

Request for Comments

Although this action is a final rule which involves flight safety and, thus, was not preceded by notice and public procedure, comments are invited. Interested persons are invited to comment on this rule by submitting such written data, views, or arguments as they may desire. Communications should identify the regulatory docket number and be submitted in duplicate to the address specified above. All communications received on or before the closing date for comments will be considered by the FAA. The rule may be changed in light of comments received.

Comments are specifically invited on the overall regulatory, economic, environmental, and energy aspects of the rule. All comments submitted will be available, both before and after the closing date for comments, in the Rules Docket, Office of the Assistant Chief Counsel, FAA, room 158, Building 3B, 4400 Blue Mound Road, Fort Worth, Texas, for examination by interested persons. A report summarizing each FAA-public contact, concerned with the substance of the proposed AD, will be filed in the Rules Docket.

Commenters wishing the FAA to acknowledge receipt of their comments submitted in response to this notice must submit a self-addressed, stamped postcard on which the following statement is made: Comments to Docket Number 91-ASW-13. The postcard will be date/time stamped and returned to the commenter.

The regulations adopted herein will not have substantial direct effects on the States, on the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government. Therefore, in accordance with Executive Order 12612, it is determined that this final rule does not have sufficient federalism implications to warrant the preparation of a Federalism Assessment.

The FAA has determined that this regulation is an emergency regulation that is not considered to be major under Executive Order 12291. It is impracticable for the agency to follow the procedures of Order 12291 with respect to this rule since the rule must be issued immediately to correct an unsafe condition in aircraft. It has been further determined that this action involves an emergency regulation under DOT Regulatory Policies and Procedures (44 FR 11034, February 26, 1979). If it is determined that this emergency regulation otherwise would be significant under DOT Regulatory Policies and Procedures, a final

regulatory evaluation will be prepared and placed in the Rules Docket (otherwise, an evaluation is not required). A copy of it, if filed, may be obtained from the Rules Docket.

List of Subjects in 14 CFR Part 39

Air transportation, Aircraft, Aviation safety, Safety.

Adoption of the Amendment

Accordingly, pursuant to the authority delegated to me by the Administrator, the Federal Aviation Administration amends 14 CFR part 39 of the Federal Aviation Regulations as follows:

PART 39—[AMENDED]

1. The authority citation for part 39 continues to read as follows:

Authority: 49 U.S.C. 1354(a), 1421 and 1423; 49 U.S.C. 106(g) [Revised Pub. L. 97-449, January 12, 1983]; and 14 CFR 11.89.

§ 39.13 [Amended]

2. Section 39.13 is amended by adding the following new AD:

AD 91-19-02. Sikorsky Aircraft: Amendment 39-8028. Docket No. 91-ASW-13.

Applicability: All Model S-76B helicopters, certificated in any category.

Compliance: Required within the next 25 hours' time in service after the effective date of this AD, and thereafter at intervals not to exceed 25 hours' time in service from the last inspection.

To prevent failure of the left and right engine-to-transmission driveshaft assemblies due to cracks emanating from the balance weight rivet attachment holes which could result in loss of flight capability, accomplish the following:

(a) Inspect the left and right engine-to-transmission driveshaft assemblies, part number (P/N) 76361-09202, serial numbers (S/N) A230-00001 thru A230-00152 inclusive, for loose balance weights. The inspection shall be performed by grasping the balance weights by hand and attempting to move them in both the radial and axial directions. Any movement of the balance weights constitutes looseness.

(b) Visually inspect the area surrounding the balance weights for cracks in the shaft using a 10-power or higher magnification glass.

(c) If any loose balance weight or cracked shaft is found, remove the affected driveshaft assembly and replace with an airworthy assembly prior to further flight.

(d) If neither a loose balance weight nor cracked shaft is found, repeat the inspections as prescribed.

(e) The helicopter may be ferried in accordance with the provisions of FAR 21.197 and 21.199 to a base where the AD can be accomplished.

(f) Upon submission of substantiating data by an owner or operator through an appropriate FAA Inspector, an alternate method of compliance or adjustment of the compliance times, which provides an

equivalent level of safety, may be used if approved by the Manager, Boston Aircraft Certification Office, ANE-150, Engine and Propeller Directorate, Aircraft Certification Service, FAA, New England Region, 12 New England Executive Park, Burlington, Massachusetts 01803-5299.

This amendment (39-8028, AD 91-19-02) becomes effective October 17, 1991.

Issued in Fort Worth, Texas, on August 26, 1991.

Henry A. Armstrong,

Acting Manager, Rotorcraft Directorate, Aircraft Certification Service.

[FR Doc. 91-22576 Filed 9-18-91; 8:45 am]

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DEPARTMENT OF THE TREASURY**Internal Revenue Service****26 CFR Parts 1 and 602**

[T.D. 8364]

RIN 1545-AP20

Corporations; Consolidated Returns—Special Rules Relating To Dispositions and Deconsolidations of Subsidiary Stock

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains technical amendments to § 1.337(d)-1 and final §§ 1.337(d)-2 and 1.1502-20. These regulations implement aspects of the repeal of the General Utilities doctrine by limiting the losses of consolidated groups with respect to the stock of subsidiaries. Section 1.1502-20 also eliminates duplication of loss with respect to the stock of subsidiaries.

DATES: The regulations are effective as of September 13, 1991 except for the removal of § 1.337(d)-2T and the addition of § 1.337(d)-2 which are effective November 19, 1990. Section 1.337(d)-2 generally applies to dispositions and deconsolidations of a subsidiary's stock on or after November 19, 1990 and before February 1, 1991. 1.1502-20 generally applies to dispositions and deconsolidations of a subsidiary's stock on or after February 1, 1991.

FOR FURTHER INFORMATION CONTACT: Mark S. Jennings, 202-566-2455 (not a toll-free number).

SUPPLEMENTARY INFORMATION:**A. Paperwork Reduction Act**

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in

accordance with the requirements of the Paperwork Reduction Act (44 U.S.C. 3504 (h)) under control number 1545-1160. The estimated annual burden per respondent is 2 hours.

These estimates are an approximation of the average time expected to be necessary for a collection of information. They are based on such information as is available to the Internal Revenue Service. Individual respondents may require greater or less time, depending on their particular circumstances.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be directed to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224, and 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.

B. Introduction

1. March 9, 1990 Regulations

The loss disallowance rule was first adopted by T.D. 8294, filed with the **Federal Register** on March 9, 1990 and published in the **Federal Register** on March 14, 1990. 1.1502-20T provided generally for the disallowance of all losses of consolidated groups on the disposition of subsidiary stock. 1.1502-20T contained related rules, including a basis reduction rule that applied on deconsolidation of a subsidiary's stock and an anti-stuffing rule that applied to certain transfers of property between members in connection with the disposition or deconsolidation of a subsidiary's stock. The regulations permitted reattribution of a subsidiary's losses to the common parent to the extent the group's loss on the disposition of the subsidiary's stock was disallowed. The rules generally applied to the disposition or deconsolidation of a subsidiary's stock on or after March 9, 1990.

Section 1.337(d)-1T added a transitional rule that generally limited loss on the disposition of a subsidiary's stock after January 6, 1987, if the subsidiary became a member of the group after that date and the disposition was not subject to § 1.1502-20T. Unlike § 1.1502-20T, the transitional rule allowed loss to the extent a group established that the loss was not attributable to the recognition of built-in gain on the disposition of assets of the subsidiary (or any lower tier subsidiary). Instead of reducing the basis of subsidiary stock on deconsolidation of the subsidiary,

§ 1.337(d)-1T treated the stock (and any successor property) that was deconsolidated during the transitional period as remaining subject to § 1.337(d)-1T even after § 1.1502-20T became effective.

1.337(d)-1T implemented Notice 87-14, 1987-1 C.B. 445, in which the Internal Revenue Service announced its intention to publish regulations that would prevent utilization of §§ 1.1502-32 and 1.1502-33 (c) (the "investment adjustment rules") to circumvent the repeal of the General Utilities doctrine by the Tax Reform Act of 1986. The loss disallowance rule of § 1.1502-20T addressed another problem relating to the investment adjustment rules by preventing a subsidiary's operating losses from being duplicated as an investment loss of the parent when the parent disposes of the subsidiary's stock.

Also filed with the **Federal Register** on March 9, 1990 and published on March 14, 1990, was a notice of proposed rulemaking (CO-78-87) that incorporated by cross reference the text of §§ 1.1502-20T and 1.337(d)-1T. Many written comments were received, and a public hearing was held on June 26, 1990.

2. November 19, 1990 Regulations

After full consideration of the comments and the statements made at the public hearing, the following actions were taken in documents filed with the **Federal Register** on November 19, 1990 and published in the **Federal Register** on November 26, 1990:

a. Proposed § 1.337(d)-1 was amended and promulgated by T.D. 8319 as final § 1.337(d)-1, superseding § 1.337(d)-1T and generally applicable to dispositions of transitional stock before November 19, 1990.

b. New § 1.337(d)-2T was promulgated by T.D. 8319 as a temporary regulation, with a crossreferenced notice of proposed rulemaking (CO-93-90). Section 1.337(d)-2T added a second transitional rule applicable to all subsidiary stock (not just stock to which § 1.337(d)-1 applied) disposed of or deconsolidated on or after November 19, 1990 and before February 1, 1991. This transitional rule allowed groups to establish that loss is not attributable to the recognition of built-in gain, but only if the group's entire equity interest in the subsidiary is disposed of to unrelated persons before the effective date of § 1.1502-20. Section 1.337(d)-2T also provided basis reduction rules for subsidiary stock that is deconsolidated and anti-stuffing rules.

c. Section 1.1502-20T and its crossreferenced notice of proposed

rulemaking were withdrawn, and a revised § 1.1502-20 was published as a proposed regulation in a notice of proposed rulemaking (CO-93-90). The provisions of proposed § 1.1502-20 are discussed below.

3. Election To Discontinue Filing Consolidated Returns

In Revenue Procedure 91-11, 1991-6 I.R.B. 9, the Service set forth procedures under which it will grant permission for all of the members of a group to discontinue filing consolidated returns, effective for the group's taxable year that includes November 19, 1990. Revenue Procedure 91-39, 1991-27 I.R.B. 1, extended the deadline to apply for permission to discontinue filing consolidated returns from June 30, 1991 to 90 days after the date proposed § 1.1502-20 is superseded by final regulations.

C. Amendment and Adoption of Section 1.1502-20

After full consideration of the comments and the statements made at the public hearing, proposed § 1.1502-20 is amended and adopted as a final regulation.

Final § 1.1502-20 retains the approach of the proposed regulations. The reasons for adopting this approach are more fully described in the preamble to § 1.1502-20T, filed with the **Federal Register** on March 9, 1990 (55 FR 9426, the "March 1990 Preamble") and in the preamble to proposed § 1.1502-20, filed with the **Federal Register** on November 19, 1990 (55 FR 49075, the "November 1990 Preamble"). This preamble expands the discussion in the earlier preambles of those issues that have remained the principal focus of comments and discusses new issues raised by the amendments to the proposed regulations.

D. Comments on Approach of Proposed Regulations

Following is a discussion of the most significant comments on the modified loss disallowance approach of the proposed regulations and the reasons for accepting or rejecting those comments.

1. Tracing

a. *In general.* Comments continued to argue that the loss disallowance approach inappropriately disallows economic loss on the sale of subsidiary stock and that a tracing approach would be preferable because tracing would more accurately measure economic loss. The comments generally contemplated that tracing would entail the

determination, at the time a subsidiary's stock is acquired, of the built-in gain inherent in each of the subsidiary's assets and the elimination of positive investment adjustments attributable to recognition of that built-in gain when the asset is disposed of.

However, the comments did not have a consistent view of how a tracing approach would be implemented. Some comments endorsed tracing in the abstract, without providing any detail on implementation. Others acknowledged that a tracing approach would be complicated, but urged that various simplifying assumptions be adopted to alleviate complexity. These simplifying assumptions were generally combined in a manner that would inevitably operate to permit significant circumvention of General Utilities repeal or were offered with the proviso that taxpayers be permitted to elect exact tracing whenever the assumptions operated to their detriment, thereby preserving the complexity associated with the tracing approach.

These comments have not persuaded the Treasury Department and the Service that a tracing approach is preferable to the loss disallowance approach. The comments tended to minimize the administrability problems presented by the necessity, under any tracing system, for valuing assets held by a subsidiary at the time its stock is acquired and for determining whether, on the disposition of such assets, any gain represents built-in gain with respect to which positive investment adjustments must be eliminated. The comments also failed to address the problem that, even under a tracing system, it may not be possible to accurately measure economic loss. The reasons the Treasury Department and the Service have rejected a tracing approach are explained in greater detail below.

b. *Valuations.* The Service considers valuations the most difficult administrative problem presented by a tracing approach. Valuations are also required under other Code provisions, and valuation issues are raised by those provisions. However, a tracing approach would present a combination of valuation concerns not present elsewhere:

(i) It would be necessary to value subsidiary assets on an asset-by-asset basis in order to identify built-in gains and losses, to prevent the netting of recognized built-in gain and post-acquisition loss, and to determine economic loss with respect to any particular asset.

(ii) There would not be any tension between buyers and sellers in allocating

the purchase price of subsidiary stock among subsidiary assets. Taxpayers would be tempted to convert built-in gain into post-acquisition gain by underallocating value to assets likely to be disposed of and overallocating value to assets likely to be retained.

(iii) The event that would require audit examination of the valuations (*i.e.*, disposition of the subsidiary stock) might not occur for years or even decades. The Service would face enormous difficulty in establishing, many years after the fact, that the valuation of a particular assets was incorrect. Audit difficulties would be multiplied in an acquisition involving a large corporate group or subgroup with a multitude of separate assets.

(iv) Values fluctuate over time. As a result, it may be difficult to identify whether gain is built-in gain or post-acquisition appreciation for purposes of determining whether investment adjustments with respect to that gain should be eliminated. If groups were permitted to take fluctuations in value into account, the Service's audit difficulties would be compounded. On the other hand, if groups were precluded from taking value fluctuations into account, the accuracy of the tracing approach in measuring economic loss would be reduced. In addition, anti-abuse rules would be necessary to prevent taxpayers from engaging in self-help, such as intercompany transfers, to mark declines in value.

c. *Measuring recognized built-in gain.* In addition to ascertaining the amount of each asset's built-in gain at the time a subsidiary is acquired, it would be necessary to develop a system for measuring the extent to which positive investment adjustments are attributable to recognition of the built-in gain. Unlike the limited guidance provided for tracing under §§ 1.337(d)-1 and 1.337(d)-2 during the transitional period, full tracing under § 1.1502-20 would apply permanently and could be implemented only by a systematic approach. Measurement of recognized built-in gain could be accomplished by establishing an earnings and profits (E&P) basis for each asset equal to the asset's value at the time the subsidiary is acquired. The difference between the asset's E&P basis and its tax basis would represent the asset's potential built-in gain or loss.

Example. The P group buys all the stock of T for \$100. T owns an asset with a basis of \$0 and a value of \$100. The E&P basis of the asset is adjusted to \$100, solely for investment adjustment purposes, when T joins the P group. T sells its asset for \$100 and recognizes \$100 of taxable gain. However, because the asset's basis was adjusted to \$100 for E&P purposes, there is no

gain for investment adjustment purposes. If the P group then sells the T stock for \$100 (the value of the proceeds of sale), it recognizes no gain or loss on the stock sale.

Although this system prevents circumvention of General Utilities repeal, it may also eliminate economic loss unless further adjustments are adopted. Assume that T's asset had declined in value and was sold for \$80, causing T to realize both a \$20 economic loss and a \$20 E&P loss (but a \$0 tax loss). If the \$20 E&P loss is reflected as a negative investment adjustment, the basis of the T stock would be reduced to \$80 under the investment adjustment system, and the P group would not subsequently recognize its \$20 economic loss when it sold the T stock for \$80.

Failure to take the E&P loss into account as a negative adjustment will not always produce an accurate measurement of economic loss however. If an asset is amortizable or depreciable, its built-in gain may be recognized through consumption as well as disposition. See Example 3 of the March 1990 Preamble. If E&P depreciation and amortization are not taken into account, the group that consumes assets through production would be in a better position than the group that sells assets. Greater accuracy would be achieved by reducing the E&P basis to reflect E&P amortization or depreciation, but this would require a separate set of books and would increase the complexity of the measurement system. In addition, a system of E&P depreciation and amortization would not produce complete accuracy in measuring economic loss if an asset depreciates at a faster or slower rate than the rate prescribed for E&P depreciation.

Additional complexity is introduced if a group acquires subsidiary stock with a basis carried over from outside the group. This commonly occurs when an acquired subsidiary has its own lower tier subsidiaries. Adjustments are needed because some or all of the built-in gain inherent in the assets of lower-tier subsidiaries may also be inherent in the acquired subsidiary's stock.

Example. S owns all the stock of T, which has a basis of \$0 and a value of \$100. T owns assets with a \$0 basis and a \$100 value. The P group buys all the S stock for \$100. S adjusts the E&P basis of the T stock to \$100 and T adjusts the E&P basis of its assets to \$100. T sells the assets for \$100 and T's \$100 of sale proceeds is offset by the E&P basis of the assets for investment adjustment purposes. S's basis in the T stock therefore remains \$0. If S sells the T stock for \$100 (the value of T's assets), S will recognize \$100 of gain, thereby duplicating the income already recognized by T from the assets (which, because the assets

had a \$0 tax basis, was not offset by tax basis).

The gain duplication illustrated by this example can be avoided by assigning one E&P basis to T's assets for purposes of determining S's investment adjustments with respect to the T stock, and another E&P basis for purposes of the P group's investment adjustments with respect to the S stock. The E&P basis for purposes of the T stock would be equal to S's carryover basis in the T stock. The E&P basis for purposes of the S stock would be equal to the value of T's assets. Additional adjustments would be needed if S's basis in the T stock differs from T's basis in its assets at the time S and T are acquired and if S and T hold stock of other subsidiaries.

2. Loss Disallowance Approach Reflects Balancing of Tax Policy Considerations

The modified loss disallowance approach contained in § 1.1502-20 represents a balancing of tax policy considerations: (i) It is effective in implementing General Utilities repeal because it prevents the elimination of corporate level tax; (ii) it allows the deduction of certain readily identifiable economic loss; (iii) it is administrable by both taxpayers and the Service; and (iv) by limiting loss duplication, it is consistent with the single entity principles reflected in the investment adjustment rules and other consolidated return regulations in that it provides a transition from separate return to consolidated return status by phasing in loss disallowance as the group and the subsidiary operate in consolidated form and it becomes more appropriate to view the group's investment in the subsidiary as an investment in its operations rather than its stock.

Comments have questioned the authority of the Treasury Department and the Service to adopt rules that are contrary to specific provisions of the Code. For example, comments have argued that a stock loss under section 165(g) cannot be denied under the authority of sections 1502 and 337(d), and that the government does not have the authority to limit loss duplication.

The essence of the Service's authority under sections 1502 and 337(d) is the authority to adapt Code provisions to solve problems resulting from the filing of consolidated returns. In addition, regulatory authority under both section 1502 and section 7805 includes the authority to adopt administrable rules. The regulatory authority under which the investment adjustment system was adopted includes the authority to adapt the system to legislative enactments and changing circumstances. As a

consequence of the repeal of the General Utilities doctrine, final § 1.1502-02 modifies the application of the investment adjustment rules to prevent elimination of corporate level tax. Because it is not administratively feasible to differentiate between loss attributable to built-in gain and duplicated loss, the final regulations disallow loss with respect to subsidiary stock that is duplicated by the subsidiary's operating losses or built-in losses with respect to its assets. In so doing, the regulations provide an administrable solution to General Utilities repeal and extend the single entity principles underlying the investment adjustment rules and other existing consolidated return rules to losses with respect to subsidiary stock.

Comments challenging the validity of separate elements of the rules contained in the proposed regulations have not recognized the balance achieved by the rules as a whole. The regulations address the potential avoidance of General Utilities repeal through the application of the investment adjustment rules of the consolidated return regulations. The approach adopted in the final regulations achieves a single administrable solution that reasonably balances the tax policy considerations presented in devising a system to implement General Utilities repeal.

Because the Treasury Department and the Service recognized that an administrable system of implementing General Utilities repeal for consolidated groups affects some taxpayers adversely as compared with the separate return system, a transitional period was provided in which tracing was permitted and groups filing consolidated returns before the rules became effective were permitted to elect to discontinue filing consolidated returns.

3. Refinement of the Section 1.1502-20(c) Formula

Section 1.1502-20(c) allows loss to the extent it exceeds an amount determined by a formula: (i) E&P from extraordinary gain dispositions (extraordinary gain factor); (ii) positive investment adjustments in excess of the amount described in (i) (positive adjustment factor); and (iii) duplicated loss (loss duplication factor). The formula is designed to protect against the elimination of corporate level tax while permitting economic loss to the extent feasible without tracing.

Many comments argued that the extraordinary gain and positive adjustment factors should be refined so that they would more accurately measure investment adjustments

attributable to recognition of built-in gain. Most of these comments requested that both the extraordinary gain and positive adjustment factors be modified to exclude E&P attributable to the disposition of assets that a subsidiary acquires in taxable transactions after it joins the group.

After careful consideration, the Treasury Department and the Service determined that an exception for after-acquired assets would introduce the same administrative problems as those associated with tracing. Although comments generally assumed that it could be readily determined whether an asset was acquired after a subsidiary joined the group, this relationship may not be readily determinable when a consolidated group acquires subsidiaries in a chain. For example, if S, a member of the P group, acquires T and the P group later sells S to another group, assets that are after-acquired as to the stock of T may or may not be after-acquired as to the stock of S. Additional complexity would arise if, after S is acquired, T or any of its assets are transferred within the acquiring group in tax-free transactions.

Comments assumed that an after-acquired asset rule would not be burdensome, in part because a group would identify gain from after-acquired assets only if it was advantageous to do so. However, because gains and losses are netted within taxable years in applying the positive adjustment factor, all losses and deductions (including cost recovery) attributable to after-acquired assets would have to be identified and excluded from positive adjustments in order to prevent elimination of corporate level tax. This would significantly increase the burden of both taxpayers and the Service in applying the positive adjustment factor.

Comments also urged that numerous other items be excluded from the extraordinary gain and positive adjustment factors. These included: (i) Goodwill; (ii) debt incurred after a subsidiary joins the group; (iii) assets of a subsidiary that may be readily valued at the time the subsidiary joins the group (e.g. marketable securities) to the extent of any subsequent gain; (iv) assets acquired by the subsidiary in carryover basis transactions after it joins the group, if the asset basis is reflected in stock basis; (v) assets sold at a loss in a deferred intercompany transaction, to the extent loss is taken into account as a result of a later gain transaction; (vi) positive adjustments attributable to an election under § 1.1502-33(d); and (vii) the excess loss account (ELA) of a lower tier subsidiary

that is taken into account on the disposition of the subsidiary, if the account did not exist when the lower tier joined the group. Incorporation of such exceptions would require the introduction of burdensome rules to prevent potential elimination of corporate level tax and would significantly increase the burden of administration. These exceptions, as well as the after-acquired asset exception, would also delay the phase-in of the loss disallowance rule, thus extending the period for which the Service and groups must monitor extraordinary gains and positive adjustments.

4. Netting of Basis Adjustments For Years on or Before September 13, 1991

Proposed § 1.1502-20(c)(1)(i) does not permit netting of extraordinary gains with extraordinary losses. Proposed § 1.1502-20(c)(1)(ii) permits netting of positive and negative adjustments within the same taxable year, but does not permit a net negative adjustment for one year to offset a net positive adjustment for another year. Many comments suggested that the factors be amended to allow netting of gains and losses attributable to extraordinary dispositions and to allow netting of positive and negative adjustments between years. Some comments argued that it was unduly burdensome to require groups to determine positive adjustments attributable to years ending before the repeal of the General Utilities doctrine because a group might not have the complete prior investment history of subsidiaries acquired in carryover basis transactions.

The Treasury Department and the Service continue to believe that netting of extraordinary gains and losses and of positive and negative adjustments between years should not be permitted. Allowing netting would facilitate planning to circumvent General Utilities repeal. Groups would be able to net built-in gains against post-acquisition losses without reduction in stock basis, and corporate level tax attributable to the built-in gains could be eliminated as a result of the stock loss.

Although the final regulations do not permit netting of positive and negative adjustments for years ending after September 13, 1991, they do provide a transitional rule permitting certain netting of positive and negative adjustments for years ending on or before that date as administrative relief. Netting is permitted for those years because they may include periods when subsidiaries were owned by a prior group or groups, and records of the

investment adjustment histories of the subsidiaries may be difficult to obtain.

Under the transitional rule contained in § 1.1502-20(c)(2)(v), the positive adjustment factor is limited, for all taxable years ending on or before September 13, 1991, to the net increase in the basis of a share from (i) the date the share was first acquired by the consolidated group to (ii) the end of any taxable year ending after December 31, 1986 and on or before September 13, 1991, whichever such year end produces the lowest net increase. Netting is not permitted for periods after the taxable year through which this netting rule is applied. For example, if using the net increase in the basis of a share as of the end of the group's taxable year ending December 31, 1988 produces the lowest increase, the group would, in applying § 1.1502-20(c)(1)(ii), not be permitted to offset the net positive adjustments and net negative adjustments arising in subsequent taxable years.

If the share is transferred basis property (within the meaning of section 7701(a)(43)) from a prior consolidated group, the net increase is measured from the date the share was first acquired by the prior group.

Under the transitional rule, positive and negative adjustments include dividends and capital contributions, and any other events affecting stock basis during the period the share is held by a member (or in the case of transferred basis property, a prior consolidated group). Because the purpose of the transitional netting rule is to reduce the difficulty of retroactively determining the source of basis adjustments, no distinction is made between those types of adjustments that taxpayers can identify and those they cannot. For example, deemed dividends elected under § 1.1502-32(f) are treated the same as actual dividends.

Although the netting permitted under the transitional rule may result in elimination of corporate level tax, taxpayers have no opportunity after the filing of final § 1.1502-20 to enhance elimination through planning, and the substantial administrative relief provided by the rule is therefore considered warranted.

5. Interaction of Section 1.1502-20 With Other Rules

Many comments expressed concern about the difficulties presented by the interaction of the worthless stock deduction, the triggering of ELAs, the loss disallowance rule, and judicial protection of a bankrupt corporation's tax attributes. Comments have also questioned the interaction of the loss disallowance rule and the proposed

regulations providing that section 304 does not apply in the consolidated return context. These issues will be addressed in future guidance. See also § 1.1502-20(e)(3), Example 2 (with respect to certain applications of § 1.1502-20 to intercompany stock sales).

6. Anti-Breakup Rule

The March 1990 Preamble announced that consideration was being given to adopting some form of anti-breakup rule in the final regulations, and that the rule would apply on a retroactive basis from the effective date of § 1.1502-20T. The rule was to prevent the sheltering of post-acquisition gain when a target is disposed of within 2 years after its stock is acquired by a group.

The final regulations do not incorporate such a rule, and in the absence of evidence of significant abuse, the Treasury Department and the Service do not plan to adopt such a rule. If it is determined in the future that an anti-breakup rule is necessary, the announcement in the March 1990 Preamble will not be treated as notification of the future rule.

7. Other General Comments

Comments continued to argue that the proposed regulations be modified in several respects, including disregarding wasting assets, limiting loss disallowance on the basis of caps or imputed rates of return on corporate assets, and deleting the loss duplication factor. For the reasons stated in the November 1990 Preamble, the Treasury Department and the Service have rejected such modifications.

E. Comments on Specific Provisions of Proposed Regulations

1. Amendments to section 1.1502-20(a)

a. Intercompany Loss

If loss is recognized on the transfer of member stock in an intercompany transaction, section 267(f) defers the loss, but proposed § 1.1502-20(a) would override section 267(f) and disallow the loss before it can be deferred. Comments argued that the section 267 rules should override loss disallowance rather than the reverse because the disallowed loss is tiered up under the investment adjustment system and may result in gain when a member other than the member whose stock was transferred in the intercompany transaction ceases to be a member of the group.

It is inconsistent with a single entity view of consolidated groups to disallow loss on an intercompany transfer of

stock that continues to be owned within the group. Accordingly, the rule of the proposed regulations is modified to provide that § 1.1502-20 overrides section 267 only at the time the stock of the member that was transferred in the intercompany transaction: (i) Ceases to be owned by a member of the consolidated group, (ii) is cancelled or redeemed (regardless of whether it is retired or held as treasury stock), or (iii) is disposed of under § 1.1502-19(b)(2) (other than § 1.1502-19(b)(2)(ii)).

The corresponding rules in §§ 1.1337(d)-1 and 1.1337(d)-2 are similarly revised.

b. Netting

Proposed § 1.1502-20(a) permits the netting of gain and loss from the sale of common stock of a subsidiary that is sold to the same purchaser pursuant to a single plan. Comments requested expansion of the single purchaser rule. They also requested expansion of the netting rule to include "related" dispositions involving gain and loss on the stock of different subsidiaries, and on preferred stock as well as common stock.

The final regulations provide that the netting rule applies to all dispositions of stock of a subsidiary, to the extent that, as a consequence of the same plan or arrangement, gain is taken into account by members with respect to stock of the same subsidiary having the same material terms. Thus, the netting rule may apply whether the buyer is the public, a member of the same consolidated group, or otherwise, and whether the amount is currently recognized or a previously deferred amount that is currently taken into account. Similarly, the netting rule may apply to the disposition of preferred stock.

The netting rule has not been further expanded because gains and losses on sales of different classes of a subsidiary's stock, of the same class of a subsidiary's stock taken into account at different times, or of stock of different subsidiaries, may be unrelated to each other, and netting of such gains and losses may permit circumvention of General Utilities repeal.

Because the final regulations also extend netting to the basis reduction rule under § 1.1502-20(b), and both §§ 1.1502-20(a) and 1.1502-20(b) may apply to the same transaction, an anti-duplication rule has been added.

Section 1.1502-19(a)(6) of the existing regulations provides an election to apply an ELA to reduce the basis of any other stock. (Section 1503(e)(4) eliminates a similar election to reduce the basis of indebtedness.) Because an election

under § 1.1502-19(a)(6) has the effect of netting one share's gain against another share's basis that may produce a loss subject to § 1.1502-20(a), the availability of the election is limited to conform to the availability of netting under § 1.1502-20 (a) and (b).

2. Amendments to Section 1.1502-20(b)

a. Netting of Gain and Basis Reduction

Under the proposed regulations, the basis of subsidiary stock is reduced to fair market value when the stock ceases to be owned by a member of a consolidated group of which the subsidiary is also a member (a "deconsolidation" event). Comments requested an upward adjustment to the basis of deconsolidated stock to offset any gain deferred in an earlier intercompany sale of the deconsolidated stock. Under § 1.1502-13T(l), deferred gain is taken into account when the basis increase attributable to the deferred intercompany sale is recovered by the group, and basis reduction on deconsolidation constitutes a basis recovery for this purpose.

Consistent with a single entity view of consolidated groups, the basis reduction on deconsolidation under § 1.1502-20(b) is eliminated to the extent that, as a consequence of the same plan or arrangement as that giving rise to the deconsolidation, gain is taken into account by members with respect to stock of the same subsidiary having the same material terms. This relief is comparable to the netting relief available under § 1.1502-20(a). Because both §§ 1.1502-20(a) and 1.1502-20(b) may apply to the same transaction, an anti-duplication rule and additional examples are included.

If a subsidiary's stock is sold at a loss in a deferred intercompany transaction, and the subsidiary is subsequently deconsolidated (e.g., through issuance of new stock to nonmembers), the basis reduction that would have occurred under § 1.1502-20(b) if the deferred intercompany transaction had not taken place causes the deferred loss to be taken into account under § 1.1502-13T(l) at the time of the deconsolidation. The deferred intercompany loss taken into account at the time of the deconsolidation may not be netted against any gain with respect to the stock that is attributable to periods after the intercompany transfer unless the gain is also taken into account at the time of the deconsolidation, because netting is available only for gain and basis reduction taken into account as a consequence of the same plan or arrangement as that giving rise to the deconsolidation.

b. Statement for Loss Within 2 Years

Under the proposed regulations, if stock was disposed of within 2 years after a basis reduction on deconsolidation, § 1.1502-20(b)(5) required that a statement be filed with the taxpayer's return for the year of disposition. Because valuation issues are presented under § 1.1502-20(b) on every deconsolidation, the final regulations clarify that the statement is to be filed even if stock basis is not actually reduced on the deconsolidation. In addition, minor errors in the description of the required information are corrected.

c. Restoration of Basis Lost Under Deconsolidation Rule

Under the proposed regulations, the basis of subsidiary stock is reduced to fair market value when the stock ceases to be owned by a member of a consolidated group of which the subsidiary is also a member (a "deconsolidation" event). Comments requested that basis lost under the deconsolidation rule be restored to offset gain if the group later sells the stock at a gain.

If basis restoration were permitted, complex additional rules would be required. For example, it would become necessary to trace deconsolidated stock that is transferred in nonrecognition transactions. In addition, the antistuffing rules of the proposed regulations would have to be extended to separate returns, and rules would be needed for subsidiaries rejoining the group following a deconsolidation (e.g., netting of related gain and loss stock dispositions, reattribution of disallowed loss, and measurement of loss duplication). Consequently, the suggested amendments are not adopted in the final regulations.

3. Amendments to Section 1.1502-20(c)

a. Extraordinary Gain Dispositions

Proposed § 1.1502-20(c)(2)(i) identifies the events that are treated as extraordinary gain dispositions. The final regulations include a change in method of accounting resulting in a positive section 481 adjustment in the list of events constituting extraordinary gain dispositions. For example, if a subsidiary joins a group and elects to recover its LIFO reserve under section 481, the recover is treated as an extraordinary gain disposition. Otherwise, on a subsequent disposition of the subsidiary stock, the income attributable to the recovery of the reserve could be offset by loss attributable to basis generated by the

recovery. The final regulations also clarify that extraordinary gain dispositions include only events that occur on or after November 19, 1990 and that result in income or gain for purposes of computing E&P. For this purpose, an accounting method change that occurs on or after November 19, 1990 is treated as an extraordinary gain disposition even if all or a part of the adjustment resulting from the change is attributable to periods before November 19, 1990.

The final regulations also provide that extraordinary gain dispositions include any additional events (or items) that the Commissioner identifies in revenue rulings and revenue procedures.

The proposed regulations provided that E&P attributable to extraordinary gain dispositions is reduced for directly related expenses, including federal income taxes, provided they are reflected as negative investment adjustments. Comments described difficulties in attributing a group's federal income taxes to particular transactions and in determining whether the taxes resulted in negative investment adjustments. Some comments argued that payments under tax sharing agreements should be treated as taxes for purposes of these rules. Others argued that a 34% rate should be imputed in every transaction.

The final regulations adopt a simplified approach that provides groups paying federal income taxes with maximum credit for those taxes while protecting against the transfer of tax benefits. Under the final regulations, the amount of federal income taxes attributable to extraordinary gain dispositions is the excess (if any) of the group's income tax liability actually imposed under subtitle A of the Code for the taxable year over the liability redetermined by not taking into account any extraordinary gain dispositions. For this purpose, the group's tax liability is determined without taking into account the foreign tax credit.

This approach is easily administered and allows taxes to be taken into account at the rates actually paid by the group in the year of the extraordinary gain disposition without regard to which member actually bears the tax or whether payments are made under a tax sharing agreement.

b. E&P Reflected in Basis

The proposed regulations effectively treated all E&P from extraordinary gain dispositions and positive investment adjustments as contributing to a loss on the disposition of stock. Comments argued that this treatment is not correct in all cases. For example, section

1503(e)(1)(A) requires the consolidated group to redetermine stock basis for purposes of determining gain or loss to account for tax benefits realized with respect to the subsidiary. The reference to E&P in the proposed regulations was intended to take into account adjustments pursuant to section 1503(e) and any similar provisions.

The final regulations clarify that, for purposes of the extraordinary gain and positive adjustment factors, E&P is taken into account only to the extent that it is "reflected" in the basis of a subsidiary's stock, directly or indirectly, immediately before a disposition or deconsolidation, after applying section 1503(e), § 1.1502-32(g), and other applicable provisions of the Code and regulations.

Under this rule, E&P is considered to be reflected in stock basis if the E&P was taken into account in determining stock basis but was distributed. Thus, amounts are considered reflected in stock basis whether or not basis is actually increased, so long as the basis is different than it would have been if the E&P had not been taken into account. Moreover, E&P derived by partnerships and other passthrough entities may be considered reflected for this purpose.

Additional examples are added to clarify when E&P is reflected in stock basis, and when it is treated as resulting in adjustments under § 1.1502-32(b)(1)(i) and (c)(1).

c. Loss Duplication

Comments argued that if duplication is to be eliminated the regulations should provide for the reduction of the buyer's inside attributes (including basis) rather than the seller's outside stock loss. Comments have not, however, identified practical methods of providing meaningful reduction of inside attributes without unreasonable complexity. The complexity results from the necessity of identifying the attributes causing the duplication. In order to accurately reduce asset basis it would be necessary to identify the extent to which the stock loss is attributable to particular assets with basis in excess of value rather than to built-in gain assets or assets whose basis is unlikely to be recovered in the near term. Moreover, the rules would have to take into account multiple tiers of subsidiaries with varying disparities between asset and stock basis.

Some comments suggested that attributes clearly unrelated to stock loss (e.g., built-in or separate return limitation year (SRLY) losses not reflected in basis of subsidiary stock) should be excluded from the loss

duplication factor. Relief for built-in losses could not be provided without the associated complexity described above. Relief for SRLY losses was provided when proposed § 1.1502-20(g) amended the reattribution rule to permit the reattribution of SRLY losses. Accordingly, no further modifications have been provided as a result of these comments.

Comments also requested clarification of the time that duplicated loss is determined. For example, if an insolvent subsidiary is to be liquidated, comments questioned whether the subsidiary's net operating losses should be taken into account in determining duplicated loss, because the parent would not succeed to the losses. See, e.g., Treas. Reg. § 1.332-2(b); Rev. Rul. 68-359, 1968-2 C.B. 161. Based on the comments, § 1.1502-20(c) has been amended to clarify that duplicated loss is measured immediately after the applicable disposition or deconsolidation. Because a loss that is reattributed under § 1.1502-20(g) would be reflected in the basis of subsidiary stock immediately before a disposition, § 1.1502-20(g) is revised to prevent circularity.

Comments also requested clarification of the "other relevant items" included in determining duplicated loss and of the proper treatment of disparities between the basis of interests in passthrough entities and the assets of those entities. Because these issues are common to other Code provisions, such as sections 338 and 382 (h), their resolution is deferred until guidance is developed under those provisions.

4. Amendments to Section 1.1502-20 (d)

Section 1.1502-20(d) provides that § 1.1502-20 may apply to any property the basis of which is determined by reference to the basis of a subsidiary's stock. Example 1 of proposed § 1.1502-20(d)(2) described the consequences of a tax-free reorganization under section 368(a)(1)(B) in which a subsidiary leaves one consolidated group and joins another. The example concluded that the transaction caused a deconsolidation of the subsidiary and therefore required a basis reduction under § 1.1502-20(b) immediately before the subsidiary left the transferor group. Comments argued that basis reduction in this circumstance was inconsistent with the principles of § 1.1502-20(b) because the subsidiary's stock continued to be held after the transaction by members of a consolidated group of which the subsidiary was a member.

The proposed Example 1 has been modified to reflect these comments.

Under the final regulations, because the subsidiary's stock remains subject to § 1.1502-20, the stock is not deconsolidated and the transferee group's basis in the stock is determined without taking into account the basis reduction under § 1.1502-20(b). However, under the successor rule of § 1.1502-20(d), which applies to the extent necessary to effectuate the purposes of § 1.1502-20, the transferor group must reduce to fair market value the basis of the stock received in the reorganization. The successor rule applies to the stock received by the transferor group because the group otherwise would be able to convert its disallowed loss on the subsidiary stock to an allowed loss on the stock of a nonmember received in the transaction.

5. Amendments to Section 1.1502-20(e)

a. Substantive Application of Rules

The purpose of § 1.1502-20(e), to prevent avoidance transactions, is clarified by adding an express provision requiring that the rules of § 1.1502-20 be construed in a manner that is consistent with and reasonably carries out their purposes. If a taxpayer acts with a view to avoid the effect of the rules of § 1.1502-20, adjustments will be made as necessary to carry out their purposes. Examples are added to illustrate the application of this provision.

b. Scope of Stuffing Transactions

The anti-stuffing rule of the proposed regulations is retained and clarified in the final regulations. Because section 267(f) permits basis to be shifted within consolidated groups through deferred intercompany transactions, comments noted that transactions subject to section 267(f) should, where appropriate, be treated as stuffing transactions. The final regulations add an example to illustrate the application of paragraph (e) to transactions under section 267(f).

In addition, amendments have been made to the proposed anti-stuffing rule to clarify its application to any transfer with a view to avoiding the disallowance of loss, reduction of basis, or the recognition of gain. As amended, the rule applies without regard to which member of the group is the transferee.

6. Amendments to Section 1.1502-20(f)

a. E&P Effects of Basis Reductions

Comments suggested that the determination of E&P under proposed § 1.1502-20(f) was unclear in certain cases. For example, if the common parent owns stock of a first tier subsidiary and the basis of the stock is reduced under § 1.1502-20(b), the proposed regulations are unclear as to

whether the common parent's E&P must be reduced to reflect the basis adjustment.

The final regulations amend § 1502-20(f) to clarify that any amount by which basis is reduced is treated for E&P purposes as a loss arising and absorbed by the subsidiary in the taxable year of the basis reduction. Thus, in the example above, the common parent's E&P would be reduced to reflect a basis reduction. The final regulations also clarify that deconsolidation of a share is treated as a disposition of the share for purposes of determining when investment adjustments are made and E&P is determined with respect to the share.

b. Basis Reduction Account

Before 1988, a deconsolidation caused the basis of subsidiary stock to be reduced by an amount equal to the stock's net positive investment adjustments. See § 1.1502-32(g). This reduction prevented dividend stripping of consolidated E&P in separate return years after the deconsolidation. It was replaced by § 1.1502-32T(a), which establishes a "basis reduction account" for any deconsolidated subsidiary's stock retained by the group. Under § 1.1502-32T(a), basis is reduced by dividend distributions to the extent of the balance in the account. Although distributions following deconsolidation reduce both the account and stock basis (to the extent of the account), § 1.1502-20(f) treats any basis reduction in connection with a deconsolidation under the loss disallowance rules as not reducing the account. One comment argued that the account should be reduced because the basis reduction reverses the net positive adjustments reflected in the account.

The final regulations retain the basis reduction account rule for the proposed regulations. Section 1.1502-20 disallows loss and reduces basis attributable to recognized built-in gain. Dividend stripping should not be a mechanism for avoiding the loss disallowance rules where the E&P is attributable to the recognition of built-in gain during consolidated return years.

c. Tiering Up of Disallowed Loss

Loss disallowed under § 1.1502-20 results in negative investment adjustments, to the same extent as if the loss had been allowed, to eliminate higher tier basis attributable to built-in gain or duplication. Comments argued that tiering up of disallowed loss may produce incorrect results, for example, by producing an ELA for one member that cannot be netted with another

member's disallowed loss with respect to stock of the same subsidiary.

The proposed regulations have not been modified to reflect these comments. To the extent that stock basis is increased because of the recognition of built-in gain, the basis of stock of higher tier members is also increased under the investment adjustment system and may prevent an ELA that would have existed otherwise. If the increase results in a disallowed loss on the disposition of stock of a lower tier subsidiary, there should be a corresponding decrease in the basis of stock of higher tier subsidiaries. If tiering up the disallowed loss results in an ELA with respect to higher tiers, the ELA is appropriate because it results from eliminating the effects of the recognized built-in gain.

7. Amendments to Section 1.1502-20(g)

a. Definition of Insolvency

Under § 1.1502-20(g), the common parent of a group is permitted to reattribute to itself certain losses of a subsidiary when a loss on the subsidiary's stock is disallowed. Because circumvention of General Utilities repeal would be possible if losses borne by creditors of the subsidiary (rather than by the group) could be reattributed to the common parent, the proposed rules limit reattribution from insolvent subsidiaries.

If a subsidiary borrows funds directly, its losses may be borne by its direct creditors regardless of the solvency of higher tier members of the group. On the other hand, if a higher tier member borrows funds that are contributed to a subsidiary, the subsidiary's loss of the funds may be borne by creditors of the higher tier member even though the subsidiary is itself solvent (because it incurred no debt).

Because the proposed regulations measured insolvency by taking into account all higher tier subsidiaries, groups would have been able to reattribute losses borne by creditors merely because of the presence of solvent higher tier subsidiaries. To prevent the reattribution of losses that are in fact borne by creditors, the proposed regulations are amended to determine insolvency by taking into account only the sum of the separate insolvencies of the reattributing subsidiary and those higher tier subsidiaries that are insolvent. Special rules are provided for preferred stock and intercompany liabilities.

Under the proposed regulations, insolvency was defined as the excess of

a subsidiary's liabilities over the fair market value of the subsidiary's assets. Comments suggested that alternative insolvency measurements should be available. For example, they suggested that insolvency be measured as either—

- (i) The excess of the subsidiary's liabilities over the greater of (A) the fair market value of its assets, or (B) the adjusted basis of its assets; or
- (ii) The lesser of (A) the subsidiary's insolvency, or (B) the sum of its adjustments for extraordinary gain dispositions and positive investment adjustments.

These suggestions are not adopted in the final regulations. Measuring insolvency by reference to the basis rather than the value of assets would introduce such problems as the proper treatment of built-in loss assets and loss carryovers from pre-acquisition years, disparities between the stock and asset basis of lower tier subsidiaries, duplication of basis if the stock and securities of lower tier subsidiaries are taken into account as well as their assets, and allocation of basis to minority stock ownership. Insolvency could not be measured by reference to extraordinary gain dispositions and positive investment adjustments because there is no relationship between insolvency and these factors.

b. Availability of Reattribution

Under the proposed regulations, reattribution of losses is available to the extent loss is disallowed but not to the extent basis is reduced in deconsolidation. Comments requested that reattribution also be permitted in connection with deconsolidations (or, if not at the time of deconsolidation, when the deconsolidated subsidiary's stock is sold by the group).

The final regulations do not extend the availability of reattribution to deconsolidation because permitting such reattribution would permit the transfer of attributes without an arm's-length transaction to protect against mismeasurement of the amount of loss. Permitting reattribution at the time deconsolidated stock is ultimately sold by the group would permit the transfer to the group of losses incurred after the subsidiary began filing separate returns.

The final regulations also clarify that reattribution is available only to the extent loss would be disallowed following the application of § 1.1502-20(c) (regardless of whether the statement required by § 1.1502-20(c)(3) is filed). Moreover, the amount of loss that would be disallowed and the losses that may be reattributed are determined immediately after the disposition, but

the reattribution is deemed to be made immediately before the disposition.

c. Applicability of Section 382 and SRLY Following Reattribution

Comments requested clarification as to the application of section 382 and the SRLY rules to losses that are reattributed under § 1.1502-20(g). The proposed regulations provided that the common parent succeeds to the reattributed losses as if the losses were succeeded to in a transaction described in section 381(a).

First, comments asked whether reattributed SRLY losses retain their character as SRLY losses. It is clear under § 1.1502-1(f) that SRLY losses of a predecessor of the common parent retain their character as SRLY losses following a transaction described in section 381(a). *See, e.g.,* Rev. Rul. 75-378, 1975-2 C.B. 355. Under § 1.1502-20(g), the subsidiary whose losses are reattributed is treated as a predecessor whose reattributed losses are succeeded to by the common parent in a transaction described in section 381(a). Proposed Example 3 of § 1.1502-20(g)(4) has been clarified to show that reattributed SRLY losses retain their character as SRLY losses. The SRLY limitation applicable to reattributed losses is based on the contribution of the common parent to the consolidated taxable income of the group.

Second, comments inquired as to the application of proposed § 1.1502-91 through § 1.1502-99 to reattributed losses. Clarification will be provided in connection with finalizing proposed § 1.1502-91 through § 1.1502-99 and proposed § 1.1502-21. For example, it is anticipated that § 1.1502-95 will be modified to provide that the common parent will be permitted to elect to retain all or any part of a section 382 limitation that applies to reattributed SRLY losses.

d. Contingent Reattribution of Loss

Comments requested that the provisions permitting reattribution of loss be expanded to permit certain adjustments to the reattribution based on subsequent events, for example, the redetermination of the amount of loss available for reattribution on a subsequent audit.

The final regulations do not adopt the suggested amendments. The rules already provide significant flexibility in identifying the losses to be reattributed. Because the group and the member whose losses are reattributed may be under the control of separate taxpayers following the disposition or file returns in different Service Centers, it would be administratively burdensome for the

Service to coordinate subsequent adjustments.

8. Amendments to Section 1.1502-20(h)

a. Application of Section 1.1502-20T

Under the proposed regulations, taxpayers may elect to apply § 1.1502-20 to dispositions on or after November 19, 1990 rather than the general February 1, 1991 effective date of § 1.1502-20. Comments requested that, because of the burdens associated with tracing under § 1.337(d)-1, the attractiveness under proposed § 1.1502-20 and § 1.1502-20T of netting of gain and loss and reattributing disallowed losses, and the difficulty of determining whether worthlessness has occurred before or after a particular date, groups be permitted to elect to apply the rules of proposed § 1.1502-20 for dispositions before November 19, 1990. Comments also urged that groups be permitted to rely, in appropriate cases, on the rules under § 1.1502-20T, which were retroactively withdrawn on November 19, 1990.

Failure to permit taxpayers that entered into transactions to which § 1.1502-20T applied by its terms to continue to rely on that section was an oversight. Because taxpayers, in reliance on its provisions, may have completed transactions following the issuance of § 1.1502-20T (or entered into binding contracts following the issuance of § 1.1502-20T which closed after it was withdrawn and while either § 1.337(d)-2 or § 1.1502-20 was effective), those temporary regulations are made available for stock dispositions on or after March 9, 1990 and before November 19, 1990 (as well as to subsequent dispositions pursuant to contracts that were binding on November 19, 1990), provided the taxpayer certifies that it is applying § 1.1502-20T to all dispositions of subsidiary stock occurring during that period. The taxpayer may not withdraw the certification. Because taxpayers were notified on November 19, 1990 of the withdrawal of § 1.1502-20T, however, § 1.1502-20T may not be applied to dispositions on and after that date (other than dispositions pursuant to a contract binding on that date).

Although comments requested that groups be permitted to elect to apply proposed § 1.1502-20 for dispositions before November 19, 1990, this election has not been provided.

b. Binding Contracts Generally

Comments asked that the binding contract rule be expanded to include letters of intent or some form of

"substantial activity" indicating an intention to proceed with a transaction. Other comments requested the ability to modify contracts in certain respects without losing the benefit of the binding contract rule. No amendments have been adopted in this regard.

The purpose of binding contract and similar rules is to permit transactions to be taxed under the rules that may have been taken into account in determining the irrevocable terms of the transaction. The factual and legal issues relevant to the determination of whether a contract is binding are not unique to these regulations, and, accordingly, no guidance is provided in these regulations.

c. Reasonable Reliance on Proposed Section 1.1502-20

To the extent that taxpayers have relied in good faith on the provisions of proposed § 1.1502-20 and are adversely affected by the amendments adopted as part of finalizing § 1.1502-20, requests may be submitted to the Service for relief under section 7805(b).

d. Effective Dates

Final § 1.1502-20 generally applies with respect to dispositions and deconsolidations occurring on or after February 1, 1991. However, taxpayers may elect to apply § 1.1502-20 to dispositions and deconsolidations occurring on or after November 19, 1990.

F. Amendment and Adoption of Section 1.337(d)-2

After full consideration of the comments and the statements made at the public hearing, proposed § 1.337(d)-2 is amended and adopted as a final regulation, superseding § 1.337(d)-2T as of November 19, 1990. Section 1.337(d)-2 provides a window period in which the rules of § 1.337(d)-1 are carried forward and more broadly applied. The purpose of this window period was to allow groups to complete transactions initiated on or before November 19, 1990.

Final § 1.337(d)-2 generally applies with respect to dispositions and deconsolidations occurring on or after November 19, 1990 and before February 1, 1991 (the effective date of § 1.1502-20). However, a group may apply § 1.337(d)-2 (c) to establish that loss is not attributable to the recognition of built-in gain only if the group's entire equity interest in the subsidiary is disposed of to unrelated persons before February 1, 1991. Thus, § 1.337(d)-2 (c) does not apply if only a portion of the stock held by the group is disposed of, or if the stock is sold to a related person.

Many of the amendments to § 1.337(d)-2 conform to the amendments to § 1.1502-20, described in paragraph E, above. To eliminate duplication, many of the provisions of § 1.337(d)-2 have been replaced by crossreferences to similar provisions of §§ 1.337(d)-1 and § 1.1502-20. To facilitate this crossreferencing, the facts of Examples 1 and 2 of § 1.1502-20(b) have been modified so that they apply to both § 1.1502-20 and § 1.337(d)-1. No substantive change is intended by these amendments.

To the extent that taxpayers have relied in good faith on the provisions of § 1.337(d)-2T and are adversely affected by the amendments adopted as part of finalizing § 1.337(d)-2, requests may be submitted to the Service for relief under section 7805(b).

1. Dispositions to Related Parties

In order to be able to use tracing to prove that stock loss during the window period is not attributable to recognized built-in gain, the group must dispose of the subsidiary's stock to an unrelated person. Many comments criticized this requirement, and asked that groups be permitted worthless stock loss and loss on liquidating distributions of lower tier stock (e.g., liquidations under section 367 to a foreign parent corporation).

Relief has been extended to worthless stock losses but not to liquidations. The purpose of the unrelated person requirement is to limit the availability of tracing to cases in which there was a meaningful disposition of the subsidiary during the window period. Because worthless stock loss is difficult to establish and is the product of involuntary events, the Treasury Department and the Service determined that relaxation of the related party requirement with respect to worthlessness of subsidiary stock was warranted. In contrast, liquidation of subsidiary stock merely rearranges assets among related entities. The availability of tracing therefore is not extended to liquidations.

Although some comments argued that special considerations were raised as to the application of General Utilities repeal to section 367(e)(2) (i.e., liquidating distributions by a domestic parent of stock of domestic subsidiaries to a foreign higher tier corporation), the Treasury Department and the Service determined that section 367 presents no special General Utilities repeal considerations that warrant preferential treatment for liquidations subject to that provision.

2. Measurement of Built-In Gain

Built-in gain is defined under proposed § 1.337(d)-2(c)(2) as gain attributable, directly or indirectly, in whole or in part, to any excess of value over basis attributable to a separate return year (as defined in § 1.1502-1(e)) with respect to the consolidated group (or prior consolidated group).

Comments argued that built-in gain should be limited to appreciation attributable to a separate return limitation year (as defined in § 1.1502-1) rather than to a separate return year. This limitation would exempt appreciation arising after a subsidiary joins a group but before the group becomes a consolidated group. The comments argued that stock loss should not be disallowed with respect to such gain because it is not reflected in the subsidiary's stock basis before the assets are disposed of.

To resolve the issues arising under the proposed definition of built-in gain and conform the definition to § 1.1502-20(c), the definition is amended. Under the amended provisions, built-in gain is defined by referring to appreciation that is reflected, before the disposition of the asset, in the basis of the share, directly or indirectly, after applying section 1503(e) and other applicable provisions of the Code and regulations. Accordingly, appreciation arising in separate return years is not treated as built-in gain unless it is reflected in stock basis before the disposition of the asset.

The amendment also addresses additional problems raised by the proposed and temporary regulations. For example, if a built-in gain asset of a corporation is exchanged in a nonrecognition transaction after the corporation becomes a member of a consolidated group, the proposed regulations are unclear as to whether gain on the asset acquired in the exchange is built-in gain, because the asset was not held by the subsidiary when it became a member of the consolidated group. Under the amendment, the gain is built-in gain, and the disposition of the asset acquired in the exchange results in disallowance of loss on the sale of the subsidiary's stock. Guidance as to when appreciation is considered to be reflected in basis is contained in § 1.1502-20(c)(2) and § 1.1502-20(e).

Although § 1.337(d)-2(c) confirms that a subsidiary's built-in gain and built-in loss may be netted, comments also questioned whether built-in gain recognized by one subsidiary may be netted with built-in loss recognized by

another subsidiary in the same chain. Because the principles of the regulations authorize netting where stock reflects or fails to reflect both amounts, no amendments are needed in this regard.

3. Effective Dates

Comments argued that requiring tracing for pre-Notice 87-14 basis is an invalid retroactive denial of loss, and that the administrative burdens of tracing investment adjustments back to 1966 are unreasonable. Other comments argued that subsidiaries becoming members of consolidated groups before January 7, 1987 should not be subject to tracing during the window period. These latter comments argued that neither Notice 87-14 nor § 1.1502-20T put these subsidiaries on notice that they would be subject to tracing or to loss disallowance because the regulations were withdrawn, and taxpayers are entitled to notice before application of the loss disallowance rules.

The window period tracing rule was adopted in response to taxpayer comments, and taxpayers therefore had adequate notice. Applying tracing to all subsidiaries during the window period is consistent with the decision, explained in the November 1990 Preamble, not to grandfather pre-1987 subsidiaries from the application of § 1.1502-20.

For the reasons described in paragraph E.8.a., above, the effective date of § 1.337(d)-2 provides that § 1.1502-20T (which was withdrawn by T.D. 8319) may be applied to certain dispositions occurring on or after November 19, 1990 pursuant to contracts that were binding on November 19, 1990.

G. Amendments to Section 1.337(d)-1

Section 1.337(d)-1 applies to stock of corporations that became members of a group after January 6, 1987, if the stock is disposed of and neither § 1.337(d)-2 nor § 1.1502-20 apply with respect to the disposition. Stock loss is disallowed except to the extent the group establishes the loss is not attributable to recognized built-in gain on the disposition of an asset. Section 1.337(d)-1 is described in the March 1990 and November 1990 Preambles.

Although § 1.337(d)-1, as finalized, confirms that a subsidiary's built-in gain and built-in loss may be netted, comments questioned whether built-in gain recognized by one subsidiary may be netted with built-in loss recognized by another subsidiary in the same chain. Because the regulations authorize netting where stock reflects or fails to reflect both amounts, no amendments are needed to permit this result.

Certain amendments have been made to § 1.337(d)-1(a) to conform to the

amendments to § 1.1502-20. These amendments are described in paragraph E, above.

For the reasons described in paragraph E.8.a., above the effective date of § 1.337(d)-1 is amended to provide that § 1.1502-20T (which was withdrawn by T.D. 8319) may be applied to dispositions occurring before November 19, 1990 (and for certain subsequent dispositions pursuant to contracts that were binding on November 19, 1990).

Comments requested a binding contract rule for agreements entered into on or after March 9, 1990, and before November 19, 1990, in order to remain subject to § 1.337(d)-1. Groups may want to apply § 1.337(d)-1 rather than § 1.337(d)-2 because of the requirement under § 1.337(d)-2(c) that the group's entire equity interest in a subsidiary be disposed of before the effective date of § 1.1502-20, and because of the deconsolidation limitations of § 1.337(d)-2(b). The final regulations do not expand the binding contract rule because taxpayers entering into agreements on or after March 9, 1990 had no reasonable expectation of an extension of the § 1.337(d)-1 rules.

Special Analyses

These final regulations are not major rules as defined in Executive Order 12291. Therefore a Regulatory Impact Analysis is not required.

It is hereby certified that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations.

It is hereby certified that these rules do not have a significant impact on a substantial number of small entities. The rules will primarily affect affiliated groups of corporations filing (or required to file) consolidated returns, which tend to be larger businesses. The rules will not significantly alter the reporting or recordkeeping duties of small entities. Therefore, a final Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required.

Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking for the regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on the impact of the rules on small business.

Drafting Information

The project attorney is Mark S. Jennings of the Office of Assistant Chief Counsel (Corporate), Internal Revenue Service. Other personnel of the Internal Revenue Service and the Treasury

Department also participated in the development of these regulations.

List of Subjects in 26 CFR

1.261-1 Through 1.280H-1T

Income taxes, Reporting and recordkeeping requirements.

1.336-1 Through 1.383(h)(10)-1T

Income taxes, Reporting and recordkeeping requirements, Securities.

1.1501-12 Through 1.1502-100

Income taxes.

Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Paragraph 1. The authority for part 1 is amended by removing the citation for § 1.337(d)-2T and adding the following citations:

Authority: Sec. 7805, 68A Stat. 917; 26 U.S.C. 7805 * * * § 1.337(d)-2 also issued under 26 U.S.C. 337(d) * * * § 1.1502-19 also issued under 26 U.S.C. 1502 * * * § 1.1502-20 also issued under 26 U.S.C. 337(d) and 1502.

Par. 2. Section 1.267(f)-3T is redesignated as § 1.267(f)-3, and is revised to read as follows:

§ 1.267(f)-3 Disposition or deconsolidation of subsidiary stock.

For purposes of applying section 267(f)(2) to the sale or exchange of the stock of one member of a consolidated group by another member, see §§ 1.337(d)-1(a), 1.337(d)-2(a), and 1.1502-20(a). For purposes of this section, the definitions in § 1.1502-1 apply.

Par. 3. Section 1.337(d)-1 is amended by revising paragraphs (a)(3), (a)(5) Example 8, (b)(3), (d)(1), and (e)(1) and by adding a new paragraph (e)(3). The revised and added provisions read as follows:

§ 1.337(d)-1 Transitional loss limitation rule.

(a) * * *

(3) *Coordination with loss deferral and other disallowance rules.* For purposes of this section, the rules of § 1.1502-20(a)(3) apply, with appropriate adjustments to reflect differences

between the approach of this section and that of § 1.1502-20.

(5) * * *

Example 8. Deferred loss and recognized gain. (i) P is the common parent of a consolidated group. S is a wholly owned subsidiary of P, and T is a wholly owned subsidiary of S. S purchased all of the T stock on February 1, 1987 for \$100, and T has an asset with a basis of \$40 and a value of \$100. T sells the asset for \$100, recognizing \$60 of gain. Under the investment adjustment system, S's basis in the T stock increases from \$100 to \$160. S sells its T stock to P for \$100 in a deferred intercompany transaction, recognizing a \$60 loss that is deferred under section 267(f) and § 1.1502-13(c). P subsequently sells all the stock of T for \$100 to X, a member of the same controlled group (as defined in section 267(f)) as P but not a member of the P consolidated group.

(ii) Under paragraph (a)(3) of this section, the application of paragraph (a)(1) of this section to S's \$60 loss is deferred, because S's loss is deferred under section 267(f) and § 1.1502-13(c). Although P's sale of the T stock to X would cause S's deferred loss to be taken into account under § 1.1502-13(f)(1)(iii), § 1.267(f)-2T(d)(2) provides that the loss is not taken into account because X is a member of the same controlled group as P and S. Nevertheless, under paragraph (a)(3) of this section, because the T stock ceases to be owned by a member of the P consolidated group, S's deferred loss is eliminated immediately before the sale and is never taken into account under section 267(f).

(iii) The facts are the same as in (i) of this Example, except that S is liquidated after its sale of the T stock to P, but before P's sale of the T stock to X. Section 1.267(f)-2T(d)(2) and § 1.267-1T(c)(6) and (7) provide that, because S liquidated while the T stock is still owned by P, S's \$60 deferred loss is not restored to S. Instead, P's basis in the T stock is increased by the unrestored deferred loss, from \$100 to \$160. Because S's deferred loss is eliminated by section 267(f) before the occurrence of any of the events described in paragraph (a)(3) of this section, no deferred loss remains to be disallowed under paragraph (a)(1) of this section. However, P's \$60 loss on its disposition of the T stock is disallowed under paragraph (a)(1) of this section, because it is attributable to the recognition of built-in gain by a transitional subsidiary on the disposition of an asset after January 6, 1987.

(b) * * *

(3) **Coordination with loss deferral and other disallowance rules.** For purposes of this section, the rules of § 1.1502-20(a)(3) apply, with appropriate adjustments to reflect differences between the approach of this section and that of § 1.1502-20.

(d) **Investment adjustments and earnings and profits—(1) In general.** For purposes of determining investment adjustments under § 1.1502-32 and earnings and profits under § 1.1502-33(c)

with respect to a member of a consolidated group that owns stock in a subsidiary, any deduction that is disallowed under this section is treated as a loss arising and absorbed by the member in the tax year in which the disallowance occurs.

(e) **Effective dates—(1) General rule.** This section applies with respect to dispositions after January 6, 1987. For dispositions on or after November 19, 1990, however, this section applies only if the stock was deconsolidated (as that term is defined in § 1.337(d)-2(b)(2)) before November 19, 1990, and only to the extent the disposition is not subject to § 1.337(d)-2 or § 1.1502-20.

(3) **Application of § 1.1502-20T to certain transactions—(i) In general.** If a group files the certification described in paragraph (e)(3)(ii) of this section, it may apply § 1.1502-20T (as contained in the CFR edition revised as of April 1, 1990), to all of its members with respect to all dispositions and deconsolidations by the certifying group to which § 1.1502-20T otherwise applied by its terms occurring—

(A) On or after March 9, 1990 (but only if not pursuant to a binding contract described in § 1.337(d)-1T(e)(2) (as contained in the CFR edition revised as of April 1, 1990) that was entered into before March 9, 1990); and

(B) Before November 19, 1990 (or thereafter, if pursuant to a binding contract described in § 1.1502-20T(g)(3) that was entered into on or after March 9, 1990 and before November 19, 1990).

The certification under this paragraph (e)(3)(i) with respect to the application of § 1.1502-20T to any transaction described in this paragraph (e)(3)(i) may not be withdrawn and, if the certification is filed, § 1.1502-20T must be applied to all such transactions on all returns (including amended returns) on which such transactions are included.

(ii) **Time and manner of filing certification.** The certification described in paragraph (e)(3)(i) of this section must be made in a separate statement entitled "[insert name and employer identification number of common parent] hereby certifies under § 1.337(d)-1 (e)(3) that the group of which it is the common parent is applying § 1.1502-20T to all transactions to which that section otherwise applied by its terms." The statement must be signed by the common parent and filed with the group's income tax return for the taxable year of the first disposition or deconsolidation to which the certification applies. If the separate statement required under this paragraph

(e)(3) is to be filed with a return the due date (including extensions) of which is before November 16, 1991, the statement may be filed with an amended return for the year of the disposition or deconsolidation that is filed within 180 days after September 13, 1991. Any other filings required under § 1.1502-20T, such as the statement required under § 1.1502-20T(f)(5), may be made with the amended return, regardless of whether § 1.1502-20T permits such filing by amended return.

Par. 4. Section 1.337(d)-2T is removed as of November 19, 1990, and new § 1.337(d)-2 is added to read as follows:

§ 1.337(d)-2 Loss limitation window period.

(a) **Loss disallowance—(1) General rule.** No deduction is allowed for any loss recognized by a member of a consolidated group with respect to the disposition of stock of a subsidiary.

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

(i) The definitions in § 1.1502-1 apply.

(ii) **Disposition** means any event in which gain or loss is recognized, in whole or in part.

(3) **Coordination with loss deferral and other disallowance rules.** For purposes of this section, the rules of § 1.1502-20(a)(3) apply, with appropriate adjustments to reflect differences between the approach of this section and that of § 1.1502-20.

(b) **Basis reduction on deconsolidation—(1) General rule.** If the basis of a member of a consolidated group in a share of stock of a subsidiary exceeds its value immediately before a deconsolidation of the share, the basis of the share is reduced at that time to an amount equal to its value. If both a disposition and a deconsolidation occur with respect to a share in the same transaction, paragraph (a) of this section applies and, to the extent necessary to effectuate the purposes of this section, this paragraph (b) applies following the application of paragraph (a) of this section.

(2) **Deconsolidation.** "Deconsolidation" means any event that causes a share of stock of a subsidiary that remains outstanding to be no longer owned by a member of any consolidated group of which the subsidiary is also a member.

(3) **Value.** Value means fair market value.

(4) **Loss within 2 years after basis reduction—(i) In general.** If a share is deconsolidated and a direct or indirect disposition of the share occurs within 2 years after the date of the deconsolidation, a separate statement

entitled "statement pursuant to § 1.337(d)-2(b)(4)" must be filed with the taxpayer's return for the year of disposition. If the taxpayer fails to file the statement as required, no deduction is allowed for any loss recognized with respect to the disposition. If the separate statement is required to be filed with a return the due date (including extensions) of which is before January 16, 1991, or with a return due (including extensions) after January 15, 1991 but filed before that date, the statement may be filed with an amended return for the year of the disposition or with the taxpayer's first subsequent return the due date (including extensions) of which is after January 15, 1991. A disposition after the 2-year period described in this paragraph (b)(4) that is pursuant to an agreement, option, or other arrangement entered into within the 2-year period is treated as a disposition within the 2-year period for purposes of this section.

(ii) *Contents of statement.* The statement required under paragraph (b)(4)(i) of this section must contain—

(A) The name and employer identification number (E.I.N.) of the subsidiary.

(B) The amount of prior basis reduction with respect to the stock of the subsidiary under paragraph (b)(1) of this section.

(C) The basis of the stock of the subsidiary immediately before the disposition.

(D) The amount realized on the disposition.

(E) The amount of the loss recognized on the disposition.

(c) *Allowable loss—(1) Application.* This paragraph (c) applies with respect to stock of a subsidiary only if—

(i) Before February 1, 1990, the consolidated group either—

(A) Disposes (in one or more transactions) of its entire equity interest in the subsidiary to persons not related to any member of the consolidated group within the meaning of section 267(b) or section 707(b)(1) (substituting "10 percent" for "50 percent" each place that it appears); or

(B) Sustains a worthless stock loss under section 165(g); and

(ii) A separate statement entitled "allowed loss under § 1.337(d)-2(c)" is filed in accordance with paragraph (c)(3) of this section.

(2) *General rule.* Loss is not disallowed under paragraph (a)(1) of this section and basis is not reduced under paragraph (b)(1) of this section to the extent the taxpayer establishes that the loss or basis is not attributable to the recognition of built-in gain on the disposition of an asset (including stock and securities). Loss or basis may be

attributable to the recognition of built-in gain on the disposition of an asset by a prior group. For purposes of this section, gain recognized on the disposition of an asset is built-in gain to the extent 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, after applying section 1503(e) and other applicable provisions of the Code and regulations.

(3) *Contents of statement and time of filing.* The statement required under paragraph (c)(1)(ii) of this section must be filed with the taxpayer's return for the year of the disposition or deconsolidation, and must contain—

(i) The name and employer identification number (E.I.N.) of the subsidiary.

(ii) The basis of the stock of the subsidiary immediately before the disposition or deconsolidation.

(iii) The amount realized on the disposition and the amount of fair market value on the deconsolidation.

(iv) The amount of the deduction not disallowed under paragraph (a)(1) of this section by reason of this paragraph (c) and the amount of basis not reduced under paragraph (b)(1) of this section by reason of this paragraph (c).

(v) The amount of loss disallowed under paragraph (a)(1) of this section and the amount of basis reduced under paragraph (b)(1) of this section.

If the separate statement is required to be filed with a return the due date (including extensions) of which is before January 16, 1991, or with a return due (including extensions) after January 15, 1991 but filed before that date, the statement may be filed with an amended return for the year of the disposition or deconsolidation or with the taxpayer's first subsequent return the due date (including extensions) of which is after January 15, 1991.

(4) *Example.* The principles of paragraphs (a), (b), and (c) of this section are illustrated by the examples in §§ 1.337(d)-1(a) and 1.1502-20(a) (other than *Examples 3, 4, and 5*) and (b), with appropriate adjustments to reflect differences between the approach of this section and that of § 1.1502-20, and by the following example. For purposes of the examples in this section, unless otherwise stated, the group files consolidated returns on a calendar year basis, the facts set forth the only corporate activity, and all sales and purchases are with unrelated buyers or sellers. The basis of each asset is the same for determining earnings and profits adjustments and taxable income. Tax liability and its

effect on basis, value, and earnings and profits are disregarded. "Investment adjustment system" means the rules of §§ 1.1502-32 and 1.1502-33(c).

Example. Loss offsetting built-in gain in a prior group. (i) P buys all the stock of T for \$50 in Year 1, and T becomes a member of the P group. T has 2 assets. Asset 1 has a basis of \$50 and a value of \$0, and asset 2 has a basis of \$0 and a value of \$50. T sells asset 2 during Year 3 for \$50, and recognizes a \$50 gain. Under the investment adjustment system, P's basis in the T stock increases to \$100 as a result of the recognition of gain. In year 5, all of the stock of P is acquired by the P1 group, and the former members of the P group become members of the P1 group. T then sells asset 1 for \$0, and recognizes a \$50 loss. Under the investment adjustment system, P's basis in the T stock decreases to \$50 as a result of the loss. T's assets decline in value from \$50 to \$40. P then sells all the stock of T for \$40 and recognizes a \$10 loss.

(ii) P's basis in the T stock reflects both T's unrecognized gain and unrecognized loss with respect to its assets. The gain T recognizes on the disposition of asset 2 is built-in gain with respect to both the P and the P1 groups for purposes of paragraph (c)(2) of this section. In addition, the loss T recognizes on the disposition of asset 2 is built-in loss with respect to the P and P1 groups for purposes of paragraph (c)(2) of this section. T's recognition of the built-in loss while a member of the P1 group offsets the effect on T's stock basis of T's recognition of the built-in gain while a member of the P group. Thus, P's \$10 loss on the sale of the T stock is not attributable to the recognition of built-in gain, and the loss is therefore not disallowed under paragraph (c)(2) of this section.

(iii) The result would be the same if, instead of having a \$50 built-in loss in asset 2 when it becomes a member of the P group, T has a \$50 net operating loss carryover and the carryover is used by the P group.

(d) *Successors.* For purposes of this section, the rules and examples of § 1.1502-20(d) apply, with appropriate adjustments to reflect differences between the approach of this section and that of § 1.1502-20.

(e) *Anti-avoidance rules.* For purposes of this section, the rules and examples of § 1.1502-20(e) apply, with appropriate adjustments to reflect differences between the approach of this section and that of § 1.1502-20.

(f) *Investment adjustments and earnings and profits.* For purposes of this section, the rules and examples of § 1.1502-20 (f) apply, with appropriate adjustments to reflect differences between the approach of this section and that of § 1.1502-20.

(g) *Effective dates—(1) General rule.* Except as otherwise provided in this paragraph (g), this section applies with respect to dispositions and deconsolidations on or after November

19, 1990, but only to the extent the disposition or deconsolidation is not subject to § 1.1502-20. For this purpose, dispositions deferred under §§ 1.1502-13, 1.1502-13T, 1.1502-14, and 1.1502-14T are deemed to occur at the time the deferred gain or loss is taken into account unless the stock was deconsolidated before November 19, 1990. If stock of a subsidiary became worthless during a taxable year including November 19, 1990, the disposition with respect to the stock is treated as occurring on the date the stock became worthless.

(2) *Binding contract rule.* For purposes of this paragraph (g), if a disposition or deconsolidation is pursuant to a binding written contract entered into before March 9, 1990, and in continuous effect until the disposition or deconsolidation, the date the contract became binding is treated as the date of the disposition or deconsolidation.

(3) *Application of § 1.1502-20T to certain transactions—(i) In general.* If a group files the certification described in paragraph (g)(3)(ii) of this section, it may apply § 1.1502-20T (as contained in the CFR edition revised as of April 1, 1990), to all of its members with respect to all dispositions and deconsolidations by the certifying group to which § 1.1502-20T otherwise applied by its terms occurring—

(A) On or after March 9, 1990 (but only if not pursuant to a binding contract described in § 1.337(d)-1T(e)(2) (as contained in the CFR edition revised as of April 1, 1990) that was entered into before March 9, 1990); and

(B) Before November 19, 1990 (or thereafter, if pursuant to a binding contract described in § 1.1502-20T(g)(3) that was entered into on or after March 9, 1990 and before November 19, 1990).

The certification under this paragraph (g)(3)(i) with respect to the application of § 1.1502-20T to any transaction described in this paragraph (g)(3)(i) may not be withdrawn and, if the certification is filed, § 1.1502-20T must be applied to all such transactions on all returns (including amended returns) on which such transactions are included.

(ii) *Time and manner of filing certification.* The certification described in paragraph (g)(3)(i) of this section must be made in a separate statement entitled "[insert name and employer identification number of common parent] hereby certifies under § 1.337(d)-2(g)(3) that the group of which it is the common parent is applying § 1.1502-20T to all transactions to which that section otherwise applied by its terms." The statement must be signed by the common parent and filed with the group's income tax return for the

taxable year of the first disposition or deconsolidation to which the certification applies. If the separate statement required under this paragraph (g)(3) is to be filed with a return the due date (including extensions) of which is before November 16, 1991, the statement may be filed with an amended return for the year of the disposition or deconsolidation that is filed within 180 days after September 13, 1991. Any other filings required under § 1.1502-20T, such as the statement required under § 1.1502-20T(f)(5), may be made with the amended return, regardless of whether § 1.1502-20T permits such filing by amended return.

Par. 5. Section 1.1502-19 is amended as follows:

- a. The text of paragraph (a)(6) is redesignated as paragraph (a)(6)(i);
- b. A heading for redesignated (a)(6)(i) is added;
- c. New paragraph (a)(6)(ii) is added;
- d. The revised and added provisions read as follows:

§ 1.1502-19 Excess losses.

- (a) * * *
- (6) *Election to reduce basis of other investment—(i) In general.* * * *
- (ii) *Limitation.* The basis of stock may not be reduced pursuant to an election under § 1.1502-19(a)(6)(i) to the extent the reduction has the effect of netting gain or loss in a manner that would not be permitted under § 1.1502-20(a)(4) and 1.1502-20(b)(4).

Par. 6. New § 1.1502-20 is added to read as follows:

§ 1.1502-20 Disposition or deconsolidation of subsidiary stock.

(a) *Loss disallowance—(1) General rule.* No deduction is allowed for any loss recognized by a member with respect to the disposition of stock of a subsidiary.

(2) *Disposition.* Disposition means any event in which gain or loss is recognized, in whole or in part.

(3) *Coordination with loss deferral and other disallowance rules—(i) In general.* Loss with respect to the stock of a subsidiary may be deferred or disallowed under other applicable provisions of the Code and regulations, including section 267(f). Paragraph (a)(1) of this section does not apply to loss that is disallowed under any other provision. If loss is deferred under any other provision, paragraph (a)(1) of this section applies when the loss is taken into account. However, if an overriding event described in paragraph (a)(3)(ii) of this section occurs before the deferred loss is taken into account, paragraph (a)(1) of this section applies to the loss

immediately before the event occurs even though the loss may not be taken into account until a later time. Any loss not disallowed under paragraph (a)(1) of this section is subject to disallowance or deferral under other applicable provisions of the Code and regulations.

(ii) *Overriding events.* For purposes of paragraph (a)(3)(i) of this section, the following are overriding events—

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

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

(C) The stock is disposed of within the meaning of § 1.1502-19(b)(2) (other than § 1.1502-19(b)(2)(ii)).

(4) *Netting.* Paragraph (a)(1) of this section does not apply to loss with respect to the disposition of stock of a subsidiary, to the extent that, as a consequence of the same plan or arrangement, gain is taken into account by members with respect to stock of the same subsidiary having the same material terms. If the gain to which this paragraph (a)(4) applies is less than the amount of the loss with respect to the disposition of the subsidiary's stock, the gain is applied to offset loss with respect to each share disposed of as a consequence of the same plan or arrangement in proportion to the amount of the loss deduction that would have been disallowed under paragraph (a)(1) of this section with respect to such share before the application of this paragraph (a)(4). If the same item of gain could be taken into account more than once in limiting the application of paragraphs (a)(1) and (b)(1) of this section, the item is taken into account only once. See § 1.1502-19(a)(6)(ii) for limits on the reduction of basis pursuant to an election under that section.

(5) *Examples.* For purposes of the examples in this section, unless otherwise stated, the group files consolidated returns on a calendar year basis, the facts set forth the only corporate activity, and all sales and purchases are with unrelated buyers or sellers. The basis of each asset is the same for determining earnings and profits adjustments and taxable income. Tax liability and its effect on basis, value, and earnings and profits are disregarded. "Investment adjustment system" means the rules of §§ 1.1502-32 and 1.1502-33(c). The principles of this paragraph (a) are illustrated by the following examples.

Example 1. Loss attributable to recognized built-it gain. P buys all the stock of T for \$100, and T becomes a member of the P group. T has an asset with a basis of \$0 and a value of \$100. T sells the asset for \$100. Under the

investment adjustment system, P's basis in the T stock increases to \$200. Five years later, P sells all the T stock for \$100 and recognizes a loss of \$100. Under paragraph (a)(1) of this section, no deduction is allowed to P for the \$100 loss.

Example 2. Effect of post-acquisition appreciation. P buys all the stock of T for \$100, and T becomes a member of the P group. T has an asset with a basis of \$0 and a value of \$100. T sells the asset for \$100. Under the investment adjustment system, P's basis in the T stock increases to \$200. T reinvests the proceeds of the sale in an asset that appreciates in value to \$180. Five years after the sale, P sells all the stock of T for \$180 and recognizes a \$20 loss. Under paragraph (a)(1) of this section, no deduction is allowed to P for the \$20 loss.

Example 3. Disallowance of duplicated loss. P forms S with a contribution of \$100 in exchange for all of the S stock, and S becomes a member of the P group. S has an operating loss of \$60. The group is unable to use the loss, and the loss becomes a consolidated net operating loss carryover attributable to S. Five years later, P sells the stock of S for \$40, recognizing a \$60 loss. Under paragraph (a)(1) of this section, P's \$60 loss on the sale of the S stock is disallowed. (See paragraph (g) of this section for the elective reattribution of S's \$60 net operating loss to P in connection with the sale.)

Example 4. Deemed asset sale election. (i) P forms S with a contribution of \$100 in exchange for all of the S stock, and S becomes a member of the P group. S buys an asset for \$100, and the value of the asset declines to \$40. P sells all the S stock to P1 for \$40. Under paragraph (a)(1) of this section, P's \$60 loss on the sale of the S stock is disallowed.

(ii) If P and P1 instead elect deemed asset sale treatment under section 338 (h) (10), S is treated as selling all of its assets, and no loss is recognized by P on its sale of the S stock. As a result of the recharacterization of the stock sale as an asset sale, the \$60 loss in the asset is recognized. Under section 338 (h)(10), S's \$60 loss is included in the consolidated return of the P group, and S is treated as liquidating into P under section 332 following the deemed asset sale. Paragraph (a)(1) of this section does not apply to S's \$60 loss.

Example 5. Gain and loss recognized with respect to stock as a consequence of the same plan or arrangement. P, the common parent of a group, owns 50 shares of the stock of T with an aggregate basis of \$50, and S, a wholly owned subsidiary of P, owns the remaining 50 shares of T's stock with an aggregate basis of \$100. All of the stock has the same terms. P and S sell all the T stock to the public for \$140 pursuant to a single public offering. P therefore recognizes a gain of \$20 and S recognizes a loss of \$30. For purposes of paragraph (a)(4) of this section, the gain and loss recognized by P and S is considered to be a consequence of the same plan or arrangement. Accordingly, the amount of S's \$30 loss disallowed under paragraph (a)(1) of this section is limited to \$10 (the \$30 reduced by P's \$20 gain).

Example 6. Deferred loss and recognized gain. (i) P is the common parent of a consolidated group, S is a wholly owned

subsidiary of P, and T is a recently purchased, wholly owned subsidiary of S. S has a \$100 basis in the T stock, and T has an asset with a basis of \$40 and a value of \$100. T sells the asset for \$100, recognizing a \$60 gain. Under the investment adjustment system, S's basis in the T stock increases from \$100 to \$160. S sells its T stock to P for \$100 in a deferred intercompany transaction, recognizing a \$60 loss that is deferred under section 267(f) and § 1.1502-13 (c). P subsequently sells all the stock of T for \$100 to X, a member of the same controlled group (as defined in section 267(f)) as P but not a member of the P consolidated group.

(ii) Under paragraph (a)(3) of this section, the application of paragraph (a)(1) of this section to S's \$60 loss is deferred, because S's loss is deferred under section 267(f) and § 1.1502-13(c). Although P's sale of the T stock to X would cause S's deferred loss to be taken into account under § 1.1502-13(f)(1)(iii), § 1.267(f)-2T (d)(2) provides that the loss is not taken into account because X is a member of the same controlled group as P and S. Nevertheless, under paragraph (a)(3) of this section, because the T stock ceases to be owned by a member of the P consolidated group, S's deferred loss is eliminated immediately before the sale and is never taken into account under section 267(f).

(iii) The facts are the same as in (i) of this Example, except that S is liquidated after its sale of the T stock to P, but before P's sale of the T stock to X. Section 1.267(f)-2T(d)(2) and § 1.267-1T(c)(6) and (7) provide that, because S is liquidated while the T stock is still owned by P, S's \$60 deferred loss is not restored to S. Instead, P's basis in the T stock is increased by the unrestored deferred loss, from \$100 to \$160. Because S's deferred loss is eliminated by section 267 (f) before the occurrence of any of the events described in paragraph (a)(3) of this section, no deferred loss remains to be disallowed under paragraph (a)(1) of this section. However, P's \$60 loss on its disposition of the T stock is disallowed under paragraph (a)(1) of this section, because its \$60 of earnings and profits from extraordinary gain dispositions are indirectly reflected immediately before the disposition in the basis of the T stock.

(b) Basis reduction on deconsolidation—(1) General rule. If a member's basis in a share of stock of a subsidiary exceeds its value immediately before a deconsolidation of the share, the basis of the share is reduced at that time to an amount equal to its value. If both a disposition and a deconsolidation occur with respect to a share in the same transaction, paragraph (a) of this section applies and, to the extent necessary to effectuate the purposes of this section, this paragraph (b) applies following the application of paragraph (a) of this section.

(2) Deconsolidation. Deconsolidation means any event that causes a share of stock of a subsidiary that remains outstanding to be no longer owned by a member of any consolidated group of which the subsidiary is also a member.

(3) Value. Value means fair market value.

(4) Netting. Paragraph (b)(1) of this section does not apply to reduce the basis of stock of a subsidiary, to the extent that, as a consequence of the same plan or arrangement as that giving rise to the deconsolidation, gain is taken into account by members with respect to stock of the same subsidiary having the same material terms. If the gain to which this paragraph (b)(4) applies is less than the amount of basis reduction with respect to shares of the subsidiary's stock, the gain is applied to offset basis reduction with respect to each share deconsolidated as a consequence of the same plan or arrangement in proportion to the amount of the reduction that would have been required under paragraph (b)(1) of this section with respect to such share before the application of this paragraph (b)(4). If the same item of gain could be taken into account more than once in limiting the application of paragraphs (a)(1) and (b)(1) of this section, the time is taken into account only once. See § 1.1502-19(a)(6)(ii) for limits on the reduction of basis pursuant to an election under that section.

(5) Loss within 2 years after basis reduction—(i) In general. If a share is deconsolidated and a direct or indirect disposition of the share occurs within 2 years after the date of the deconsolidation, a separate statement entitled "Statement Pursuant to Section § 1.1502-20(b)(5)" must be filed with the taxpayer's return for the year of disposition. If the taxpayer fails to file the statement as required, no deduction is allowed for any loss recognized with respect to the disposition. A disposition after the 2-year period described in this paragraph (b)(5) that is pursuant to an agreement, option, or other arrangement entered into within the 2-year period is treated as a disposition within the 2-year period for purposes of this section.

(ii) Contents of statement. The statement required under paragraph (b)(5)(i) of this section must contain—

(A) The name and employer identification number (E.I.N.) of the subsidiary.

(B) The amount of prior basis reduction (if any) with respect to the stock of the subsidiary under paragraph (b)(1) of this section.

(C) The basis of the stock of the subsidiary immediately before the disposition.

(D) The amount realized on the disposition.

(E) The amount of the loss recognized on the disposition.

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

Example 1. Simultaneous application of loss disallowance rule and basis reduction rule to stock of the same subsidiary. (i) P buys all the stock of T for \$100, and T becomes a member of the P group. T has an asset with a basis of \$0 and a value of \$100. T sells the asset for \$100. Under the investment adjustment system, P's basis in the T stock increases to \$200. Five years later, P sells 60 shares of T stock for \$60 and recognizes \$60 loss on the sale. The sale causes a deconsolidation of the remaining 40 shares of T stock held by P.

(ii) P's \$60 loss on the sale of T stock is disallowed under paragraph (a)(1) of this section. Under paragraph (b)(1) of this section, P must reduce the basis of the 40 shares of T stock it continues to own from \$80 to \$40, the value of the shares immediately before the deconsolidation.

(iii) Although P's disposition of the 60 shares also causes a deconsolidation of these shares, paragraph (b)(1) of this section provides that, if both paragraph (a) and paragraph (b) of this section apply to a share in the same transaction, paragraph (a) of this section applies first and this paragraph (b) applies only to the extent necessary to effectuate the purposes of this section. Under paragraph (a)(1) of this section, P's \$60 loss on the sale of the 60 shares is disallowed. Under the facts of this example, it is not necessary to also apply this paragraph (b) to the 60 shares in order to effectuate the purposes of this section.

Example 2. Deconsolidation of subsidiary stock on contribution to a partnership. (i) P buys all the stock of T for \$100, and T becomes a member of the P group. T has an asset with a basis of \$0 and a value of \$100. T sells the asset for \$100. Under the investment adjustment system, P's basis in the T stock increases to \$200. Five years later, P transfers all the stock of T to partnership M in exchange for a partnership interest in M, in a transaction to which section 721 applies.

(ii) At the time of the exchange, P's basis in the T stock is \$200 and the T stock's value is \$100. Under paragraph (b) of this section, the transfer to M causes a deconsolidation of the T stock, and P must reduce its basis in the T stock, immediately before the transfer to M, from \$200 to the stock's \$100 value at the time of the transfer. As a result, P has a basis of \$100 in its interest in M, and M has a basis of \$100 in the stock of T.

Example 3. Simultaneous application of loss disallowance and basis reduction to stock of different subsidiaries. (i) P owns all the stock of S, which in turn owns all the stock of S1, and S and S1 are members of the P group. P's basis in the S stock is \$100 and S's basis in the S1 stock is \$100. S1 buys all the stock of T for \$100, and T becomes a member of the P group. T has an asset with a basis of \$0 and a value of \$100. T sells the asset for \$100. Under the investment adjustment system, S1's basis in the T stock, S's basis in the S1 stock, and P's basis in the S stock each increase from \$100 to \$200. S then sells all the S1 stock for \$100 and recognizes a loss of \$100.

(ii) Under paragraph (a)(1) of this section, S's \$100 loss on the sale of the S1 stock is disallowed.

(iii) If S1 and T are not members of a consolidated group immediately after the sale of the stock of S1, the T stock is deconsolidated and, under paragraph (b)(1) of this section, S1 must reduce the basis of the T stock to its \$100 value immediately before the sale.

(iv) If S1 and T are members of a consolidated group immediately after the sale of the S1 stock, the T stock is not deconsolidated, and no reduction is required under paragraph (b)(1) of this section.

Example 4. Extending the time period for dispositions. (i) In Year 1, P, the common parent of a group, buys all 100 shares of the stock of T for \$100. T's only asset has a basis of \$0 and a value of \$100. T sells the asset for \$100. Under the investment adjustment system, P's basis in the T stock increases from \$100 to \$200. At the beginning of Year 5, P causes T to issue 30 additional shares of stock to the public for \$30. This issuance causes a deconsolidation of the T stock owned by P, and paragraph (b)(1) of this section requires P to reduce its basis in the T stock from \$200 to \$100.

(ii) Within 2 years after the date of the basis reduction, P agrees to sell all of its T stock for \$90 at the end of Year 7. Under paragraph (b)(5) of this section, P's disposition of the T stock at the end of Year 7 is treated as occurring within the 2-year period following the basis reduction, because the disposition is pursuant to an agreement reached within 2 years after the basis reduction. Accordingly, P's \$10 loss may not be deducted unless P files the statement required under paragraph (b)(5) of this section. This result is reached whether or not the agreement is in writing. P's disposition would also have been treated as occurring within the 2-year period if the disposition were pursuant to an option issued within the period.

Example 5. Deferred loss and subsequent basis reduction. (i) P is the common parent of a consolidated group, S is a wholly owned subsidiary of P, and T is a recently purchased, wholly owned subsidiary of S. S has a \$100 basis in the T stock, and T has an asset with a basis of \$40 and a value of \$100. T sells the asset for \$100, recognizing \$60 of gain. Under the investment adjustment system, S's basis in the T stock increases from \$100 to \$160. S sells its T stock to P for \$100 in a deferred intercompany transaction and its \$60 loss is deferred under section 267(f) and § 1.1502-13(c). T issues 30 additional shares of stock to the public for \$30 which causes a deconsolidation of the T stock owned by P.

(ii) Because the fair market value of the T stock owned by P is \$100 immediately before the deconsolidation and P has a \$100 basis in the stock at that time, no basis reduction is required under paragraph (b)(1) of this section.

(iii) Under § 1.1502-13T(l), loss deferred with respect to stock sold in an intercompany transaction is generally taken into account in an amount equal to the decrease for the taxable year in the stock's basis recovery that is attributable to the intercompany

transaction. If S had not sold its T stock to P, paragraph (b)(1) of this section would have reduced the basis of the shares by \$60. The basis reduction required under paragraph (b)(1) of this section is a basis recovery for purposes of § 1.1502-13T(l), and the deferred intercompany transaction has reduced this basis recovery from \$60 to \$0. Thus, S's \$60 deferred loss is taken into account immediately before the deconsolidation.

(iv) Under paragraph (a)(3) of this section, the application of paragraph (a)(1) of this section to S's \$60 loss was deferred at the time of the sale to P because S's loss was deferred under section 267(f) and § 1.1502-13(c). However, the deconsolidation of the T stock is an overriding event under paragraph (a)(3)(ii) of this section and § 1.1502-19(b)(2)(i), and paragraph (a)(1) of this section applies to the loss immediately before the deconsolidation, even though the loss is not taken into account at that time.

Example 6. Gain and basis reduction with respect to the same plan or arrangement. (i) P, the common parent of a group, owns 50 shares of T stock with an aggregate basis of \$50, and S, a wholly owned subsidiary of P, owns the remaining 50 shares of T stock with an aggregate basis of \$100. All of the stock has the same terms. P sells all of its T stock to the public for \$70 and recognizes a \$20 gain. The sale causes a deconsolidation of S's 50 shares of T stock.

(ii) Under paragraph (b)(1) of this section, S must reduce the basis of its 50 shares of T stock from \$100 to \$70, the value of the shares immediately before the deconsolidation. However, under paragraph (b)(4) of this section, because P's \$20 gain is recognized as a consequence of the same plan or arrangement as that giving rise to the deconsolidation, S's basis reduction is eliminated to the extent of \$20. Thus, S must reduce the basis of its T stock from \$100 to \$90.

Example 7. Netting allocated between loss disallowance and basis reduction. (i) P is the common parent of a group and S is its wholly owned subsidiary. P and S each own 50 shares of T stock and each has an aggregate basis of \$50. All of the stock has the same terms. S recently purchased its T stock from S1, a lower tier subsidiary, in a deferred intercompany transaction in which S1 recognized a \$30 gain that was deferred under § 1.1502-13(c). T has an asset with a basis of \$0 and a value of \$100. T sells the asset for \$100, recognizing \$100 of gain. Under the investment adjustment system, P and S each increase the basis of their T stock to \$100. S sells all of its T stock to the public for \$50 and recognizes a \$50 loss. The sale causes a deconsolidation of P's T stock.

(ii) S's \$50 loss on the sale of T stock is disallowed under paragraph (a)(1) of this section. Under paragraph (b)(1) of this section, P must reduce its \$100 basis in the T stock to the \$50 value immediately before the deconsolidation.

(iii) Under § 1.1502-13T(l), the sale of S's T stock causes S1's \$30 deferred gain to be taken into account. Under paragraphs (a)(4) and (b)(4) of this section, the gain may be taken into account by P and S in limiting the application of paragraphs (a)(1) and (b)(1) of

this section, but it may be taken into account only once. Under paragraph (a)(4) of this section, S may apply the gain to decrease the amount of loss disallowed under paragraph (a)(1) of this section from \$50 to \$20. None of the gain remains to decrease the \$50 of P's basis reduction under paragraph (b)(1) of this section. (P may instead apply the gain to decrease the basis reduction under paragraph (b)(1) of this section instead of S decreasing its disallowed loss, but if the T stock is sold within 2 years, the statement described in paragraph (b)(5) of this section must be filed if a deduction is to be allowed for any loss recognized on the disposition.)

(c) *Allowable loss*—(1) *General rule*. The amount of loss disallowed under paragraph (a)(1) of this section and the amount of basis reduction under paragraph (b)(1) of this section with respect to a share of stock shall not exceed the sum of the following amounts—

(i) *Extraordinary gain dispositions*. The share's allocable part of any member's earnings and profits, net of directly related expenses, from extraordinary gain dispositions.

(ii) *Positive investment adjustments*. Earnings and profits that result in adjustments with respect to the share under § 1.1502-32 (b)(1)(i) and (c)(1), but only to the extent the amount of these earnings and profits for a taxable year exceeds the amount described in paragraph (c)(1)(i) of this section for the same taxable year.

(iii) *Duplicated loss*. The amount of duplicated loss with respect to the share.

(2) *Operating rules*. For purposes of applying paragraph (c)(1) of this section—

(i) *Extraordinary gain dispositions*. An "extraordinary gain disposition" is—

(A) An actual or deemed disposition of—

(1) A capital asset as defined in section 1221 (determined without the application of any other provision of the Code or regulations).

(2) Property used in a trade or business as defined in section 1231(b) (determined without the application of any holding period requirement).

(3) An asset described in section 1221 (1), (3), (4), or (5), if substantially all the assets in such category from the same trade or business are disposed of in one transaction (or series of related transactions).

(4) Assets disposed of in an applicable asset acquisition under section 1060(c).

(B) A change in method of accounting resulting in a positive section 481 adjustment.

(C) A discharge of indebtedness.

(D) Any other event (or item) identified by the Commissioner in revenue rulings and revenue procedures.

An extraordinary gain disposition is taken into account under paragraph (c)(1)(i) of this section only if it occurs on or after November 19, 1990 and results in income or gain for purposes of computing earnings and profits (determined net of directly related expenses). For this purpose, federal income taxes may be directly related to extraordinary gain dispositions only to the extent of the excess (if any) of the group's income tax liability actually imposed under subtitle A of the Internal Revenue Code for the taxable year of the extraordinary gain dispositions over the group's income tax liability for the taxable year redetermined by not taking into account the extraordinary gain dispositions. For this purpose, the group's income tax liability actually imposed and its redetermined income tax liability are determined without taking into account the foreign tax credit under section 27(a) of the Code.

(ii) *Positive investment adjustments*. For purposes of paragraph (c)(1)(ii) of this section, earnings and profits are treated as resulting in adjustments under § 1.1502-32 (b)(1)(i) and (c)(1) with respect to a share if they would have resulted in such adjustments but for distributions with respect to the share. If the adjustments with respect to a share are modified pursuant to § 1.1502-32(c)(3), the adjustments taken into account under paragraph (c)(1)(ii) of this section must be appropriately modified.

(iii) *Applicable earnings and profits*. Earnings and profits are described in paragraphs (c)(1) (i) and (ii) of this section only to the extent they are reflected in the basis of the share, directly or indirectly, immediately before the disposition or deconsolidation, after applying section 1503(e), § 1.1502-32(g), and other applicable provisions of the Code and regulations.

(iv) *Related party rule*. The amounts described in paragraphs (c)(1) (i) and (ii) of this section are not reduced or eliminated by reason of an acquisition of the share from a person related within the meaning of section 267(b) or section 707(b)(1), substituting "10 percent" for "50 percent" each place that it appears, even if the share is not transferred basis property as defined in section 7701 (a)(43).

(v) *Pre-September 13, 1991 positive investment adjustments*. The amount determined under paragraph (c)(1)(ii) of this section for all taxable years ending on or before September 13, 1991 (or such earlier taxable year determined under paragraph (c)(2)(v)(B)(1) of this section) is limited to the net increase, if any, in the basis of the share from—

(A) The date—

(1) The share was first acquired by a member (whether or not a member at that time), or

(2) If the share is transferred basis property (within the meaning of section 7701(a)(43)) from a prior consolidated group, the share was first acquired by a member of the prior group, to

(B) The earlier of—

(1) The end of any taxable year ending after December 31, 1986 and on or before [September 13, 1991] (whichever such year end produces the lowest net increase), or

(2) The date of disposition or deconsolidation of the share.

(vi) *Duplicated loss*. "Duplicated loss" is determined immediately after a disposition or deconsolidation, and equals the excess (if any) of—

(A) The sum of—

(1) The aggregate adjusted basis of the assets of the subsidiary other than any stock and securities that the subsidiary owns in another subsidiary, and

(2) Any losses attributable to the subsidiary and carried to the subsidiary's first taxable year following the disposition or deconsolidation, and

(3) Any deferred deductions (such as deductions deferred under section 469) of the subsidiary, over

(B) The sum of—

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

(2) Any liabilities of the subsidiary, and

(3) Any other relevant items.

The amounts determined under this paragraph (c)(2)(vi) with respect to a subsidiary include its allocable share of corresponding amounts with respect to all lower tier subsidiaries. If 80 percent or more in value of the stock of a subsidiary is acquired by purchase in a single transaction (or in a series of related transactions during any 12-month period), the value of the subsidiary's stock may not exceed the purchase price of the stock divided by the percentage of the stock (by value) so purchased. For this purpose, stock is acquired by purchase if the transferee is not related to the transferor within the meaning of sections 267(b) and 707(b)(1), substituting "10 percent" for "50 percent" each place that it appears, and the transferee's basis in the stock is determined wholly by reference to the consideration paid for such stock.

(3) *Statement of allowed loss*.

Paragraph (c)(1) of this section applies only if the separate statement required under this paragraph (c)(3) is filed with the taxpayer's return for the year of the disposition or deconsolidation. The statement must be entitled "ALLOWED

LOSS UNDER SECTION 1.1502-20(c)" and must contain—

(i) The name and employer identification number (E.I.N.) of the subsidiary.

(ii) The basis of the stock of the subsidiary immediately before the disposition or deconsolidation.

(iii) The amount realized on the disposition and the amount of fair market value on the deconsolidation.

(iv) The amount of the deduction not disallowed under paragraph (a)(1) of this section by reason of this paragraph (c) and the amount of basis not reduced under paragraph (b)(1) of this section by reason of this paragraph (c).

(v) The amount of loss disallowed under paragraph (a)(1) of this section and the amount of basis reduced under paragraph (b)(1) of this section.

(4) *Examples.* For purposes of the examples in this paragraph, unless otherwise stated, the group files the statement required under paragraph (c)(3) of this section. The principles of this paragraph (c) are illustrated by the following examples.

Example 1. Allowed loss attributable to lost built-in gain. (i) Individual A forms T. P buys all the stock of T from A for \$100, and T becomes a member of the P group. T has a capital asset with a basis of \$0 and a value of \$100. The value of the asset declines, and T sells the asset for \$40. Under the investment adjustment system, P's basis in the T stock increases to \$140. P then sells all the stock of T for \$40 and recognizes a loss of \$100.

(ii) The amount of the \$100 loss disallowed under paragraph (a)(1) of this section may not exceed the amount determined under paragraph (c)(1) of this section. The \$40 of T's earnings and profits is from an extraordinary gain disposition, as defined in paragraph (c)(2)(i) of this section, and is reflected, within the meaning of paragraph (c)(2)(iii) of this section, in the basis of the T stock immediately before the disposition. The earnings and profits are therefore described in paragraph (c)(1)(i) of this section. Because this amount is the only amount described in paragraph (c)(1) of this section, the amount of P's \$100 loss that is disallowed under paragraph (a)(1) of this section is limited to \$40. (No amount is described in paragraph (c)(1)(ii) of this section because the amount of T's positive investment adjustments does not exceed the amount included under paragraph (c)(1)(i) of this section.)

(iii) The results would be the same if the asset, instead of being owned by T, is owned by a partnership in which T is a partner and T is allocated the \$40 of gain pursuant to section 704(b). The \$40 gain represents earnings and profits from an extraordinary gain disposition, as defined in paragraph (c)(2)(i) of this section, and is reflected in the basis of the T stock immediately before the disposition, as required under paragraph (c)(2)(iii) of this section.

Example 2. Extraordinary gain dispositions. (i) Individual A forms T. P buys all the stock of T from A for \$100 in Year 1,

and T becomes a member of the P group. T owns a capital asset, asset 1, with a basis of \$0 and a value of \$100. T sells asset 1 for \$100 in Year 1 and invests the proceeds in a trade or business asset, asset 2. During Year 2, asset 2 produces \$30 of gross operating income and \$20 of cost recovery deductions. At the end of Year 2, asset 2 has an \$80 adjusted basis and T disposes of asset 2 for \$85; however, because T incurs \$20 of expenses directly related to the sale of asset 2, the disposition produces a \$15 loss for computing earnings and profits (this loss offsets T's \$10 of operating income in Year 2, as well as \$5 of operating income of P in that year). Under the investment adjustment system, P's basis in the T stock increases by \$95, to \$195, because T has \$110 of earnings and a \$15 loss. P sells the T stock for \$95 in Year 5 and recognizes a \$100 loss.

(ii) The \$100 of earnings and profits from the disposition of asset 1 is from an extraordinary gain disposition, as defined in paragraph (c)(2)(i) of this section, and is reflected, within the meaning of paragraph (c)(2)(iii) of this section, in the basis of the T stock immediately before the disposition. The earnings and profits are therefore described in paragraph (c)(1)(i) of this section. The sale of asset 2 is not an extraordinary gain disposition because, under paragraph (c)(2)(i) of this section, that sale did not result in income or gain when determined net of directly related expenses. (No amount is described under paragraph (c)(1)(ii) of this section because T does not have any positive investment adjustments in excess of the amount included under paragraph (c)(1)(i) of this section.) Because the \$100 amount described under paragraph (c)(1)(i) of this section equals P's \$100 loss from the disposition of T stock, all of the loss is disallowed.

Example 3. Positive investment adjustments. (i) Individual A forms T. S, a member of the P group, buys all the stock of T from A for \$100, and T becomes a member of the P group. T has an asset with a basis of \$0 and a value of \$100. The asset earns \$100 of operating income in Year 1 and declines in value to \$0. T invests the operating income in another asset which produces a \$25 operating deficit during Year 2. Under the investment adjustment system, S's basis in the T stock increases to \$200 at the end of Year 1, and decreases to \$175 at the end of Year 2. S sells all the stock of T for \$75 in Year 5 and recognizes a loss of \$100.

(ii) The \$100 of earnings and profits from operations in Year 1 is earnings and profits described in paragraph (c)(1)(ii) of this section. This amount is not reduced by the \$25 deficit from operations in Year 2. Because the \$100 amount described under paragraph (c)(1)(ii) of this section equals S's \$100 loss from the disposition of T stock, all of the loss is disallowed.

(iii) Under paragraph (c)(2)(iv) of this section, the result would have been the same if, prior to the decline in the value of the first asset (the value of the T stock was \$200, \$100 cash and a \$100 asset), S had sold the T stock to P for \$200 at no gain or loss, and P then sold the T stock to the unrelated buyer for \$75 (after the \$100 decline in the value of the asset and the \$25 operating deficit) and

recognized a \$100 loss. T had \$100 of earnings and profits that resulted in investment adjustments under the investment adjustment system and are reflected, within the meaning of paragraph (c)(2)(iii) of this section, in the basis of the T stock. The earnings and profits and investment adjustments with respect to the T stock are not reduced or eliminated for purposes of paragraphs (c)(1)(ii) of this section by reason of P's purchase of the stock, because P is a person related to S within the meaning of section 267(b).

Example 4. Treatment of net operating income as attributable to built-in gain. (i) Individual A forms T. P buys all the stock of T from A for \$100, and T becomes a member of the P group. T has a capital asset with a basis of \$0 and a value of \$100. The asset declines in value to \$40. The asset earns \$100 of operating income unrelated to its \$60 decline in value. Under the investment adjustment system, P's basis in the T stock increases to \$200. P then sells all the stock of T for \$140 (the asset worth \$40 and \$100 cash) and recognizes a loss of \$60.

(ii) The \$100 adjustment to the basis of the T stock is an amount described in paragraph (c)(1)(ii) of this section. Because this amount exceeds the amount of loss otherwise disallowed under paragraph (a)(1) of this section, P's entire \$60 loss from the disposition of T stock is disallowed.

Example 5. Carryover basis transactions—amounts attributable to separate return years. (i) Individual A forms T. S purchases all the stock of T from A for \$100, and T becomes a member of the S group. T has a capital asset with a basis of \$0 and a value of \$100. T sells the asset for \$100. Under the investment adjustment system, S's basis in the T stock increases to \$200. P buys all of the stock of S for \$100, and both S and T become members of the P group. S then sells the T stock for \$100 and recognizes a loss of \$100.

(ii) Under paragraph (c)(2)(iii) of this section, the \$100 adjustment to S's basis in the T stock while a member of the S group is an amount described in paragraph (c)(1)(i) of this section with respect to the P group because it continues to be reflected in the basis of the T stock immediately before the stock is disposed of. Because this amount equals the loss otherwise disallowed under paragraph (a)(1) of this section, S's \$100 loss from the disposition of T stock is disallowed.

Example 6. Cost basis for subsidiary stock. (i) In Year 1, individual A forms T. T's assets appreciate in value from \$0 to \$100, and T recognizes \$100 of gain in an extraordinary gain disposition. T reinvests the sale proceeds in assets that appreciate in value to \$150. In Year 3, A sells all of the T stock to P for \$150, and T becomes a member of the P group. While a member of the P group, T's assets decline in value to \$130 and P sells the T stock in Year 7 for \$130 and recognizes a \$20 loss.

(ii) Although T has \$100 of earnings and profits from extraordinary gain dispositions, the earnings and profits are not reflected, within the meaning of paragraph (c)(2)(iii) of this section, in P's basis in the T stock. P's basis in the T stock reflects the stock's value at the time of P's purchase, and is determined without regard to whether T recognized the

earnings and profits before the purchase. Thus, no part of T's earnings and profits are described in paragraph (c)(1) of this section, and no part of the \$20 loss is disallowed under paragraph (a) of this section. (For rules that apply if A and P are related persons, see paragraph (c)(2)(iv) of this section.)

Example 7. Adjustments to stock basis under applicable provisions of the Code and regulations. (i) Individual A forms T. P buys all the stock of T from A for \$100, and T becomes a member of the P group. T has indebtedness of \$300. After T becomes a member of the P group, T's assets decline in value and T's creditors agree to discharge \$200 of T's indebtedness. However, pursuant to section 108(a), the \$200 discharge is not included in the P group's gross income. Moreover, no attributes are reduced under section 108(b). Following the discharge, P disposes of its T stock for \$0.

(ii) The \$200 discharge of indebtedness is included in T's earnings and profits and, under § 1.1502-32(b)(1)(i), P's basis in the T stock is increased from \$100 to \$300. Under paragraph (c)(2)(i) of this section, this discharge is an extraordinary gain disposition for purposes of paragraph (c)(1)(i) of this section.

(iii) However, in determining the P group's loss on the disposition of the T stock, section 1503(e) excludes the \$200 discharge of indebtedness from T's earnings and profits and P's loss on the disposition is \$100 rather than \$300. Thus, for purposes of paragraph (c)(2)(iii) of this section, T's earnings and profits from the discharge of indebtedness are not reflected in the stock basis, directly or indirectly, immediately before the disposition. Consequently, when P disposes of the T stock, T's earnings and profits for purposes of paragraphs (c)(1)(i) and (ii) of this section are \$0, and P's \$100 loss on the disposition is not disallowed under paragraph (a) of this section.

Example 8. Duplicated loss. (i) Individual A forms T with a contribution of \$100 in exchange for all of the T stock. Individual B forms T1 with a contribution of land that has a \$90 basis and \$100 value. T buys all the stock of T1 from B for \$100. P buys all the stock of T from A for \$100, and both T and T1 become members of the P group. The value of T1's land declines to \$40. P sells all of the T stock for \$40 and recognizes a loss of \$60.

(ii) Under paragraph (c)(1)(iii) of this section, P's amount of duplicated loss is \$50. This is computed under paragraph (c)(2)(vi) of this section immediately after the disposition as the excess of—

(A) The \$90 aggregate adjusted basis of the assets of T and T1 (other than stock and securities of T1 owned by T), over

(B) The \$40 fair market value of the T stock (determined under paragraph (c)(2)(vi) of this section). Because this amount is the only amount described in paragraph (c)(1) of this section, the amount of P's \$60 loss disallowed under paragraph (a)(1) of this section is limited to \$50.

(iii) The result would be the same if the value of T1's property did not decline and T1 instead had an operating loss of \$60 (attributable to borrowed funds) which the P group was unable to use. In that case, the \$50 excess of the sum of—

(A) The \$90 aggregate adjusted basis of the assets of T and T1 (other than stock and securities of members of the P group), plus the \$60 net operating loss attributable to T1 and carried to its first taxable year following the disposition, over

(B) The sum of the \$40 fair market value of the T stock, plus the \$60 of T1 liabilities, is an amount described in paragraph (c)(2)(vi) of this section. (See paragraph (g) of this section for the elective reattribution of T1's \$60 net operating loss to P in connection with the sale.)

(d) *Successors*—(1) *General rule.* This section applies, to the extent necessary to effectuate the purposes of this section, to any property the basis of which is determined, directly or indirectly, in whole or in part, by reference to the basis of a subsidiary's stock.

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

Example 1. Status of successor as member.

(i) P, the common parent of a group, buys all the stock of T for \$100. T's only asset has a basis of \$0 and a value of \$100. T sells the asset for \$100, and buys another asset for \$100. Under the investment adjustment system, P's basis in the T stock increases to \$200, and the earnings and profits of P increase by \$100. P later transfers all the stock of T to an unrelated consolidation group in exchange for 10 percent of the stock of X, the common parent of that group, in a transaction described in section 368(a)(1)(B). At the time of the exchange, the value of the X stock received by P is \$80.

(ii) Under section 358, P has a basis of \$200 in the X stock it receives in exchange for T. Under section 362, X has a \$200 basis in the T stock.

(iii) Neither paragraph (a)(1) nor (b)(1) of this section applies to the stock of T on P's transfer of the stock to the X group, because no gain or loss is recognized on the transfer, and the transfer is not a deconsolidation of the stock of T under paragraph (b)(2) of this section.

(iv) The X stock owned by P after the reorganization is a successor interest to the T stock because P's basis in the X stock is determined by reference to P's basis in the T stock. The purposes of this section require that the reorganization exchange be treated as a deconsolidation event with respect to P's interest in the X stock. Because X is not a member of the P group, a failure to reduce the basis of the X stock owned by P to its fair market value would permit the P group to recognize and deduct the loss attributable to the T stock. However, because T is a member of the X group, a reduction in the basis of the T stock is not necessary to prevent the X group from recognizing and deducting the loss arising in the P group. The transfer of T stock to X therefore constitutes a deconsolidation of the X stock but not the T stock. Therefore, P must reduce its basis in the X stock from \$200 to its \$80 value at that time. However, X's basis in the T stock remains \$200.

Example 2. Continued application after deconsolidation. (i) P, the common parent of

a group, buys all the stock of T for \$100. T's only asset has a basis of \$0 and a value of \$100. T sells the asset for \$100, and buys another asset for \$100. Under the investment adjustment system, P's basis in the T stock increases to \$200. P later transfers all the stock of T to partnership M in exchange for a partnership interest in M, in a transaction to which section 721 applies. The value of the T stock immediately before the transfer to M is \$100. Less than 2 years later, P sells its interest in M for \$80.

(ii) Under paragraph (b)(1) of this section, because the stock of T is deconsolidated on the transfer to M, immediately before the transfer to M, P reduces its basis in the T stock to the stock's \$100 value immediately before the transfer. As a result, P has a basis of \$100 in its interest in M, and M has a basis of \$100 in the T stock.

(iii) When P sells its interest in M for \$80, it recognizes a \$20 loss. Because the basis of P's interest in M is determined by reference to P's basis in the T stock, and the reporting requirements could otherwise be circumvented, P's partnership interest in M is a successor interest to the T stock. Under paragraph (b)(5) of this section, P is required to file a statement with its return for the year of its disposition of its interest in M in order to deduct its loss. If P does not file the required statement described in paragraph (b)(5) of this section, P's loss on the disposition of its interest in M is disallowed.

(e) *Anti-avoidance rules*—(1) *General rule.* The rules of § 1.1502-20 must be applied in a manner that is consistent with and reasonably carries out their purposes. If a taxpayer acts with a view to avoid the effect of the rules of this section, adjustments will be made as necessary to carry out their purposes.

(2) *Anti-stuffing rule*—(1) *Application.* This paragraph (e)(2) applies if—

(A) A transfer of any asset (including stock and securities) on or after March 9, 1990 is followed within 2 years by a direct or indirect disposition or a deconsolidation of stock, and

(B) The transfer is with a view to avoiding, directly or indirectly, in whole or in part—

(1) The disallowance of loss on the disposition or the basis reduction on the deconsolidation of stock of a subsidiary, or

(2) The recognition of the unrealized gain following the transfer.

A disposition or deconsolidation after the 2-year period described in this paragraph (e)(2)(i) that is pursuant to an agreement, option, or other arrangement entered into within the 2-year period is treated as a disposition or deconsolidation within the 2-year period for purposes of this section.

(ii) *Basis reduction.* If this paragraph (e)(2) applies, the basis of the stock is reduced, immediately before the disposition or deconsolidation, to cause the disallowance of loss, the reduction

of basis, or the recognition of gain, otherwise avoided by reason of the transfer.

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

Example 1. Affiliated return activity. (i) In Year 1, individual A forms T. T's assets appreciate in value from \$0 to \$100. In year 3, A sells all of the T stock to P for \$100 and T becomes a member of the P group, which does not file consolidated returns. During Years 3 to 6, the \$100 of gain with respect to T's asset is recognized, generating earnings and profits that would have been described in paragraph (c)(1)(ii) of this section if the P group had filed consolidated returns during those years. Intending to sell the T stock and claim a loss on the sale, the P group elects to file consolidated returns for that year and makes a deemed dividend election under § 1.1502-32(f)(2) with a view to avoid the effect of the rules of this section. The deemed dividend election has the effect of increasing P's basis in the T stock from \$100 to \$200. At the end of Year 7, P sells all of the T stock for \$100 and recognizes a loss of \$100.

(ii) Under the deemed dividend election, T is deemed to distribute its earnings and profits to P, and P is deemed to recontribute the distribution to T. Thus, the election has the effect of a basis increase described in paragraph (c)(1)(ii) of this section. The deemed distribution does not reduce P's basis in the T stock because it is not a distribution for which a negative adjustment is made under § 1.1502-32(b)(2)(iii), but the deemed recontribution increases P's basis in the T stock. T's earnings and profits are not described in (c)(1)(ii) of this section. Therefore, the deemed dividend election has the effect of producing a stock loss that is not disallowed under § 1.1502-20 even though a comparable loss arising under the investment adjustment system would be disallowed. Because the deemed dividend election was made with the view described in paragraph (e)(1) of this section, P's loss is disallowed.

(iii) The facts are the same as in (i) of this *Example*, except that, more than 2 years after it makes the deemed dividend election, T reinvests its sale proceeds in assets that appreciate in value and P sells the T stock for \$200. The deemed dividend election has the effect of eliminating P's gain on the disposition of the T stock, but does not result in P recognizing a loss. P would not have been required to recognize gain if T's earnings and profits had been described in (c)(1)(ii) of this section. Therefore, the election does not cause P to recognize gain even though P made the election with the view described in paragraph (e)(1) of this section.

Example 2. Intercompany stock sales. (i) P is the common parent of a consolidated group. S is a wholly owned subsidiary of P, and T is a wholly owned recently purchased subsidiary of S. S has a \$100 basis in the T stock, and T has a capital asset with a basis of \$0 and a value of \$100. T's asset declines in value to \$60. Before T has any positive investment adjustments or extraordinary gain dispositions, S sells its T stock to P for \$60 with a view to avoid the effect of the rules of

this section on any subsequent sale of the T stock. T's asset reappreciates and is sold for \$100, and T recognizes \$100 of gain. P then cause T to liquidate and distribute the sale proceeds.

(ii) S's sale of the T stock to P is a deferred intercompany transaction, and S's \$40 loss is deferred under section 267(f) and § 1.1502-13(c). When T liquidates, the \$40 loss is taken into account under § 1.1502-13(f)(1) and § 1.267(f)-2T(d)(2). Because the amount determined under paragraph (c)(1) of this section is \$0, none of S's loss would be disallowed under paragraph (a) of this section and \$40 of the \$100 built-in gain with respect to T's asset would be offset by the \$40 stock loss.

(iii) If S had not sold the T stock to P, the P group would have had to recognize \$100 of net income in order to increase the basis of T's assets from \$0 to \$100. The intercompany stock sale prevents this section from applying to disallow the stock loss and the sale therefore has the effect of avoiding the rules of this section. Consequently, because the sale to P was with the requisite view, S's \$40 loss is disallowed.

Example 3. Basic stuffing case. (i) In Year 1, P buys all the stock of T for \$100, and T becomes a member of the P group. T has an asset with a basis of \$0 and a value of \$100. T sells the asset for \$100. Under the investment adjustment system, P's basis in the T stock increases from \$100 to \$200. In Year 5, P transfers to T an asset with a basis of \$0 and a value of \$100 in a transaction to which section 351 applies, with the view described in paragraph (e)(2)(i) of this section. In Year 6, P sells all the stock of T for \$200.

(ii) Under paragraph (e)(2)(ii) of this section, P must reduce the basis in its T stock by \$100 immediately before the sale. This basis reduction causes a \$100 gain to be recognized on the sale.

(iii) The \$100 basis reduction also would be required if the T stock is deconsolidated in Year 6 instead of being sold. P must reduce the basis in its T stock by \$100 immediately before the deconsolidation.

(iv) The \$100 basis reduction also would be required if the P stock were acquired at the beginning of Year 6 by the M consolidated group, even though the asset transfer took place outside the M group. Paragraph (e)(2)(i) of this section requires only that the transferor have the view at the time of the transfer.

Example 4. Stacking rules. (i) In Year 1, P buys all the stock of T for \$100, and T becomes a member of the P group. T has an asset with a basis of \$0 and a value of \$100. T sells the asset for \$100. Under the investment adjustment system, P's basis in the T stock increases from \$100 to \$200. In Year 5, when the value of the T stock remains \$100, P transfers to T an asset with a basis of \$0 and a value of \$100 in a transaction to which section 351 applies, with the view described in paragraph (e)(2)(i) of this section. Thereafter, the value of the contributed asset declines to \$10. In Year 6, P sells all the T stock for \$110 and recognizes a \$90 loss.

(ii) Because the transferred asset declined in value by \$90, the transfer enabled P to avoid the disallowance of loss by the sale of T only to the extent of \$10. Under paragraph

(e)(2)(ii) of this section, P must reduce the basis in its T stock immediately before the sale to cause recognition of gain in an amount equal to the loss disallowance otherwise avoided by reason of the transfer. The amount of this basis reduction is \$100, causing a \$10 gain to be recognized on the sale.

(iii) The facts are the same as in (i) of this *Example*, except that the transferred asset does not decline in value and that T reinvests the \$100 in proceeds from the asset sale in another asset that appreciates in value to \$190. In Year 6, P sells T for \$290. Because the new asset appreciated in value by \$90, the transfer enabled P to avoid the disallowance of loss on the sale of T only to the extent of \$10. Under paragraph (e)(2)(ii) of this section, P must reduce the basis in its T stock immediately before the sale to cause recognition of gain in an amount equal to the loss disallowance otherwise avoided by reason of the transfer. The amount of this basis reduction is \$10, causing a \$100 gain to be recognized on the sale.

Example 5. Contribution of built-in loss asset. (i) In Year 1, P forms S with a contribution of \$100 in exchange for all of S's stock, and S becomes a member of the P group. S buys an asset for \$100, and the asset appreciates in value to \$200. P then buys all the stock of T for \$100, and T becomes a member of the P group. T has an asset with a basis of \$0 and a value of \$100. T sells the asset for \$100, and under the investment adjustment system P's basis in the T stock increases from \$100 to \$200. In Year 5, when the value of the T stock remains \$100, P transfers the T stock to S in a transaction to which section 351 applies, with the view described in paragraph (e)(2)(i) of this section. The transfer causes P's basis in the S stock to increase from \$100 to \$300 and the value of S to increase from \$200 to \$300. In Year 6, P sells the S stock for \$300.

(ii) Under paragraph (e)(2)(ii) of this section, P must reduce the basis in its S stock immediately before the sale to cause recognition of gain in an amount equal to the gain recognition otherwise avoided by reason of the transfer. The amount of this basis reduction is \$100, causing a \$100 gain to be recognized on the sale.

Example 6. Absence of view. (i) In Year 1, P buys all the stock of T for \$100, and T becomes a member of the P group. T has 2 assets, asset 1 with a basis of \$50 and value of \$100, and asset 2 with a basis of \$50 and value of \$0. T sells asset 1 for \$100. Under the investment adjustment system, P's basis in the T stock increases from \$100 to \$150. In Year 5, T transfers asset 2 to P in a transaction to which § 1.1502-14(a) applies, with a view to having the group retain the loss inherent in the asset. This transfer reduces P's basis in the T stock from \$150 to \$100. In Year 6, P sells all the T stock for \$100.

(ii) The transfer from T to P achieves a result that could have been obtained by other methods that would not have been prevented by this section. The transfer therefore is not with the view described in paragraph (e)(2)(i) of this section, and P is not required to reduce the basis of its T stock under paragraph (e)(2)(ii) of this section. P is in substantially

the same position holding asset 2 as it would be if T sold the asset and the resulting loss was available to the P group (either through T or by reattribution under paragraph (g) of this section).

Example 7. Extending the time period for dispositions. (i) In Year 1, P buys all the stock of T for \$100, and T becomes a member of the P group. T has an asset with a basis of \$0 and a value of \$100. T sells the asset for \$100. Under the investment adjustment system, P's basis in the T stock increases from \$100 to \$200. At the beginning of Year 5, P transfers to T an asset with a basis of \$0 and a value of \$100 in a transaction to which section 351 applies, with the view described in paragraph (e)(2)(i) of this section. Within 2 years, P agrees to sell all the stock of T for \$200 at the end of Year 7.

(ii) Under paragraph (e)(2)(i) of this section, P's disposition of the T stock at the end of Year 7 is treated as occurring within the 2-year period following P's transfer of the asset to T, because the disposition is pursuant to an agreement reached within 2 years after the transfer. Accordingly, under paragraph (e)(2)(ii) of this section, P must reduce the basis in its T stock by \$100 immediately before the sale. This result is reached whether or not the agreement is in writing. P's disposition would also have been treated as occurring within the 2-year period if the disposition were pursuant to an option issued within the period.

Example 8. Application of section 267(f). (i) In Year 1, P forms S with a \$100 capital contribution and S buys an asset for \$100. In Year 2, the asset declines in value, and S sells the asset to P for \$50 with the view described in paragraph (e)(2)(i) of this section. In Year 3, P sells the stock of S to an unrelated party for \$50. In Year 4, P sells the asset to an unrelated party for \$50.

(ii) S recognizes a \$50 loss on its sale of the asset to P in Year 2, and the loss is deferred under section 267(f) and §§ 1.267(f)-2T(b) and 1.1502-13(c). Section 1.1502-13(f)(1)(iii) generally restores a selling member's deferred loss when the member ceases to be a member of the group. However, §§ 1.267(f)-2T(d)(1) and 1.267(f)-1(c)(6) provide that S's deferred loss is not restored when S ceases to be a member of the P group. Instead, under §§ 1.267(f)-2T(d)(2) and 1.267(f)-1T(c)(7), the \$50 loss is restored to P's basis in the asset and P recognizes a \$50 loss when P sells the asset in Year 4.

(iii) P recognizes a \$50 loss on its sale of the S stock in Year 3. None of this loss is disallowed under paragraph (a)(1) of this section, because the amount disallowed may not exceed the \$0 amount determined under paragraph (c)(1) of this section.

(iv) The sale of the asset by S to P has the effect of shifting the asset's \$50 loss from S to P without a corresponding reduction in P's basis in the S stock. After the sale, P's loss with respect to the S stock is no longer duplicated with respect to S's assets for purposes of paragraph (c)(1)(iii) of this section. Because S's sale is with the requisite view, paragraph (e)(2)(ii) of this section applies. Accordingly, P must reduce the basis in its S stock by \$50 immediately before the sale to prevent avoidance of the disallowance of loss on the stock disposition.

(f) Investment adjustments and earnings and profits—

(1) **Effect on investment adjustments and earnings and profits—(i) General rule.** For purposes of determining investment adjustments under § 1.1502-32 and earnings and profits under § 1.1502-33(c) with respect to a member that owns stock in a subsidiary, any deduction that is disallowed, or any amount by which basis is reduced, under this section is treated as a loss arising and absorbed by the member in the tax year in which the disallowance or basis reduction occurs.

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

Example. (i) In Year 1, P forms S with a contribution of \$100 and S becomes a member of the P group. S buys all the stock of T for \$100. T has an asset with a basis of \$0 and a value of \$100. In Year 2, T sells the asset for \$100. Under the investment adjustment system, S's basis in the T stock increases from \$100 to \$200, and P's basis in the S stock increases from \$100 to \$200. In Year 6, S sells all the stock of T for \$100, and S recognizes a loss of \$100 that is disallowed under paragraph (a)(1) of this section.

(ii) Under paragraph (f)(1) of this section, the earnings and profits of S for Year 6 are reduced by \$100, the amount of the loss disallowed under paragraph (a)(1) of this section. P's basis in the S stock is reduced from \$200 to \$100 under the investment adjustment system. Correspondingly, P's earnings and profits for Year 6 are reduced by \$100, the amount of the loss disallowed under paragraph (a)(1) of this section.

(2) **Coordination rules—(i) Order of adjustments.** Deconsolidation of a share is treated as a disposition of the share for purposes of determining when investment adjustments are made and earnings and profits are determined with respect to the share.

(ii) **No tiering up of certain adjustments.** If the basis of stock of a subsidiary owned by a member (the "owning member") is reduced under this section on the deconsolidation of the stock, no corresponding adjustment is made under § 1.1502-32 to the basis of the stock of the owning member (or any higher tier member) if a disposition or deconsolidation occurs in the same transaction with respect to all the stock of the owning member. In the case of a disposition or deconsolidation in the same transaction of less than all the stock of the owning member, appropriate adjustments shall be made under § 1.1502-32 with respect to the stock of the owning member (or any higher tier member).

(iii) **Example.** The principles of this paragraph (f)(2) are illustrated by the following example.

Example. (i) P, the common parent of a group, owns all the stock of S. S owns all the stock of S1, and S1 owns all the stock of S2. P's basis in the S stock is \$100, S's basis in the S1 stock is \$100, and S1's basis in the S2 stock is \$100. In Year 1, S2 buys all the stock of T for \$100. T has an asset with a basis of \$0 and a value of \$100. In Year 2, T sells the asset for \$100. Under the investment adjustment system, the basis of each subsidiary's stock increases from \$100 to \$200. In Year 6, S sells all the stock of S1 for \$100 to A, an individual, and recognizes a loss of \$100. S1, S2, and T are not members of a consolidated group immediately after the sale because the new S1 group does not file a consolidated return for its first taxable year.

(ii) Under paragraph (a)(1) of this section, no deduction is allowed to S for its loss on the sale of the S1 stock. Under paragraph (f)(1) of this section, S's earnings and profits for Year 6 are reduced by the \$100 loss that is disallowed. Correspondingly, under the investment adjustment system, S's reduction in earnings and profits causes a deduction in P's basis in the S stock, and a reduction in P's earnings and profits for Year 6.

(iii) Under paragraph (b)(1) of this section, because the stock of T and S2 are deconsolidated, S2 must reduce the basis of the T stock from \$200 to \$100 (its value immediately before the deconsolidation), and S1 must reduce the basis of the S2 stock from \$200 to \$100 (its value immediately before the deconsolidation). Under paragraph (f)(1) of this section, S2's earnings and profits for Year 6 are reduced by the \$100 reduction to the basis of the T stock, and S1's earnings and profits are reduced by the \$100 reduction to the basis of the S2 stock. Under paragraph (f)(2)(ii) of this section, because the stock of S2 is deconsolidated in the same transaction, the basis reduction to the T stock does not cause any corresponding investment adjustment to the stock of S2, or to the stock of any higher tier subsidiary. Similarly, because the stock of S1 is disposed of in the same transaction, the reduction to the basis of the S2 stock does not cause an investment adjustment to the stock of S1, or the stock of any higher tier subsidiary.

(iv) **Basis reduction treated as investment adjustment.** For purposes of the consolidated return regulations, the amount of any basis reduction to stock under this section is generally treated as a net negative adjustment under § 1.1502-32(e) (in addition to the adjustment otherwise required under § 1.1502-32(e)) with respect to the stock. The amount of the basis reduction is not treated as a net negative adjustment for purposes of § 1.1502-32T(a), however.

(g) **Reattribution of subsidiary's losses to common parent—(1) Reattribution rule.** If a member disposes of stock of a subsidiary and the member's loss would be disallowed under paragraph (a)(1) of this section, the common parent may make an irrevocable election to reattribute to itself any portion of the net operating

loss carryovers and net capital loss carryovers attributable to the subsidiary (and any lower tier subsidiary) without regard to the order in which they were incurred. The amount reattributed may not exceed the amount of loss that would be disallowed if no election is made under this paragraph (g). For this purpose, the amount of loss that would be disallowed is determined by applying paragraph (c)(1) of this section (without taking into account the requirement under paragraph (c)(3) of this section that a statement be filed) and by not taking the reattribution into account. The amount of loss that would be disallowed and the losses that may be reattributed are determined immediately after the disposition, but the reattribution is deemed to be made immediately before the disposition. The common parent succeeds to the reattributed losses as if the losses 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 382(l)(3)) in connection with the disposition is not taken into account under section 382 with respect to the reattributed losses.

(2) *Insolvency limitation.* If the subsidiary whose losses are to be reattributed, or any higher tier subsidiary, is insolvent within the meaning of section 108(d)(3) at the time of the disposition, losses of the subsidiary may be reattributed only to the extent they exceed the sum of the separate insolvencies of any subsidiaries (taking into account only the subsidiary 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.

(3) *Investment adjustments.* Any losses reattributed under this paragraph (g) are treated for purposes of determining investment adjustments under § 1.1502-32 and earnings and profits under § 1.1502-33(c) as absorbed by the subsidiary (or lower tier subsidiary) immediately before the disposition. The losses, however, are not treated as absorbed for other tax purposes, such as section 172 or section 1212.

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

Example 1. Basic reattribution case. (i) P, the common parent of a group, forms S with a contribution of \$100. S has an operating loss of \$60, which produces a deficit in earnings and profits that reduces P's basis in the S stock by \$60 under the investment adjustment system. The group is unable to use the loss, and the loss becomes a net operating loss carryover attributable to S. Under the investment adjustment system, P's basis in the S stock is increased by \$60, the amount of the unused loss, thus preserving P's \$100 basis in the S stock. The remaining assets of S appreciate in value, and P sells all the stock of S for \$55. But for an election to reattribute losses under this paragraph (g), P would have a \$45 loss on the sale of S that would be disallowed.

(ii) P elects under paragraph (g)(1) of this section to reattribute to itself \$45 of S's losses (the maximum amount permitted). As a result, \$45 of the \$60 net operating loss carryover attributable to S is reattributed to P. This reattributed loss may be included in the net operating loss carryover to subsequent consolidated return years of the P group. P succeeds to these losses as if the losses were succeeded to in a transaction described in section 381(a) and they retain their character as ordinary losses. The remaining \$15 of net operating loss carryover attributable to S is carried over to the first separate return year of S.

(iii) The \$45 reattributed loss is treated, solely for purposes of the investment adjustment system, as absorbed by S immediately before the disposition. This reduces P's basis in the S stock from \$100 to \$55 immediately before the disposition. As a result, P does not recognize any gain or loss on the disposition. However, S's deemed absorption of the reattributed loss for purposes of determining investment adjustments does not affect the use of the loss by the P group.

(iv) Assume that \$20 of S's losses arose in Year 1 and \$40 in Year 2, and that P elects to reattribute all \$40 from Year 2 and \$5 from Year 1. P succeeds to these losses as if the losses were succeeded to in a transaction described in section 381(a), and the losses retain their character as ordinary losses arising in Years 1 and 2. The losses continue to be subject to any limitations originally applicable to S, but P succeeds to them and may absorb the losses independently of S. (For example, P's use of the Year 2 losses does not depend on S's use of the Year 1 losses that were not reattributed to P.)

Example 2. Lower tier subsidiary. (i) P, the common parent of a group, forms S with a contribution of \$100. S then forms T with a contribution of \$40, and T borrows \$60 from an unrelated lender. S has a net operating loss of \$30. T has a net operating loss of \$55 and is insolvent by \$15. The group is unable to use these losses and the losses become net operating loss carryovers attributable to T and S. Under the investment adjustment system, S's basis in the T stock remains \$40 and P's basis in the S stock remains \$100. P sells all of the S stock for \$30 (\$100 invested,

less S's \$30 net operating loss and S's \$40 unrealized loss on its investment in T stock). But for an election to reattribute losses under this paragraph (g), P would have a \$70 loss on the sale of the S stock that would be disallowed.

(ii) S's \$30 portion of the net operating loss carryover may be reattributed to P under paragraph (g)(1) of this section. Because T is insolvent by \$15, paragraph (g)(2) of this section provides that only \$40 of its \$55 portion of the net operating loss carryover may be reattributed to P under paragraph (g)(1) of this section. There is no limitation, however, on which \$40 of T's \$55 loss may be reattributed.

(iii) P elects under paragraph (g)(1) of this section to reattribute to itself \$40 of T's losses (the maximum amount permitted). P does not elect, however, to reattribute to itself any of S's losses. As a result, \$40 of the \$85 net operating loss carryover is reattributed to P. This reattributed loss may be included in the net operating loss carryover to subsequent consolidated return years of the P group. Of the \$45 remaining net operating loss carryover, the \$15 attributable to T and \$30 attributable to S are carried over to their first separate return years.

(iv) The loss reattributed from T is treated, solely for purposes of the investment adjustment system, as absorbed by T immediately before the disposition. This reduces P's basis in the S stock to \$60 immediately before the disposition. As a result, P recognizes only a \$30 loss on the disposition of its S stock (\$30 sale proceeds and \$60 basis), and this loss is disallowed. However, T's deemed absorption of the reattributed loss for purposes of determining investment adjustments does not affect the use of the loss by the P group.

Example 3. Separate return limitation year losses. (i) P, the common parent of a group, buys the stock of S for \$100. S has a net operating loss carryover of \$40 from a separate return limitation year, and assets with a value and basis of \$100. The assets of S decline in value by \$40, and P sells all the stock of S for \$60. But for an election to reattribute losses under this paragraph (g), P would have a \$40 loss on the sale of S that would be disallowed.

(ii) S's \$40 loss carryover from a separate return limitation year may be reattributed to P under paragraph (g)(1) of this section.

(iii) P elects under paragraph (g)(1) of this section to reattribute to itself S's \$40 (loss the maximum amount permitted). Following the reattribution, the loss is included in the net operating loss carryover to subsequent consolidated return years of the P group.

(iv) The loss reattributed from S is treated, solely for purposes of the investment adjustment system, as absorbed by S immediately before the disposition. This reduces P's basis in the S stock to \$60 immediately before the disposition. As a result, P recognizes no gain or loss on the disposition of its S stock. However, S's deemed absorption of the reattributed loss for purposes of determining investment adjustments does not affect the use of the loss by the P group, and the loss retains its

character as a separate return limitation year loss.

(5) *Time and manner of making the election*—(i) *In general.* The election described in paragraph (g)(1) of this section must be made in a separate statement entitled "this is an election under § 1.1502-20(g)(1) To reattribute losses of [insert names and employer identification numbers (E.I.N.) of each subsidiary whose losses are reattributed] to [insert name and employer identification number of common parent]." The statement must include the following information—

(A) For each subsidiary, the amount of each net operating loss and net capital loss, and the year in which each arose, that is reattributed to the common parent, and

(B) If a subsidiary ceases to be a member, the name and employer identification number of the person acquiring the subsidiary's stock.

The statement must be signed by the common parent, and by each subsidiary with respect to which loss is reattributed under this paragraph (g) that does not remain a member of the common parent's group immediately following the disposition. The statement must be filed with the group's income tax return for the tax year of the disposition and a copy of the statement must be retained by the subsidiary. If the acquirer is a subsidiary in a consolidated group, the name and employer identification number of the common parent of the group must be included in the statement, and a copy of the statement must also be delivered to the common parent.

(ii) *Filing of subsidiary's copy of statement.* The subsidiary whose losses are reattributed (or the common parent of any consolidated group that acquires the subsidiary or lower tier subsidiary) must attach its copy of the statement described in paragraph (g)(5)(i) of this section to its income return for the first tax year ending after the due date, including extensions, of the return in which the election required by paragraph (g)(5)(i) of this section is to be filed.

(h) *Effective dates*—(1) *General rule.* Except as otherwise provided in this paragraph (h), this section applies with respect to dispositions and deconsolidations on or after February 1, 1991. For this purpose, dispositions deferred under §§ 1.1502-13, 1.1502-13T, 1.1502-14, and 1.1502-14T are deemed to occur at the time the deferred gain or loss is taken into account unless the stock was deconsolidated before February 1, 1991. If stock of a subsidiary became worthless during a taxable year

including February 1, 1991, the disposition with respect to the stock is treated as occurring on the date the stock became worthless.

(2) *Election to accelerate effective date*—(i) *In general.* A group may make an irrevocable election to apply this section to all its members, instead of § 1.337(d)-2, with respect to all dispositions and deconsolidations on or after November 19, 1990.

(ii) *Time and manner of making the election*—*in general.* The election described in paragraph (h)(2)(i) of this section must be made in a separate statement entitled "this is an election under § 1.1502-20(h)(2) to accelerate the application of § 1.1502-20 to the consolidated group of which [insert name and employer identification number of common parent] is the common parent." The statement must be signed by the common parent and filed with the group's income tax return for the tax year of the first disposition or deconsolidation to which the election applies. If the separate statement required under this paragraph (h) (2) (ii) is to be filed with a return the due date (including extensions) of which is before April 16, 1991, the statement may be filed with an amended return for the year of the disposition or deconsolidation. Any other filings required under this § 1.1502-20, such as the statement required under § 1.1502-20(c)(3), which ordinarily cannot be made with an amended return, must be made at such time and in such manner as permitted by the Commissioner.

(3) *Binding contract rule.* For purposes of this paragraph (h), if a disposition or deconsolidation is pursuant to a binding written contract entered into before March 9, 1990, and in continuous effect until the disposition or deconsolidation, the date the contract became binding is treated as the date of the disposition or deconsolidation.

(4) *Application of § 1.1502-20T to certain transactions*—(i) *In general.* If a group files the certification described in paragraph (h)(4)(ii) of this section, it may apply § 1.1502-20T (as contained in the CFR edition revised as of April 1, 1990), to all of its members with respect to all dispositions and deconsolidations by the certifying group to which § 1.1502-20T otherwise applied by its terms occurring—

(A) On or after March 9, 1990 (but only if not pursuant to a binding contract described in § 1.337(d)-1T(e)(2) (as contained in the CFR edition revised as of April 1, 1990) that was entered into before March 9, 1990); and

(B) Before November 19, 1990 (or thereafter, if pursuant to a binding contract described in § 1.1502-20T(g)(3)

that was entered into on or after March 9, 1990 and before November 19, 1990).

The certification under this paragraph (h)(4)(i) with respect to the application of § 1.1502-20T to any transaction described in this paragraph (h)(4)(i) may not be withdrawn and, if the certification is filed, § 1.1502-20T must be applied to all such transactions on all returns (including amended returns) on which such transactions are included.

(ii) *Time and manner of filing certification.* The certification described in paragraph (h)(4)(i) of this section must be made in a separate statement entitled "[insert name and employer identification number of common parent] hereby certifies under § 1.1502-20 (h)(4) that the group of which it is the common parent is applying § 1.1502-20T to all transactions to which that section otherwise applied by its terms." The statement must be signed by the common parent and filed with the group's income tax return for the taxable year of the first disposition or deconsolidation to which the certification applies. If the separate statement required under this paragraph (h)(4) is to be filed with a return the due date (including extensions) of which is before November 16, 1991, the statement may be filed with an amended return for the year of the disposition or deconsolidation that is filed within 180 days after September 13, 1991. Any other filings required under § 1.1502-20T such as the statement required under § 1.1502-20T(f)(5), may be made with the amended return, regardless of whether § 1.1502-20T permits such filing by amended return.

(5) *Cross reference.* For transitional loss limitation rules, see §§ 1.337(d)-1 and 1.337(d)-2.

Par. 7. Paragraph (r) of § 1.1502-12 is revised to read as follows:

§ 1.1502-12 Separate taxable income.

(r) For rules relating to loss disallowance or basis reduction on the disposition or deconsolidation of stock of a subsidiary, see §§ 1.337(d)-1, 1.337(d)-2 and § 1.1502-20.

Par. 8. The last sentence of § 1.1502-32 (a) is revised to read as follows:

§ 1.1502-32 Investment adjustment.

(a) * * * For rules relating to loss disallowance or basis reduction on the disposition or deconsolidation of stock of a subsidiary, see §§ 1.337(d)-1, 1.337(d)-2 and § 1.1502-20.

Par. 9. The last sentence of § 1.1502-33(c)(6) is revised to read as follows:

§ 1.1502-33 Earnings and profits.

(c) * * *

(6) * * * For rules relating to the effect on earnings and profits of loss disallowance or basis reduction on the disposition or deconsolidation of stock of a subsidiary, see §§ 1.337(d)-1, 1.337(d)-2 and § 1.1502-20.

Par. 10.1 Section § 1.1502-79 is amended by adding paragraph (a) (1) (iii) to read as follows:

§ 1.1502-79 Separate return years.

(a) * * *

(1) * * *

((iii)) For rules permitting the reattribution of losses of a subsidiary to the common parent in the case of loss disallowance or basis reduction on the disposition or deconsolidation of stock of the subsidiary, see § 1.1502-20.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 11. The authority citation for part 602 continues to read as follows:

Authority: (26 U.S.C. 7805)

Par. 12. Section 602.101(c) is amended by adding in the appropriate place in the table § 1.337(d)-2 * * * 1545-1160" and "§ 1.1502-20 * * * 1545-1160".

September 6, 1991.

Fred T. Goldberg, Jr.,
Commissioner of Internal Revenue.

Approved:
Kenneth W. Gideon,
Assistant Secretary of the Treasury.

[FR Doc. 91-22463 Filed 9-13-91; 1:50 am]
BILLING CODE 4830-01-M

LIBRARY OF CONGRESS**Copyright Office****37 CFR Part 202**

[Docket No. 91-8]

Registration of Claims to Copyright: Deposit of CD-ROM Format

AGENCY: Library of Congress, Copyright Office.

ACTION: Final rules.

SUMMARY: The Copyright Office of the Library of Congress is amending its regulations governing the deposit for copyright registration of works fixed in a CD-ROM format, pursuant to section 408 of the Copyright Act. The proposed amendments require the deposit of the best edition CD-ROM package of any

work, including the accompanying operating software, instruction manual, and a printed version, if available.

EFFECTIVE DATE: October 21, 1991.

FOR FURTHER INFORMATION CONTACT: Dorothy Schrader, (202) 707-8380.

SUPPLEMENTARY INFORMATION: Under section 408 of the Copyright Act of 1976, title 17 of the United States Code, the Register of Copyrights is authorized to specify by regulation the nature of the copies or phonorecords to be deposited for various classes of works. Pursuant to the authority granted to the Register in section 408(c), which authorizes the Register to require or permit for particular classes the deposit of identifying materials instead of copies or phonorecords, the Copyright Office regulations at 37 CFR 202.20(c) require the deposit of identifying portions of certain works embodied in a machine-readable format in lieu of machine-readable copies.

At the time this regulation was implemented in 1978, machine-readable copies were not widely marketed to the public-at-large and for this reason the Library of Congress decided not to acquire such copies for its collections, and exempted machine-readable copies from mandatory deposit for use of the Library under section 407. Since that time, great changes have occurred. As a result of their great popularity, machine-readable computer software and databases are in wide demand. In response to these public needs, the Library of Congress established a Machine-Readable Collections Reading Room to provide access to standard reference materials and computer programs available in machine-readable form.

On October 16, 1989 the Copyright Office published final regulations (54 FR 42295) revoking the exemption from mandatory deposit of certain machine-readable copies under section 407 for use of the Library of Congress. The amended rules require the deposit of the best edition CD-ROM package under section 408 for copyright registration for any work reproduced in CD-ROM format. The regulations regarding mandatory deposit pursuant to section 407 are also adjusted to parallel the change in the deposit for registration.

Under the amended rules, where a work has been fixed in a CD-ROM format, the deposit for registration shall consist of the complete CD-ROM package, including the accompanying software and instruction manual, and a printed version of the work, if available. A complete copy of a published work includes all of the elements comprising the applicable unit of publication of the

work, including elements that, if considered separately, would not be copyrightable subject matter or could be the subject of a separate registration.

These amendments are issued to clarify that a CD-ROM package, whenever available, is the preferred form of deposit for the works embodied therein, both for registration and mandatory deposit. The CD-ROM package is emerging as a major format for dissemination of important information and reference works. The Library of Congress needs to add this format to the national collection for the benefit of the public and the Congress.

The deposit requirements for automated databases, compilations, statistical compendia and the like are not changed if the works are available only on-line, or if they are not available in a CD-ROM format. The deposit for most machine-readable works will continue to be one copy of identifying portions of the work, reproduced in visually perceptible form.

The Machine-Readable Reading Room displays a warning of copyright to advise readers about the restrictions of the copyright law.

With respect to the Regulatory Flexibility Act, the Copyright Office takes the position that this Act does not apply to Copyright Office rulemaking. The Copyright Office is a department of the Library of Congress, which is part of the legislative branch. Neither the Library of Congress nor the Copyright Office is an "agency" within the meaning of the Administrative Procedure Act of June 11, 1946, as amended (title 5, of U.S. Code, subchapter II and chapter 7). The Regulatory Flexibility Act consequently does not apply to the Copyright Office since that Act affects only those entities of the Federal Government that are agencies as defined in the Administrative Procedure Act.¹

Alternatively, if it is later determined by a court of competent jurisdiction that the Copyright Office is an "agency" subject to the Regulatory Flexibility Act, the Register of Copyrights has determined and hereby certifies that this regulation will have no significant impact on small businesses.

¹ The Copyright Office was not subject to the Administrative Procedure Act before 1978, and it is now subject to it only in areas specified by section 701(d) of the Copyright Act (i.e. "all actions taken by the Register of Copyrights under this title (17), except with respect to the making of copies of copyright deposits") (17 U.S.C. 706(b)). The Copyright Act does not make the Office an "agency" as defined in the Administrative Procedure Act. For example, personnel actions taken by the Office are not subject to APA-FOIA requirements.

List of Subjects in 37 CFR Part 202

Copyright registration; Computer technology; Databases.

Final Rules

In consideration of the foregoing, part 202 of 37 CFR, chapter II is amended in the manner set forth below.

PART 202—REGISTRATION OF CLAIMS TO COPYRIGHT

1. The authority citation for part 202 continues to read as follows:

Authority: Sec. 702, Pub. L. 94-553, 90 Stat. 2541 (17 U.S.C. 702).

2. Section 202.19(c)(5) is revised to read as follows:

§ 202.19 Deposit of published copies or phonorecords for the Library of Congress.

(c) * * *

(5) Automated databases available only on-line in the United States. The exemption does not include the following: automated databases distributed in the form of machine-readable copies (such as magnetic tape or disks, CD-ROM formats, punch cards, or the like); computerized information works in the nature of statistical compendia, serials, and reference works; works published in a form requiring the use of a machine or device for purposes of optical enlargement (such as film, filmstrips, slide films and works published in any variety of microform); works published in visually perceptible form but used in connection with optical scanning devices; and works reproduced in CD-ROM formats.

3. Section 202.20(c)(2)(vii) introductory text is revised to read as follows:

§ 202.20 Deposit of copies and phonorecords for copyright registration.

(c) * * *

(2) * * *

(vii) *Computer programs and databases embodied in machine-readable copies other than CD-ROM format.* In cases where a computer program, database, compilation, statistical compendium, or the like, if unpublished is fixed, or if published is published only in the form of machine-readable copies (such as magnetic tape or disks, punched cards, semiconductor chip products, or the like) other than a CD-ROM format, from which the work cannot ordinarily be perceived except with the aid of a machine or device, the deposit shall consist of:

§ 202.20 [Amended]

4. The heading and the first sentence of § 202.20(c)(2)(viii) introductory text are revised to read as follows:

* * * * *

(c) * * *

(2) * * *

(viii) *Machine-readable copies of works other than computer programs, databases, and works fixed in a CD-ROM format.* Where a literary, musical, pictorial, graphic, or audiovisual work, or a sound recording, except for works fixed in a CD-ROM format and literary works which are computer programs, databases, compilations, statistical compendia or the like, if unpublished has been fixed or, if published, has been published only in machine-readable form, the deposit must consist of identifying material.

* * * * *

§ 202.20 [Amended]

5. Section 202.20(c)(2)(ix) is revised to read as follows:

* * * * *

(c) * * *

(2) * * *

(ix) *Copies containing both visually-perceptible and machine-readable material other than a CD-ROM format.* Where a published literary work is embodied in copies containing both visually-perceptible and machine-readable material, except in the case of a CD-ROM format, the deposit shall consist of the visually-perceptible material and identifying portions of the machine-readable material.

* * * * *

§ 202.20 [Amended]

6. Section 202.20 is amended by adding a new paragraph (c)(2) (xvii) to read as follows:

* * * * *

(c) * * *

(2) * * *

(xvii) *Works fixed in a CD-ROM format.* (A) Where a work is fixed in a CD-ROM format, the deposit must consist of one complete copy of the entire CD-ROM package, including a complete copy of any accompanying operating software and instructional manual, and a printed version of the work embodied in the CD-ROM, if the work is fixed in print as well as a CD-ROM. A complete copy of a published CD-ROM package includes all of the elements comprising the applicable unit of publication, including elements that if considered separately would not be copyrightable subject matter or could be the subject of a separate registration.

(B) In any case where the work fixed in a CD-ROM package cannot be viewed

on equipment available in the Examining Division of the Copyright Office, the Office will seek an appropriate deposit in accordance with paragraph (d) of this section, in addition to the deposit of the CD-ROM package.

* * * * *

Dated: August 8, 1991.

Ralph Oman,

Register of Copyrights.

Approved by:

James H. Billington,

Librarian of Congress.

[FR Doc. 91-22532 Filed 9-18-91; 8:45 am]

BILLING CODE 1410-07-M

ENVIRONMENTAL PROTECTION AGENCY**40 CFR Part 35**

[OA-FRL-4010-4]

State and Local Assistance Grants for Construction of Wastewater Treatment Works

AGENCY: Environmental Protection Agency.

ACTION: Deviation to rule.

SUMMARY: Under the authority of 40 CFR 31.6(d), the Environmental Protection Agency (EPA) issued a class deviation from the provisions of 40 CFR 35.2010(d) of the construction grant regulations. This deviation extended the period of availability on deobligated construction grant funds reissued on or after October 1, 1990, after their initial period of availability, until the last day of FY 1995 (September 30, 1995).

DATES: This deviation was effective August 23, 1991.

FOR FURTHER INFORMATION CONTACT:

Ms. Marian P. Cody, Grants Administration Division (PM-216F), 401 M Street, SW., Washington, DC 20460, 202-382-5273.

SUPPLEMENTARY INFORMATION: Under the authority of 40 CFR 31.6(d), the Environmental Protection Agency (EPA) issued a class deviation from the provisions of 40 CFR 35.2010(d). The deviation extended the period of availability for deobligated Title II funds reissued on or after October 1, 1990, until the end of FY 1995.

Closing out the construction grant program in the next several years is a high priority for EPA and the States. Deobligated funds are important because they will be the only source within each State for funding future program needs (i.e., grant increases and State program management costs in

accordance with the LaJuana Wilcher memorandum of July 17, 1990.) Because needs for deobligated funds may not occur within the current two year period of availability under current regulation, it would be inappropriate for EPA to force States to choose between obligating such funds and losing them to reallocation. Rather, States should be allowed to manage their deobligated funds in a manner which will allow them to use these funds to manage their projects to successful completion.

The class deviation is published following this notice.

Dated: August 21, 1991.

Edward J. Hanley,

Acting Assistant Administrator for Administration and Resources Management.

Dated: August 5, 1991.

Martha G. Prothro,

Acting Assistant Administrator for Water.

Memorandum

Subject: Class Deviation from 40 CFR 35.2010(d).

From: Harvey G. Pippen, Jr., Director, Grants Administration Division

To: Regional Administrators, Regions I-X

Dated: August 23, 1991.

Action

I am approving a deviation from the provisions of 40 CFR 35.2010(d). This deviation allows deobligated (CWA) construction grant funds reissued on or after October 1, 1990, and after their initial period of availability, to remain available for obligation in the same State until the last day of FY 1995.

Background

Section 205(b)(2) of the Clean Water Act provides that deobligated funds be added to amounts last allotted to a State and be available for obligation in the same manner and to the same extent as such last allotment. Section 205(d) provides that allotted funds that remain unobligated at the end of the year following the year of allotment shall be reallocated. EPA implemented these provisions in 1984, in part, through regulation at 40 CFR 35.2010(d) (1984) which states that deobligated funds reissued after their reallocation date shall be available for up to 2 years for obligation in the same State. This was an appropriate procedure prior to FY 1991 when there was a series of follow-on allotments and reallocations.

Circumstances have now changed because there are no more construction grant allotments. The last allotment was in FY 1990 and those funds are available for obligation only through the end of FY 1991. Funds not obligated during that period are subject to reallocation and reissuance to the States in FY 1992. Beginning in FY 1993, section 205(d) does not require reallocations. Since deobligated construction grant funds are no-year money (i.e., they remain available until expended to carry out the purpose of the appropriation), the funds may remain available for obligation in the same State.

Therefore, it is appropriate to grant this deviation from the regulatory two year limit on availability.

Bringing the construction grant program to an expeditious and successful completion in the next several years is a high priority for the Agency and the States. Deobligations are important because they will be the only source within each State for funding grant increases. (Up to \$400,000 per year may also be used to fund State program management costs in accordance with the LaJuana Wilcher memorandum of July 17, 1990.) Because needs for deobligated funds may not occur within the period of their availability under the current regulation (i.e., within two years or less time), it would be inappropriate for EPA to force States to choose between obligating such funds and losing them to reallocation. Rather, States should be allowed to manage their deobligated funds in a manner that allows them to manage their projects to successful completion.

Providing a longer period of availability for deobligated funds gives States the flexibility necessary to manage program completion efficiently and effectively. This action is consistent with the principles of Total Quality Management and Section 101(f) of the Act, which directs the Agency to make the best use of available funds. That is, this deviation will permit States to match dwindling funds to priority needs in a timely manner.

The goal of the national strategy for completing and closing out the construction grant program is to have all projects administratively completed by the end of FY 1995. Extending the reallocation date of deobligated funds through FY 1995 should provide sufficient time for States to use these funds effectively.

This deviation extends the reallocation date of deobligated Title II funds reissued on or after October 1, 1990, until the end of FY 1995.

Dated: August 5, 1991.

Concur:

Martha G. Prothro,

Acting Assistant Administrator for Water.

Dated: August 21, 1991.

Concur:

Edward J. Hanley,

Assistant Administrator for Administration and Resources Management.

[FR Doc. 91-22622 Filed 9-18-91; 8:45 am]

BILLING CODE 6580-59-M

40 CFR Part 61

[AD-FRL-3975-3]

National Emission Standards for Hazardous Air Pollutants; Amendment to Benzene Rule for Coke By-Product Recovery Plants

AGENCY: Environmental Protection Agency (EPA).

ACTION: Final rule.

SUMMARY: On September 14, 1989, EPA published, under the authority of section 112 of the Clean Air Act (CAA), a final

rule promulgating 40 CFR part 61 subpart L, national emission standards for hazardous air pollutants (NESHAP) for benzene emissions from coke by-product recovery plants (54 FR 38044). The EPA proposed on April 1, 1991 (56 FR 13368), and today is promulgating, a revision to subpart L to add provisions for the use of certain add-on control devices as alternative means of complying with the standards for process vessels, storage tanks and tar-intercepting sumps. The additional provisions do not change the stringency of the standards. The provisions also include testing, monitoring, recordkeeping and reporting requirements for these alternative controls. No other changes to the September 14, 1989 benzene NESHAP are made in this notice.

DATES: *Effective Date.* September 19, 1991.

Each NESHAP issued under the authority of section 112 of the CAA is effective on the date of publication of the final NESHAP in the **Federal Register**. The NESHAP to control benzene emissions from coke by-product recovery plants, 40 CFR part 61 subpart L, was effective September 14, 1989. The revisions to Subpart L in today's notice are effective September 19, 1991. Promulgation of these revisions does not alter the general effective date of subpart L.

Judicial Review. Under section 307(b)(1) of the CAA, judicial review of the actions taken by this notice is available only by the filing of a petition for review in the U.S. Court of Appeals for the District of Columbia Circuit within 60 days of today's publication of this rule. Under section 307(b)(2) of the CAA, the requirements that are the subject of today's notice may not be challenged later in civil or criminal proceedings brought by EPA to enforce these requirements.

ADDRESSES: *Docket.* Docket No. A-79-16, containing information considered by EPA in the development of the promulgated standards, is available for public inspection and copying between 8:30 a.m. and 3:30 p.m., Monday through Friday, at EPA's Air Docket Section, Waterside Mall, room M1500, 1st floor, 401 M Street, SW., Washington, DC 20460. A reasonable fee may be charged for copying.

FOR FURTHER INFORMATION CONTACT: For further information on the basis and content of this rulemaking, contact Ms. Gail Lacy at (919) 541-5261, Standards Development Branch, Emission Standards Division (MD-13), U.S. Environmental Protection Agency.