the basis of each member's share of subsidiary stock to the share's allocable portion of the subsidiary's net inside attribute amount as defined in paragraph (c)(5) of this section, without regard to paragraph (c)(6) of this section. The 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—

(A) A subsidiary's net inside attribute amount is determined by treating the basis in stock of a lower-tier subsidiary as the actual basis of the stock, as adjusted under this section;

(B) The net inside attribute amount is treated as decreased by any attribute reduction amount suspended under paragraph (d)(4)(ii)(A)(*1*) of this section (liabilities not taken into account); and

(C) If a subsidiary received property in a prior intercompany section 362(e)(2) transaction and the stock of such subsidiary was reduced as the result of an election under section 362(e)(2)(C) (taking into account the provisions of § 1.1502–13(e)(4)), the net inside attribute amount must be reduced as provided in paragraph (e)(2) of this section.

(6) *Elections to reduce the potential for loss duplication*—(i) *In general.* Notwithstanding the general operation of this paragraph (d), the common parent of the group of which S is a member immediately before the transaction (P) may make an irrevocable election to reduce the potential for loss duplication, and thereby avoid or reduce attribute reduction. Under this paragraph (d)(6), P may elect to reduce members' bases in transferred loss shares of S stock, or reattribute S's attributes (including attributes of lower-tier subsidiaries) to the extent such attributes would otherwise be subject to reduction under this paragraph (d), or both. The combined amount of stock basis reduction and reattribution of attributes may not exceed S's attribute reduction amount, tentatively computed without regard to any election under this paragraph (d)(6).

(ii) *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), based on the tentatively computed attribute reduction amount. If a transferred share is still a loss share after giving effect to this election, the 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)(ii)(B). The scope of the election for the transfer at the lowest tier is determined by tentatively applying 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 tier up (under the principles of § 1.1502–32) to adjust members' bases in all higher-tier shares. The process is repeated for elections for each next higher-tier transfer.

(iii) *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, 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. The election to reattribute S's attributes can only be made for attributes in Category A, Category B, and Category C. Attributes subject to the election will be reattributed to P in the same order, manner, and amount that they would otherwise be reduced under paragraph (d)(4) of this section. P succeeds to reattributed attributes as if such attributes were succeeded to in a transaction described in section 381(a). 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. 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)(B) 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 disposition.

(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)(iii)(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)(ii)(D) 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)(B)) will not create an excess loss account in any such stock.

(iv) *Special rules for stock basis reduction elections.* An election to reduce basis in S stock is effective for all members' basis 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 of the transferring member. The attribute reduction amount (determined under paragraph (d)(3)(i) of this section) is treated as reduced by the amount of any 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.

(v) *Form and manner of election.* An election under this paragraph (d)(6) is made in the form of a statement titled ''Section 1.1502–36 Election to Reattribute Attributes,'' ''Section 1.1502–36 Election to Reduce Stock Basis,'' or ''Section 1.1502–36 Election to Reattribute Attributes and Reduce Stock Basis,'' as applicable. The statement must include the name and employer identification number of the subsidiary the stock of which is transferred, the name and employer identification number of any lower-tier subsidiary whose attributes are reattributed, and the amount by which the group is electing to reattribute attributes and/or reduce stock basis. The statement must be included on or with the group's timely filed original return for the taxable year of the transfer of the subsidiary stock to which the election relates.

(7) *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.* P 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. P sells 30 of the S shares to X for $30. As a result of the sale, P and S cease to be members of the same group. Accordingly, P transfers all 100 S shares. See paragraphs (f)(11)(i)(A) and (f)(11)(i)(B) of this section. P's transfer of the S shares is a transfer of loss shares and therefore subject to the provisions of this section.

(B) *Application of paragraphs (b) and (c) of this section.* No adjustment is required under paragraph (b) of this section either redetermination would not change any member's basis in an S share (there is only

one class of stock outstanding and there is no disparity in the basis of the shares). See paragraph (b)(1)(ii)(A) 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, P'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 aggregate bases of the transferred shares ($200) over the aggregate value of the transferred shares ($100), or $100. S's aggregate inside loss is the excess of its net inside attribute amount ($220, the sum of the $100 basis of the land and the $120 loss carryover) over the value of all outstanding S shares ($100), or $120. The attribute reduction amount is therefore the lesser of the net stock loss ($100) and the aggregate inside loss ($120), 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)(ii)(C) of this section, the reduction of the loss carryover is not a noncapital, nondeductible expense and has no effect on P'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 P only sells 20 S shares to X. P's sale of the 20 S shares is a transfer of loss shares and therefore subject to the provisions of this section.

(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, P'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 aggregate bases of the transferred shares ($40) over the aggregate value of the transferred shares ($20), or $20. S's aggregate inside loss is the excess of its net inside attribute amount ($220) over the value of all outstanding S shares ($100), or $120. The attribute reduction amount is therefore the lesser of the net stock loss ($20) and the aggregate inside loss ($120), or $20. 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. Under paragraph (d)(4)(ii)(C) of this section, the reduction of the loss carryover is not a noncapital, nondeductible expense and has no effect on P's basis in the S stock.

Example 2. Proportionate allocation of attribute reduction amount. (i) *Facts.* P owns the sole outstanding share of S stock with a basis of $150. S owns land with a basis of $100, a factory with a basis of $20, and rental property with a basis of $30. P sells its S share for $90. P's sale of the S share is a transfer of a loss share and therefore subject to the provisions of this section.

(ii) *Application of paragraphs (b) and (c) of this section.* No adjustment is required under paragraph (b) of this section, either because redetermination would not change any member's basis in a share (members hold only one share of S stock) or because P transfers the group's entire interest in S to a nonmember in a fully taxable transaction. See, respectively, paragraphs (b)(1)(ii)(A) and (b)(1)(ii)(B) 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, P'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 net stock loss ($60) and S's aggregate inside loss ($60, the excess of S's $150 net inside attribute amount (the $100 basis of the land plus the $20 basis of the factory plus the $30 basis of the rental property) over the $90 value of the S share). Under paragraph (d)(4) of this section, the $60 attribute reduction amount is allocated and applied proportionately to reduce S's attributes as follows:

Available attributes	Attribute amount	Allocable portion of attribute reduction amount	Adjusted attributes amount
Category E:			
Basis of land	$100	(100/150 × $60) $40	$60
Basis of factory	20	(20/150 × $60) $8	12
Basis of rental property	30	(30/150 × $60) $12	18
Total attributes	150	$60	90

Example 3. Publicly traded property. (i) *Facts.* The facts are the same as in paragraph (i) of *Example 2*, except that, instead of the factory and rental property, S holds two shares of publicly traded stock, Share X (basis and value of $20) and Share Y (basis of $30 and value of $5). P's sale of the S share is a transfer of a loss share and therefore subject to the provisions of this section.

(ii) *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 (ii) of *Example 2.* 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).

(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 net stock loss ($60) and S's aggregate inside loss ($60, the excess of S's $150 net inside attribute amount (the $20 basis of Share X plus the $30 basis of Share Y plus the $100 basis of the land) over the $90 value of the S share). Although S has $150 of attributes, S's attributes available for reduction include the basis of publicly traded property only to the extent it exceeds the value of the property. That loss on publicly traded property is a Category D attribute. S's attribute reduction amount is allocated and applied to reduce S's attributes as follows:

Available attributes	Attribute amount	Application of attribute reduction amount	Adjusted attribute amount
Category D:			
Loss in Share Y	$25	$25	$0
Category E:			
Basis of land	100	35	65
Total attributes	125	60	65

ATTRIBUTES AFTER APPLICATION OF PARAGRAPH (D)

Attribute	Amount
Basis of Share X	$20
Basis of Share Y	5
Basis of land	65

Example 4. Attributes attributable to liability not taken into account. (i) *S operates one business.* (A) *Facts.* On January 1, year 1, P forms S by exchanging $100 and land with a basis of $50 for the sole outstanding share of S stock. In year 1, S earns $500, spends $100 to build a factory on its land, and purchases $450 of publicly traded property. S also earns a section 38 general business credit of $50. However, pollution generated by S's business gives rise to a substantial environmental remediation liability under Federal law. Before any amounts have been taken into account with respect to the environmental remediation liability, P sells its S share to X for $150. At the time of the sale, the value of the publicly traded property was $450. If X had purchased S's assets and assumed S's liabilities directly, X would have been required to capitalize any expenses related to environmental remediation. After giving effect to all other provisions of law, P's basis in the S share is $650 (the original basis of $150 increased by the $500 income earned). The sale is therefore a transfer of a loss share of subsidiary stock and subject to this section.

(B) *Application of paragraphs (b) and (c) of this section.* No adjustment is required under paragraph (b) of this section, either because redetermination would not change any member's basis in a share (P holds only one share of S stock) or because P transfers the group's entire interest in S to a nonmember in a fully taxable transaction. See, respectively, paragraphs (b)(1)(ii)(A) and (b)(1)(ii)(B) 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, 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).* Under paragraph (d)(3) of this section, S's attribute reduction amount is the lesser of the net stock loss ($500) and the aggregate inside loss. The aggregate inside loss is $500, computed as the excess of S's net inside attribute amount ($650, the sum of $100 (basis in factory), $50 (basis in land), $450 (basis in publicly traded property), and $50 (cash remaining after purchases)) over the value of the S share ($150). Thus, S's attribute reduction amount is $500, the lesser of the net stock loss ($500) and the aggregate inside loss ($500). Under paragraph (d)(4) 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:			
Loss on publicly traded property	$0	$0	$0
Category E:			
Basis of factory	100	100	0
Basis of land	50	50	0

Under the general rule of this paragraph (d), the remaining $350 attribute reduction amount would have no further effect (and would not be applied to reduce S's general business tax credit). However, S has a liability that has not been taken into account, and, therefore, under paragraph (d)(4)(ii)(A)(*1*) of this section, the remaining $350 attribute reduction amount is suspended and allocated and applied to reduce any amounts that would be deductible or capitalizable as a result of the liability later being taken into account. If the liability is satisfied for an amount that is less than $350, under paragraph (d)(4)(ii)(A)(*2*) the remaining portion of that $350 is disregarded and has no further effect.

(ii) *S operates more than one business.* (A) *Facts.* The facts are the same as in paragraph (i)(A) of *Example 4*, except that S operates a business providing environmental remediation services. Prior to P's sale of the S share, S transfers its environmental remediation services business and its $50 of cash to S1 in exchange for the sole outstanding share of S1 stock. (S's basis in the assets transferred in connection with the environmental remediation business is $0.)

(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, 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.* Under paragraph (d)(3) of this section, S's attribute reduction amount is the lesser of the net stock loss ($500) 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 paragraph (d)(5)(i)(B) of this section, S's net inside attribute amount is determined by using S's deemed basis in the S1 share ($50, the greater of its basis ($50) and S1's net inside attribute amount ($50)). Accordingly, S's net inside attribute amount is $650 (the sum of $100 (basis in factory), $50 (basis in land), $450 (basis in publicly traded property), and $50 (deemed basis in S1 stock)). The aggregate inside loss is $500, computed as the excess of S's net inside attribute amount ($650) over the value of the S share ($150). Thus, S's attribute reduction amount is $500, computed as the lesser of the net stock loss ($500) and the aggregate inside loss ($500).

(*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 assets and the S1 share. Under paragraph (d)(5)(ii)(A) of this section, for this purpose, S's basis in its S1 share is its deemed basis ($50) reduced by S1's cash ($50), or, $0. As a result, no portion of S's attribute reduction amount is allocated to the S1 share and the entire attribute reduction amount is allocated as set forth in paragraph (i)(C) of this *Example 4*. In addition, as in paragraph (i)(C) of this *Example 4*, under paragraph (d)(4)(ii)(A)(*1*) of this section, the remaining $350 excess attribute reduction amount is suspended and applied to the extent of S's environmental remediation liability to reduce any amounts that would be deductible or capitalizable as a result of such liability later being taken into account. Alternatively, assume that S1 had liabilities for employee medical expenses that had not been taken into account for tax purposes, the $350 excess attribute reduction amount would be suspended and then allocated and applied as S's and S1's liabilities are taken into account. In either case, under paragraph (d)(4)(ii)(A)(*2*) of this section, to the extent the suspended amount exceeds the liabilities taken into account, that excess 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. P 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. P 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.

(B) *Application of paragraphs (b) and (c) of this section*. No adjustment is required under paragraph (b) of this section, either because redetermination would not change any member's basis in a share (members hold only one share of S stock) or because P transfers the group's entire interest in S to a nonmember in a fully taxable transaction. See, respectively, paragraphs (b)(1)(ii)(A) and (b)(1)(ii)(B) 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, 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*. 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 $200 ($250 basis minus $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) of this section, S's net inside attribute amount is $200, computed as the sum of S's basis in Asset ($100) and its deemed basis in the S1 stock (treated as a single share) ($100, computed as the greater of S's $100 total 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 minus $50 value of the S share). Accordingly, S's attribute reduction amount is $150, the lesser of the net stock loss ($200) and the aggregate inside loss ($150).

(*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 (basis $100) and the S1 stock (treated as a single share) (deemed basis $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 allocated to Asset is applied to reduce S's basis in Asset to $25. The $75 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. The application of the apportioned amounts reduces the basis of each share to $12.50. 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)(ii)(D) of this section, any 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). Under the general rules of this paragraph (d), the $75 allocated to the S1 stock would be applied to reduce S1's basis in Asset 1 to $0. However, under paragraph (d)(5)(ii)(D)(*2*) of this section, S1's attributes can be reduced by only $25 as a result of tier down attribute reduction, the excess of the portion of S1's net inside attribute amount that is allocable to all S1 shares held by members immediately before the transaction ($50) over the sum of aggregate value of S1 shares transferred by members in the transaction (none) and the aggregate amount of members' bases in nontransferred S1 shares, after reduction under this paragraph ($25). 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 remaining $50 of allocated amount has no further effect.

(*4*) *Basis restoration*. Under paragraph (d)(5)(iii) 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)(ii)(B) 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. 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 basis of each share (as reduced by this paragraph (d)) is already conformed with its allocable portion of S1's net inside attribute amount and no restoration will be required or permitted under paragraph (d)(5)(iii) of this section.

(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, P'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 P's net stock loss and S's aggregate inside loss. P's net stock loss is $200 ($250 basis minus $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) of this section, S's net inside attribute amount is $200, computed as the sum of S's basis in Asset ($100) and its deemed basis in the S1 stock (treated as a single share) ($100, computed as the greater of S's $50 total 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 minus $50 value of the S share). Accordingly, S's attribute reduction amount is $150, the lesser of the net stock loss ($200) and the aggregate inside loss ($150).

(*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 (basis $100) and the S1 stock (treated as a single share) (deemed basis $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 allocated to Asset is applied to reduce S's basis in Asset to $25. The $75 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. The application of the apportioned amounts reduces the basis of each share to an excess loss account of $12.50. 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, application of limitation*. Under paragraph (d)(5)(ii)(D) of this section, any 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 allocated to the S1 stock is applied to reduce S1's basis in Asset 1 from $100 to $25.

(*4*) *Basis restoration*. Under paragraph (d)(5)(iii) 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)(ii)(B) 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. 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 this paragraph (d) are reversed to restore the basis of each share to $12.50. Thus, $25 of the $27.50 attribute reduction applied to reduce the basis of share A and $25 of the $47.50 attribute reduction applied to reduce the basis of share B are 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.* P 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 P's basis in the S share. S1 owns one asset with a basis of $250. P 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) (after the transaction, S1 will no longer be a member of the P group). Under 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 P's basis in its S share to $220. After giving effect to the recognition of the excess loss account, P's sale of the S share is a transfer of a loss share and therefore subject to the provisions of this section.

(B) *Basis redetermination and basis reduction under paragraphs (b) and (c) of this section.* No adjustment is made under paragraph (b) of this section, either because redetermination would change no member's basis in a share (members hold only one share of S stock) or because P transfers the group's entire interest in S to a nonmember in a fully taxable transaction. See, respectively, paragraphs (b)(1)(ii)(A) and (b)(1)(ii)(B) of this section. No adjustment is made under paragraph (c) of this section because, even though there is a disconformity amount of $120, the net positive adjustment is zero. See paragraph (c)(3) of this section. Thus, after the application of paragraph (c) of this section, P'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 P's net stock loss and S's aggregate inside loss. P's net stock loss is $200 (the S share's $220 basis minus its $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) of this section, S's net inside attribute amount is $250, S's deemed basis in the S1 stock (treated as a single share) ($250, computed as the greater of S's $80 total basis in the S1 shares ($0 basis of share A plus $20 of 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 minus $20 value of the S share). Accordingly, S's attribute reduction amount is $200, the lesser of the net stock loss ($200) and the aggregate inside loss ($230).

(*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 there is no transfer of the S1 shares, the apportioned amounts are applied fully to reduce the basis of each share to an excess loss account of $24.

(*3*) *Tier down of S's attribute reduction amount.* Under paragraph (d)(5)(ii)(D) 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). Accordingly, under the general rules of this paragraph (d), S1's $200 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)(iii) 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)(ii)(B) 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. 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 stock under this paragraph (d) are reversed to restore (to the extent possible) the basis of each share to $10. Thus, $24 of the $24 attribute reduction applied to reduce the basis of share A is reversed, restoring the basis of share A to $0, and $34 of the $44 attribute reduction applied to reduce 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 P 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 P 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) (because the share continues to be held by P, and S1 continues to be a member of the P group). 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. P's sale of the S share, however, is a transfer of a loss share and therefore subject to the provisions 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)(1) of this section, because there are no transfers of loss shares at that tier, no adjustments are required under paragraphs (b) and (c) of this section. However, S's gain recognized on the transfer of share E is computed and immediately adjusts members basis in subsidiary stock under the principles of § 1.1502–32 (because P and S are not members of the same group immediately after the transaction the sale is not subject to § 1.1502–13). Accordingly, P's basis in its S share is increased by $20, from $200 to $220.

(C) *Transfers in next higher (the highest) tier (application of paragraphs (b) and (c) of this section).* The next highest tier transfer is P's sale of the S stock. Because the sale is a transfer of a loss share, first paragraph (b) of this section and then paragraph (c) of this section apply to the transfer. No adjustments are required under paragraph (b), either because there is no potential for redetermination (members hold only one share of S stock) or because P transfers the group's entire interest in S to a nonmember in a fully taxable transaction. See, respectively, paragraphs (b)(1)(ii)(A) and (b)(1)(ii)(B) of this section. Under paragraph (c) of this section, P's basis in its S share is decreased by $20, the lesser of the disconformity amount ($200, computed as the excess of stock basis ($220) over S's net inside attribute amount ($20, the $40 value of the transferred Share E minus the $20 liability)) and the net positive adjustment ($20). Thus, after the application of paragraph (c) of this section, P'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, P'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 P's net stock loss and S's aggregate inside loss. After the application of paragraph (c) of this section, P's net stock loss is $180 (the S share's $200 basis minus its $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) of this section, S's net inside attribute amount is $80, computed as $100 (S's deemed basis in share E (the greater of S's basis in share E, adjusted for the gain recognized, ($40) and share E's allocable portion of S1's net inside attribute amount ($100, representing 1/5 of S1's $500 basis in its asset)) minus S's liability ($20). Accordingly, S's net aggregate inside loss is $60 ($80 net inside attribute amount minus $20 value of the S stock). S's attribute reduction amount is therefore the lesser of $180 and $60, or $60.

(*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, under paragraph (d)(5)(ii)(B)(*1*) of this section, none of the allocated amount is apportioned to, or applied to reduce the basis of share E because share E was transferred in a transaction in which gain or loss was recognized. Under paragraph (d)(5)(ii)(C) of this section, the $60 allocated amount not apportioned 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 amount was apportioned to or applied to reduced the basis of share E, the entire $60 allocated amount tiers down and is an attribute

reduction amount of S1. See paragraphs (d)(5)(ii)(C) and (d)(5)(ii)(D) of this section. Under the general rules of this paragraph (d), S1's $60 attribute reduction amount is allocated and applied to reduce S1's basis in its asset from $500 to $440.

(*4*) *Basis restoration.* Under paragraph (d)(5)(iii) 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)(ii)(B) 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 any share of subsidiary stock under paragraph (d)(5)(ii)(B) of this section. Therefore, no stock basis is increased under the basis restoration rule in paragraph (d)(5)(iii) of this section.

Example 7. Allocation of attribute reduction if lower-tier subsidiary has nonloss assets or liabilities. (i) *S1 holds cash.* (A) *Facts.* P owns the sole outstanding share of S stock with a basis of $800. S owns Asset 1 with a basis of $400 and the sole outstanding share of S1 stock with a basis of $300. S1 holds Asset 2 with a basis of $50, and $100 cash. P sells its S share to P1, the common parent of a consolidated group, for $100.

(B) *Application of paragraphs (b) and (c) of this section.* No adjustment is required under paragraph (b) of this section, either because redetermination would change no member's basis in a share (members hold only one share of S stock) or because P transfers the group's entire interest in S to a nonmember in a fully taxable transaction. See, respectively, paragraphs (b)(1)(ii)(A) and (b)(1)(ii)(B) 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, 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.* 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 $700 (the S share's $800 basis minus its $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) of this section, S's net inside attribute amount is the sum of its basis in Asset 1 of $400 and its deemed basis in the S1 share. S's deemed basis in the S1 share is $300, the greater of S's basis in the S1 share ($300) and S1's net inside attribute amount ($150, S1's $50 basis in Asset 2 plus S1's $100 cash). Therefore, S's net inside attribute amount is $700 and S's aggregate inside loss is $600 ($700 net inside attribute amount less $100 value). S's attribute reduction amount is $600, the lesser of the net stock loss ($700) and the aggregate inside loss ($600).

(*2*) *Allocation, apportionment, and application of S's attribute reduction amount.* Under paragraphs (d)(4) and (d)(5)(ii)(A) of this section, S's $600 attribute reduction amount is allocated proportionately (by basis) between S's basis in Asset 1 ($400) and its deemed basis in the S1 share. For purposes of allocating the attribute reduction amount, S's deemed basis in the S1 share is reduced by S1's $100 cash (from $300 to $200). Thus, the $600 is allocated $400 to Asset 1 ($400/$600 × $600) and $200 to the S1 share ($200/$600 × $600). The $400 allocated to Asset 1 is applied to reduce S's basis in Asset 1 to $0. The $200 allocated to the S1 share is apportioned and applied to reduce S's basis in the S1 share to $100.

(*3*) *Tier down of S's attribute reduction amount.* Under paragraph (d)(5)(ii)(D) of this section, any 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). Accordingly, under the general rules of this paragraph (d), the $200 allocated to the S1 share is an attribute reduction amount of S1 that is allocated and applied entirely to reduce S1's basis in Asset 2 from $50 to $0. The remaining $150 S1 attribute reduction amount is disregarded and has no further effect.

(*4*) *Basis restoration.* Under paragraph (d)(5)(iii) 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)(ii)(B) 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. S1's net inside attribute amount after the application of this paragraph (d) is $100 and thus the S1 share's allocable portion of S1's net inside attribute amount is $100. Accordingly, the basis of the share (as reduced by this paragraph (d)) is already conformed with its allocable portion of S1's net inside attribute amount and no restoration will be required or permitted under paragraph (d)(5)(iii) of this section.

(ii) *S1 borrows cash.* The facts are the same as in paragraph (i)(A) of this *Example 7* except that S1 borrows $50 from X, an unrelated person, immediately before P sells the S share. The computation of the attribute reduction amount is the same as in paragraph (i)(C) of this *Example 7* (because the $50 cash from the loan proceeds and the $50 liability offset in the computation of S's net inside attribute amount). However, under paragraph (d)(5)(ii)(A) of this section, for purposes of allocating the attribute reduction amount, deemed basis is reduced by the amount of S1's cash, but only to the extent it exceeds S1's liabilities. S1's cash ($150, the original $100 plus the $50 loan proceeds) exceeds its liability ($50) by $100, so S's deemed basis in the S1 share is reduced by $100 (from $300 to $200) for allocation purposes. The results are the same as in paragraph (i) of this *Example 7*.

(iii) *S1 borrows cash and invests in non-publicly traded property.* (A) *Facts.* The facts are the same as in paragraph (ii) of this *Example 7* except that S1 uses its $150 (the original $100 plus the $50 loan proceeds) to purchase Asset 3, an asset that is not publicly traded.

(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* (because $50 of the basis in S1's assets and the $50 liability offset in the computation of S1's net inside attribute amount of $150).

(*2*) *Allocation, apportionment, and application of S's attribute reduction amount.* Under paragraphs (d)(4) and (d)(5)(ii)(A) of this section, S's $600 attribute reduction amount is allocated proportionately (by basis) between S's basis in Asset 1 ($400) and its deemed basis in the S1 share. For purposes of allocating the attribute reduction amount, deemed basis is only reduced for allocation purposes by cash, cash equivalents, and the value of publicly traded property (reduced by liabilities). Thus, there is no reduction to the basis of the S1 share for purposes of allocating the attribute reduction amount. Accordingly, S's $600 attribute reduction amount is allocated $343 ($400/$700 × $600) to Asset 1 and $257 ($300/$700 × $600) to the S1 share.

(*3*) *Tier down of S's attribute reduction amount, application of conforming limitation.* Under paragraph (d)(5)(ii)(D) of this section, any 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). Thus, the entire $257 of S's attribute reduction amount allocated to the S1 share is an attribute reduction amount of S1. Under the general rules of this paragraph (d), the entire amount is allocated to, and would be applied to reduce, S1's bases in Asset 2 and Asset 3, reducing the basis of both assets to $0. However, under paragraph (d)(5)(ii)(D)(2) of this section, the reduction is limited to the excess of S1's net inside attribute amount ($150) over S's basis in the S1 share after reduction under this paragraph (d) ($43). Thus, of the $257 attribute reduction amount allocated to the S1 share, only $107 is applied proportionately to reduce S1's bases in Asset 2 by $26.75 ($50/$200 × $107), to $23.25, and Asset 3 by $80.25 ($150/$200 × $107), to $69.75. The remaining $150 S1 attribute reduction amount is disregarded has no further effect.

(*4*) *Basis restoration.* Under paragraph (d)(5)(iii) 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)(ii)(B) 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. S1's net inside

attribute amount after the application of this paragraph (d) is $43 ($23.25 basis in Asset 2 plus $69.75 basis in Asset 3 minus $50 liability) and thus the S1 share's allocable portion of S1's net inside attribute amount is $43. Accordingly, the basis of the share (as reduced by this paragraph (d)) is already conformed with its allocable portion of S1's net inside attribute amount and no restoration will be required or permitted under paragraph (d)(5)(iii) 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 (total $100) and makes no election under paragraph (d)(6) of this section. At the time of the sale, S has no liabilities and the following:

Category	Attribute	Attribute amount
Category A	NOL	$10
Category E	Basis of Asset 1	20
	Basis of Asset 2	180
	Total Category E	200

(B) *Application of paragraphs (b) and (c) of this section.* No adjustment is made under paragraph (b) of this section, either because redetermination would change no member's basis in a share (S has only one class of stock outstanding and there is no disparity in the basis of the shares) or because P transfers the group's entire interest in S to a nonmember in a fully taxable transaction. See, respectively, paragraphs (b)(1)(ii)(A) and (b)(1)(ii)(B) 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).* (*1*) *Computation of attribute reduction amount.* Under paragraph (d)(3) of this section, S's attribute reduction amount is the lesser of the net stock loss ($110, P's aggregate basis in the transferred S shares ($210) less the aggregate value of the transferred shares ($100)) and S's aggregate inside loss. S's aggregate inside loss is $110 (S's $210 net inside attribute amount (the $10 NOL plus the $20 basis of Asset 1 plus the $180 basis of Asset 2) less the $100 value of all outstanding S shares). Thus, the attribute reduction amount is $110.

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

Category	Attribute	Attribute amount	Allocation of attribute reduction amount	Adjusted attribute amount
Category A	NOL	$10	$10	$0
Category E	Basis of Asset 1	20	(20/200 x $100) $10	10
	Basis of Asset 2	180	(180/200 x $100) $90	90
	Total Category E	200	$100	100

(D) *Results.* The P group realizes a $110 loss on M's sale of the S shares, which reduces P's basis in the M share from $1,000 to $890. The reduction of S's attributes is not a noncapital, nondeductible expense of S and does not tier up to reduce the basis of the S shares or M share. Immediately after the transaction, the entities own the following:

Entity	Asset	Basis
P	M share	$890
X	100 S shares	100
S	Asset 1	10
	Asset 2	90

(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 such shares in proportion to the loss in each share. 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 reduction of 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)(iv) of this section. Immediately after the transaction, the entities own the following:

Entity		Basis/attribute
P	M share	$890
X	100 S shares	100
S	NOL	10
	Asset 1	20
	Asset 2	180

(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. Although S's attribute reduction amount is $110, P can only

reattribute attributes in Category A, Category B, and Category C. P can therefore elect to reattribute $10 of attributes (the NOL), and, as a result, will reduce S's NOL to $0. The reattribution of the $10 NOL is a noncapital, nondeductible expense of S, and under § 1.1502–32(c)(1)(ii)(B) this expense is allocated to the loss shares of S stock sold in proportion to the loss in the shares, or $.10 per share. Further, this expense tiers up under the general rules of § 1.1502–32 and reduces P's basis in the M stock by $10. After giving effect to the election, the P group would realize a $100 loss on M's sale of the S shares. M could recognize the $100 stock loss (in which case S's basis in Asset 1 and Asset 2 would be reduced to $10 and $90, respectively, as in paragraph (i)(C)(*2*) of this *Example 8*) or P could elect to reduce M's basis in the S shares by all or any portion of the $100 stock loss (in which case S's attribute reduction amount would be reduced by the amount of the reduction in the basis of the S stock, and S's basis in Asset 1 and Asset 2 would be reduced proportionately).

(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 (for a total of $20).

(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 net stock loss ($22, P's aggregate basis in the transferred S shares ($42) less the aggregate value of the transferred shares ($20)) and S's $110 aggregate inside loss (as calculated in paragraph (i)(C)(*1*) of this *Example 8*). Thus, the attribute reduction amount is $22.

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

Category	Attribute	Attribute amount	Allocation of attribute reduction amount	Adjusted attribute amount
Category A	NOL	$10	$10	$0
Category E	Basis of Asset 1	20	(20/200 x $12) $1.20	18.80
	Basis of Asset 2	180	(180/200 x $12) $10.80	169.20
	Total Category E	200	$12	188

(D) *Results.* The P group realizes a $22 loss on M's sale of the S shares, which reduces P's basis in the M share from $1,000 to $978. The reduction of S's attributes is not a noncapital, nondeductible expense of S and does not tier up to reduce the basis of the S shares or M share. Immediately after the transaction, the entities have the following:

Entity	Asset	Basis
P	M share	$978
X	20 S shares	20
S	Asset 1	18.80
	Asset 2	169.20

(E) *Election to reduce stock basis.* The facts are the same as 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. Accordingly, the basis of each of the 20 transferred shares is reduced from $2.10 to $1.00. The P group realizes no loss on M's sale of the S shares. The reduction of 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. Immediately after the transaction, the entities have the following:

Entity		Basis/attribute
P	M share	$978
X	20 S shares	20
S	NOL	10
	Asset 1	20
	Asset 2	180

(F) *Subsequent events.* As the NOL is absorbed and/or Asset 1 or Asset 2 are depreciated or sold, the anti-duplication provision of § 1.1502–80(a) prevents the inclusion of the $10 NOL and $12 of realized loss on Asset 1 and Asset 2 in the investment adjustment to any shares.

(G) *Election to reattribute attributes.* The facts are the same as paragraph (ii)(A) of this *Example 8.* Because S remains a member of the P group 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.* P 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, P 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 transfers S1 share 2 to a partnership in a section 721 transaction, and S1 sells its S2 share to Y for $50. No election is made under paragraph (d)(6) to reduce stock basis or reattribute attributes.

(ii) *Transfer in lowest tier (only gain share).* S1's sale of the S2 share is a transfer of the S2 share and that is the lowest tier in which there is a transfer. There is no transfer of a loss share at that tier, and thus this section does not apply to that transfer. The gain recognized on the transfer of the S2 share is computed and is applied to adjust the basis of members' shares of subsidiary stock under the principles of § 1.1502–32. Accordingly, $5 is allocated to each of 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 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 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 made to the bases of S1 shares, there are no negative adjustments that can be reallocated to further reduce the basis of S1 share 1. Finally, under paragraph (b)(2)(ii)(B), the positive investment adjustment removed from S1 share 1 is reallocated and applied to increase the bases of other S1 shares in a manner that reduces disparity to the greatest extent possible. Accordingly, the entire $5 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, S1 share 1 is still a loss share and therefore subject to basis reduction under paragraph (c) of this section.

(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 because, although the disconformity amount is $149 (the excess of the $170 stock basis over the share's $21 allocable portion of S1's net inside attribute amount ($210, determined under paragraph (c)(5) of this section as S1's basis in the stock of S2 (adjusted for the gain recognized) ($50), S3 ($60), and S4 ($100))), the share'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.

(C) *Computation of loss, adjustments to stock basis.* S recognizes a loss of $150 on the sale of the S1 share 1 ($170 adjusted basis minus $20 amount realized). P's basis in its S share is therefore decreased by the $150 loss recognized by S (on the sale of the S1 share) and increased by the $50 gain that tiered up from S1 (as a result of S1's sale of the S2 share). Following these adjustments, P'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.* No adjustment is required under paragraph (b) of this section, either because there is no potential for redetermination (members hold only one share of S stock) or because P transfers the group's entire interest in S to a nonmember in a fully taxable transaction. See, respectively, paragraphs (b)(1)(ii)(A) and (b)(1)(ii)(B) of this section. In addition, no adjustment is required under paragraph (c) of this section because, although the disconformity amount is $230 (the excess of the $600 stock basis over the $370 allocable portion of S's net inside attribute amount ($370, determined under paragraph (c)(5) of this section as S's basis in the stock of S1 (adjusted for the loss recognized) ($200) and Asset 1 ($170))), the share's net positive adjustment is $0. 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 (the S share's $600 adjusted basis minus $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. S1's deemed basis in the S2 stock is $75 (the greater of $50 (S1's basis in the S2 share ($0) increased by the $50 gain recognized) and $75 (S2's 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 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 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 and S's $20 basis in each other S1 share, reduced by the $150 loss recognized). 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 $250 (S's deemed basis in S1 stock) and $170 (S's basis in Asset 1). Accordingly, the aggregate inside loss is $180, the excess of S's net inside attribute amount ($420) over the value of all of the S stock ($240). S's attribute reduction amount is therefore $180, the lesser of the net stock loss ($360) and the aggregate inside loss ($180).

(*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 and its S1 stock. Under paragraph (d)(5)(ii)(A) of this section, for purposes of allocating S's $180 attribute reduction amount, S's deemed basis in the S1 stock is reduced by the value of any transferred S1 shares (and other items that are not relevant here). Additionally, for this purpose, S's deemed basis in S1 stock is reduced by S's nontransferred S1 shares' allocable portion of the value of S1's transferred shares of each lower-tier subsidiary's stock (and other items that are not relevant here). Accordingly, for purposes of allocating S's attribute reduction amount, S's deemed basis in the S1 stock must be reduced by $80 (the $40 value of the two transferred S1 shares, and S's eight nontransferred S1 shares' $40 allocable portion of the $50 value of the transferred S2 share), to $170. Thus, $90 of the attribute reduction amount ($170/$340 × $180) is allocated to Asset 1 and $90 of the attribute reduction amount ($170/$340 × $180) is allocated to the S1 stock. Under paragraph (d)(5)(ii)(B)(*1*) of this section, none of the $90 allocated to the S1 stock is apportioned to share 1 because loss is recognized on the transfer of share 1. Under paragraph (d)(5)(ii)(B)(*2*) of this section, the $90 allocated amount is apportioned among other nine shares of S1 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 shares of S1 stock. Under paragraph (d)(5)(ii)(B)(*3*) of this section, however, an apportioned amount cannot be applied to reduce the basis of a transferred share below its value. Because the basis of share 2 is already equal to its value, none of the $10 apportioned to share 2 is applied to reduce its basis. The amounts apportioned to the remaining S1 shares, however, are applied to reduce the bases of those shares without limitation, reducing the basis of each 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 basis in share 1 is $170, its basis in share 2 is $20, and its basis in each other share of S1 stock is $10. Under paragraph (d)(5)(ii)(D) 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 share 1 and none of the amount apportioned to share 2 was applied to reduce the basis of 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 share 1 is a transfer of a loss share and is in the next lower tier. Thus, this paragraph (d) next applies with respect to S's transfer of 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 the S1 share 1 (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 share 1 plus $20 in share 2) over the value of those shares ($40). 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 10*) over the $200 value of all outstanding S1 shares (extrapolated from the amount realized on the sale of share 1). 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 attribute reduction amount that tiered down from S and the $50 direct attribute reduction amount computed with respect to the transfer of share 1.

(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. As described in paragraph (iv)(B)(*2*) of this *Example 10*, under paragraph (d)(5)(ii)(A) of this section, for purposes of allocating S1's $140 attribute reduction amount, S1's deemed basis in the S2 stock is reduced by the value of the transferred S2 share. Accordingly, for purposes of allocating S1's attribute reduction amount, S1's deemed basis in the S2 stock must be reduced by $50 (the value of the transferred S2 share), 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)(ii)(B)(*1*) of this section, none of the amount allocated to S2 stock is apportioned to the S2 share because gain was recognized on the transfer of the S2 share. However, the $52.50 allocated to the S3 stock is apportioned and applied to reduce the basis in the S3 share, from $60 to $7.50, and the $70 allocated to the S4 stock is apportioned and applied to reduce the basis of the S4 share, from $100 to $30. (Note: Although the conforming limitation in paragraph (d)(5)(ii)(D)(*2*) of this section limits the application of tier down attribute reduction such that the total amount of attribute reduction applied to reduce S1's attributes does not exceed $130 (the excess of S1's $250 net inside attribute amount over $120, the value of the transferred S1 shares ($40) plus the basis of the nontransferred S1 shares after reduction ($80)), this limitation does not apply because only $122.50 ($52.50 plus $70) of attribute reduction is applied to reduce S1's attributes.) Under paragraph (d)(5)(ii)(D) 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 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 the provisions of 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 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 of 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 attribute reduction amount is allocated to, and would be applied to reduce, S4's basis in Asset 4. However, under paragraph (d)(5)(ii)(D)(*2*) of this section, the reduction is limited to the excess of S4's net inside attribute amount ($80) over the basis of the S4 share ($30, 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 remaining $20 of S4's attribute reduction amount is disregarded and has no further effect.

(vii) *Application of basis restoration rule.* After all adjustments required under this paragraph (d) have been given effect, reductions made to the basis of subsidiary stock under this paragraph (d) are subject to reversal under the basis restoration rule in paragraph (d)(5)(iii) of this section. Under this rule, adjustments are reversed (and basis is restored) only to the extent necessary to conform the basis of each share with its allocable portion of the subsidiary's net inside attribute amount. The restoration adjustments are first made at the lowest tier and then at each next higher tier successively.

(A) *Basis restoration at lowest tier.* No restoration is permitted with respect to the S2 share because the basis of the S2 share was not reduced under paragraph (d)(5)(ii)(B) of this section. S3's net inside attribute amount ($22.50, after reduction under this paragraph (d)) exceeds S1's basis in the S3 share ($7.50, 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)(ii)(B) of this section is reversed by $15 (restoring basis 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 basis in the S4 share ($30, after reduction under this paragraph (d)) is already conformed with S4's net inside attribute amount ($30, after reduction under this paragraph (d)) and no restoration will be required or permitted under paragraph (d)(5)(iii) of this section.

(B) *Basis restoration at next higher tier.* Each share of S1 stock has an allocable portion of S1's net inside attribute amount equal to $10.25 (1/10 × $102.50, the sum of S1's adjusted bases in its S2 stock ($50, $0 plus $50 gain recognized), S3 stock ($22.50 after restoration), and S4 stock ($30)). Neither S's basis in S1 share 1 nor S's basis in S1 share 2 was reduced under this paragraph (d). Accordingly the basis of neither share is subject to restoration under paragraph (d)(5)(iii) of this section. However, S's basis in each of its other shares of S1 stock was reduced by $10, from $20 to $10. Accordingly, the 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).

(vii) *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 Share 1 of S1 stock	20	20
	Partnership interest received for Share 2	$20	20
	Shares 3 through 10 of S1 stock	82 ($10.25 per share)	
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	Share 1 of S1 stock	20	20
Y	The S2 share	50	50
Partnership	Share 2 of S1 stock	20	20

(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 the 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 are adjusted in a manner that alters the relationship between stock basis and inside attributes. Such adjustments affect the extent to which this relationship identifies unrecognized asset gain reflected in stock basis and the extent to which loss is duplicated. 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) *Reductions to S's basis in assets or other attributes pursuant to section 362(e)(2)(A).* If S's attributes have been reduced under section 362(e)(2) (taking into account the provisions of § 1.1502–13(e)(4)), then the disconformity amount of the S shares received (or deemed received) in the transaction to which section 362(e)(2) applied is reduced by the amount that the basis in such shares would have been reduced under section 362(e)(2)(C) (taking into account the provisions of § 1.1502–13(e)(4)) 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 a transaction to which section 362(e)(2) applied, and for purposes of applying paragraph (d)(5)(ii)(D)(*2*) of this section (conforming limitation) to S, the basis in such shares is treated as reduced by the amount the basis in such shares would have been reduced under section 362(e)(2)(C) (taking into account the provisions of § 1.1502–13(e)(4)) had such an election been made.

(ii) *Reductions to the basis of any share of S stock pursuant to an election under section 362(e)(2)(C).* If the basis of any share of S stock has been reduced as the result of an election under section 362(e)(2)(C) (taking into account the provisions of § 1.1502–13(e)(4)), 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)(iii) of this section (stock basis restoration) to S, S's net inside attribute amount is reduced by the amount that S's attributes would have been reduced under section 362(e)(2)(A) (taking into account the provisions of § 1.1502–13(e)(4)) in the absence of an election under section 362(e)(2)(C) (taking into account the provisions of § 1.1502–13(e)(4)).

(iii) *Other adjustments.* The Commissioner shall make such adjustments as appropriate if the relationship between a member's basis in a share of S stock and the share's allocable portion of S's attributes has been altered, other than by the operation of § 1.1502–32 or this section, provided that such change is not otherwise addressed in this section. Taxpayers may request a written determination from the Commissioner determining that other adjustments to M's basis in S stock or S's attributes are to be adjusted in a manner consistent with the principles of this paragraph (e)(2) for purposes of making the computations under paragraphs (c) and (d) of this section.

(iv) *Example.* The application of this paragraph (e)(2) is illustrated by the following example:

Example. Adjustments for intercompany section 362(e)(2) transaction. (i) Adjustments for reduction of S's basis in assets. (A) *Facts.* In an intercompany section 362(e)(2) transaction (within the meaning of § 1.1502–13(e)(4)(i)), P contributes Asset 1 to newly formed S in exchange for the sole outstanding share of S stock. At the time of the contribution, P's basis in Asset 1 was $100 and its value was $20. Accordingly, S's basis of A1 would have been reduced by $80 under section 362(e)(2) and that $80 is a section 362(e)(2) amount within the meaning of § 1.1502–13(e)(4)(ii)(A). P sells the S share for $20 in year 3. As of the time of the sale, no portion of the section 362(e)(2) amount has been taken into account and thus the entire $80 is a remaining section 362(e)(2) amount reflected in S's basis in Asset 1 and P's basis in the share of S stock. P's sale of the S share is a section 362(e)(2) application event within the meaning of § 1.1502–13(e)(4)(iii) and therefore, immediately before the sale, S's basis in Asset 1 is reduced by $80 pursuant to section 362(e)(2) and § 1.1502–13(e)(4)(iv). Under § 1.1502–13(e)(4)(iv)(C), this reduction is not a noncapital, nondeductible expense described in § 1.1502–32(b)(2)(iii), and does not affect P's basis in the S share. The sale is also a transfer of a loss share and therefore subject to the provisions of this section.

(B) *Application of paragraph (b) of this section.* No adjustment is required under paragraph (b) of this section, either because there is no potential for redetermination (members hold only one share of S stock) or because P transfers the group's entire interest in S to a nonmember in a fully taxable transaction. See, respectively, paragraphs (b)(1)(ii)(A) and (b)(1)(ii)(B) of this section. After the application of paragraph (b) of this section, P's sale of the S share is still a transfer of a loss share and therefore subject to this paragraph (c).

(C) *Basis reduction under paragraph (c) of this section.* In determining the reduction of basis under paragraph (c) of this section, the share's disconformity amount is reduced by $80, the amount that the basis in the S share would have been reduced under § 1.1502–13(e)(4)(v) had such an election been made. The disconformity amount (and the net positive adjustment) are $0 and so no basis adjustment will be made under paragraph (c) of this section. The transferred share is still a loss share and so is therefore subject to paragraph (d) of this section.

(D) *Attribute reduction under paragraph (d) of this section.* In determining the attribute reduction amount under paragraph (d)(3) of this section, P's basis in the transferred share is treated as reduced by $80, the amount that the basis in the S share would have been reduced under § 1.1502–13(e)(4)(v) had such an election been made. As a result, P recognizes an $80 loss on the sale of the S stock, but, for purposes of applying paragraph (d) of this section, the net stock loss and, therefore, the attribute reduction amount are $0.

(ii) *Adjustments for election to reduce stock basis under section 362(e)(2)(C).* The facts are the same as in paragraph (i) of this *Example,* except that P and S elect to reduce P's basis in the S share by $80 under § 1.1502–13(e)(4)(v). As a result, the basis of Asset 1 remains $100 and, immediately before the sale of the S stock, P's basis in the S share is reduced to $20. Because the share is then not a loss share, this section does not apply to the transfer. If, instead, the share were sold for less than $20, it would be a loss share and the transfer would be subject to this section. In that case, for purposes of computing the S share's disconformity amount, S's aggregate inside loss, and applying paragraph (d)(5)(iii) of this section, S's net inside attributes would be treated as reduced by $80,the amount that S's attributes would have been reduced under § 1.1502–13(e)(4)(iv) had the election under § 1.1502–13(e)(4)(v) not been made.

(3) *Plural, singular.* All terms used in this section include both the plural and singular as the context may require.

(f) *Definitions.* In addition to the definitions in other paragraphs of this section and in § 1.1502–1, 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 equivalent amounts, such as negative adjustments under section 475 (mark to market accounting method for dealers in securities) and 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 basis of shares of S2 stock under § 1.1502–32 affect the investment adjustments made to the basis of the stock of S1. 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 basis of shares of S1 stock affect the investment adjustments made to the basis 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)(A)(*1*) of this section.

(6) *Loss carryover* means any net operating or capital loss carryover attributable to S that is or, under the principles of § 1.1502–21, would be carried to S's first taxable year, if any, following the year of the transfer.

(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) *Publicly traded property.* Property is *publicly traded property* if it is traded on an established market within the meaning of § 1.1273–2(f).

(10) *Transaction* includes all the steps taken pursuant to the same plan or arrangement.

(11) *Transfer*—(i) *Definition.* Except as provided in paragraph (f)(11)(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, M would recognize gain or loss with respect to the share;

(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(g), taking into account the provisions of § 1.1502–80(c).

(ii) *Excluded transactions.* Notwithstanding paragraph (f)(11)(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 section 381(a) transaction in which any member acquires assets from S or in which S acquires assets from M, provided that, in either case, M recognizes no gain or loss with respect to the share; 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, provided M does not recognize any gain or loss with respect to the share as a result of the distribution of the share.

(12) *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. Stuffing gain asset to eliminate loss. (i) *Facts.* On January 1, year 1, P owns Asset 1 with a basis of $0 and a value of $100. On that same date, P purchases the sole outstanding share of S stock for $100. At that time, S owns Asset 2 with a basis of $0 and a value of $100. In year 1, S sells Asset 2 for $100. In year 2, with a view to avoiding the basis reduction rule in paragraph (c) of this section upon the sale of the S share, P contributes Asset 1 to S in a transaction to which section 351 applies and receives an additional share of S stock with a basis of $0 under section 358. On December 31, year 2, P sells its two S shares for $200. After applying and giving effect to all generally applicable rules of law (other than this section), P's basis in the original share of S stock is $200 (P's original $100 basis, increased by $100 under § 1.1502–32 to reflect the $100 gain recognized on the sale of Asset 2), and P's basis in the other share of S stock is $0.

(ii) *Analysis.* Absent the application of this paragraph (g), P would not recognize any net gain or loss on the sale of the two S shares. Under paragraph (c)(7) of this section, for purposes of computing the basis reduction required by paragraph (c) of this section, P's basis in the original share of S stock would be treated as reduced by the gain recognized on the other share of S stock. Further, P would not recognize any net stock loss within the meaning of paragraph (d)(3)(ii) of this section. Accordingly, this section would not apply to the transfer of the S shares. However, because P contributed Asset 1 to S with a view to avoiding the basis reduction rule in paragraph (c) of this section, the contribution of Asset 1 is disregarded for purpose of applying this section. Accordingly, this section applies to the sale of the S share without regard to the contribution of Asset 1, and the basis of the original S share is reduced by $100 under paragraph (c) of this section. P recognizes no gain or loss on the sale of the original S share, and $100 of gain on the sale of the other S share.

Example 2. Loss Trafficking. (i) *Facts.* On January 1, year 1, P purchases the sole outstanding share of S stock for $100. At that time, S owns one asset, Asset 1, with a basis of $0 and a value of $100. In year 1, S sells Asset 1 for $100 and, with a view to eliminating the disconformity amount, S purchases the sole outstanding share of X stock, a corporation with a $100 NOL and an asset with a basis and value of $1, from an unrelated party for $1. In year 2, X is liquidated into S in a transaction to which section 332 applies. On December 31, year 2, P sells its S share for $100. After applying and giving effect to all generally applicable rules of law (other than this section), P's basis in the S share is $200 (P's original $100 basis, increased under § 1.1502–32 to reflect the $100 gain recognized on the sale of Asset 1). P's sale of the S share is a transfer of a loss share and therefore subject to the provisions of this section.

(ii) *Analysis.* No adjustment is required under paragraph (b) of this section, either because there is no potential for redetermination (members hold only one share of S stock) or because P transfers the group's entire interest in S to a nonmember in a fully taxable transaction. See, respectively, paragraphs (b)(1)(ii)(A) and (b)(1)(ii)(B) of this section. Under paragraph (c) of this section, P's basis in the S share ($200) is reduced, but not below the share's 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 applied to the basis of the share, computed without taking distributions into account. There are no distributions. The only investment adjustment to the S share is the $100 positive adjustment attributable to the gain recognized on the sale of Asset 1. The share's net positive adjustment is therefore $100. The share's disconformity amount is the excess, if any, of its basis ($200) over its allocable portion of S's net inside attribute amount. Because S purchased the X stock and liquidated X with a view to avoiding the purposes of this section (to utilize X's attributes to minimize the disconformity amount of the S loss share), the attributes acquired from X are disregarded for purposes

of applying this section. Accordingly, S's net inside attribute amount is limited to S's money ($100 from the sale of Asset 1, less $1 for the purchase of the X stock), or $99. The loss share's allocable portion of the $99 net inside attribute amount is $99. The loss share's disconformity amount is therefore the excess of $200 over $99, or $101. The lesser of the share's net positive adjustment ($100) and disconformity amount ($101) is $100. As a result, the basis in the loss share is reduced by $100, and P recognizes no gain or loss on the sale of the S share.

Example 3. Use of a partnership to prevent current attribute reduction. (i) *Facts.* P owns 100 shares of S stock with a basis of $10 each. S owns Asset 1 with a basis of $1000 and a value of $100. In year 1, with a view to preventing a current reduction in the basis of Asset 1, S and M form a partnership. S contributes Asset 1 and M contributes Asset 2. On December 31, year 1, P sells 20 S shares for $1 each. After applying paragraph (c) of this section, P's basis in each transferred S share is still $10, and P recognizes a $180 loss (a $9 loss on each transferred S share).

(ii) *Analysis.* No adjustment is required under paragraph (b) of this section because S has only one class of stock outstanding and there is no disparity in the basis of the shares. See paragraph (b)(1)(ii)(A) 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. Absent the application of this paragraph (g), under paragraph (d) of this section S's attribute reduction amount of $180 would be applied to reduce S's basis in the partnership interest. 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.

Example 4. Creation of an intercompany receivable to mitigate attribute reduction. (i) *Facts.* P owns 100 shares of S stock each with equal basis that exceeds value. S owns Asset 1 with a basis that exceeds value and cash. In year 1, with a view to mitigating a reduction in the basis of Asset 1, S lends the cash to M. On December 31, year 1, P sells 20 S shares and recognizes a loss.

(ii) *Analysis.* No adjustment is required under paragraph (b) of this section because S has only one class of stock outstanding and there is no disparity in the basis of the shares. See paragraph (b)(1)(ii)(A) 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. Absent the application of this paragraph (g), under paragraph (d) of this section S's attribute reduction amount would be applied to proportionately reduce the basis in S's assets. Accordingly, S's basis in both its intercompany receivable and Asset 1 would be reduced. 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.

(h) *Effective date.* This section applies to all transfers on or after the date these regulations are published as final regulations in the **Federal Register**. For rules applicable on and after March 10, 2006, and before the date these regulations are published as final regulations in the **Federal Register**, see §§ 1.1502–35 and 1.337(d)–2 as contained in 26 CFR part 1 in effect on January 1, 2007. For rules applicable on and after March 3, 2005 and before March 10, 2006, see §§ 1.337(d)–2T, 1.1502–20 and 1.1502–35T as contained in 26 CFR part 1 in effect on April 1, 2005. For rules applicable before March 3, 2005, see §§ 1.337(d)–2T, 1.1502–20, and 1.1502–35T as contained in 26 CFR part 1 in effect on April 1, 2004.

Par. 16. Section 1.1502–80 is amended by:

1. Revising paragraphs (a) and (c).
2. Adding new paragraph (g).

The revisions and addition reads as follows:

§ 1.1502–80 Applicability of other provisions of law.

(a) *In general.* The Internal Revenue Code, or other law, shall be applicable to the group to the extent the regulations do not exclude its application. To the extent not excluded, other rules operate in addition to, and may be modified by, these regulations. Thus, for example, in a transaction to which section 381(a) applies, the acquiring corporation will succeed to the tax attributes described in section 381(c). Furthermore, sections 269 and 482 apply for any consolidated year. However, in a recognition transaction otherwise subject to section 1001, for example, the rules of section 1001 continue to apply, but may be modified by the intercompany transaction regulations under § 1.1502–13. Nothing in these regulations shall be interpreted or applied to require an adjustment to a member's basis in subsidiary stock or other attributes to the extent the adjustment would have the effect of duplicating another adjustment required under the Code or other rule of law, including other provisions of these regulations.

* * * * *

(c) *Deferral of section 165*—(1) *General rule.* Subsidiary stock is not treated as worthless under section 165 until immediately before the earlier of the time—

(i) The stock is worthless within the meaning of § 1.1502–19(c)(1)(iii); and

(ii) The subsidiary for any reason ceases to be a member of the group.

(2) *Cross reference.* See § 1.1502–36 for additional rules relating to stock loss.

* * * * *

(g) *Effective dates.* Paragraphs (a) and (c) of this section are applicable on or after the date these regulations are published as final regulations in the **Federal Register**.

Par. 17. Section 1.1502–91 is amended by revising paragraph (h)(2) to read as follows:

§ 1.1502–91 Application of section 382 with respect to a consolidated group.

* * * * *

(h) * * *

(2) *Disposition of stock or an intercompany obligation of a member.* Gain or loss recognized by a member on the disposition of stock (including stock described in section 1504(a)(4) and § 1.382–2T(f)(18)(ii) and (iii)) of another member is treated as a recognized gain or loss for purposes of section 382(h)(2) (unless disallowed) even though gain or loss on such stock was not included in the determination of a net unrealized built-in gain or loss under paragraph (g)(1) of this section. Gain or loss recognized by a member with respect to an intercompany obligation is treated as recognized gain or loss only to the extent (if any) the transaction gives rise to aggregate income or loss within the consolidated group. The first sentence of this paragraph (h)(2) is applicable on or after the date these regulations are published as final regulations in the **Federal Register**.

* * * * *

Par. 18. For each section listed in the table, remove the language in the ''Remove'' column and add in its place the language in the ''Add'' column as set forth below:

Section	Remove	Add
§ 1.267(f)–1(k)	§ 1.337(d)–2; § 1.1502–35	§ 1.1502–36.
§ 1.597–4(g)(2)(v)	§§ 1.337(d)–2 and § 1.1502–35(f)	§ 1.1502–36.
§ 1.1502–11(b)(3)(ii)(c)	§§ 1.337(d)–2 and § 1.1502–35	§ 1.1502–36.
§ 1.1502–12(r)	§§ 1.337(d)–2 and § 1.1502–35	§ 1.1502–36.
§ 1.1502–15(b)(2)(iii)	§§ 1.337(d)–2, 1.1502–35, or	§ 1.1502–36.
§ 1.1502–32(b)(3)(iii)(B)	§ 1.1502–35(b) or (f)(2).	

Mark E. Matthews,

Deputy Commissioner for Services and Enforcement.

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