(4) No. 057561 for use of OTC HCl concentration in paragraph (a)(6) of this section in chickens, turkeys, and swine.

* * * * *

(e) * * *

(1) * * *

(ii) * * *

(A) * * *

(*3*) * * * Withdraw 5 days prior to slaughter those products sponsored by Nos. 000069, 017144, and 057561 in § 510.600(c) of this chapter.

(B) * * *

(*3*) * * * Withdraw 5 days prior to slaughter those products sponsored by Nos. 000069, 017144, and 057561 in § 510.600(c) of this chapter.

(C) * * *

(*3*) * * * Withdraw 5 days prior to slaughter those products sponsored by Nos. 000069, 017144, and 057561 in § 510.600(c) of this chapter.

(iii) * * *

(C) * * * Administer up to 5 days; do not use for more than 5 consecutive days; withdraw 13 days prior to slaughter those products sponsored by Nos. 017144 and 057561.

* * * * *

Dated: August 8, 1994.

Richard H. Teske,

Deputy Director, Premarket Review, Center for Veterinary Medicine.

[FR Doc. 94–19934 Filed 8–12–94; 8:45 am]

BILLING CODE 4160–01–F

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21 CFR Part 522

Implantation or Injectable Dosage Form New Animal Drugs; Butorphanol Tartrate Injection

AGENCY: Food and Drug Administration, HHS.

ACTION: Final rule.

SUMMARY: The Food and Drug Administration (FDA) is amending the animal drug regulations to reflect approval of a new animal drug application (NADA) filed by Fort Dodge Laboratories. The NADA provides for the use of butorphanol tartrate injection in cats for the relief of pain caused by major or minor trauma, or pain associated with surgical procedures.

EFFECTIVE DATE: August 15, 1994.

FOR FURTHER INFORMATION CONTACT: Marcia K. Larkins, Center for Veterinary Medicine (HFV–112), Food and Drug Administration, 7500 Standish Pl., Rockville, MD 20855, 301–594–0614.

SUPPLEMENTARY INFORMATION: Fort Dodge Laboratories, Fort Dodge, IA 50501, currently holds approval for NADA 102–990 which provides for use of butorphanol tartrate injection for the treatment of dogs for relief of chronic nonproductive cough originating from inflammatory conditions of the upper respiratory tract and for NADA 135–780 which provides for use of the drug for the treatment of horses and yearlings for relief of pain associated with colic, and for postpartum pain. The firm has filed NADA 141–047 which provides for use of a new concentration (2 milligrams per milliliter) of the drug in cats for the relief of pain caused by major or minor trauma, or pain associated with surgical procedures. The NADA is approved as of July 5, 1994, and the regulations are amended in 21 CFR 522.246 to reflect the approval. The basis for approval is discussed in the freedom of infofmation summary.

In accordance with the freedom of information provisions of part 20 (21 CFR part 20) and § 514.11(e)(2)(ii) (21 CFR 514.11(e)(2)(ii)), a summary of safety and effectiveness data and information submitted to support approval of this application may be seen in the Dockets Management Branch (HFA–305), Food and Drug Administration, rm. 1–23, 12420 Parklawn Dr., Rockville, MD 20857, between 9 a.m. and 4 p.m., Monday through Friday.

Under section 512(c)(2)(F)(ii) of the Federal Food, Drug, and Cosmetic Act (21 U.S.C. 360b(c)(2)(F)(ii)), this approval for nonfood producing animals qualifies for 3 years of marketing exclusivity beginning July 5, 1994, because the application contains reports of new clinical or field investigations (other than bioequivalence studies) essential to the approval of the application and conducted or sponsored by the applicant.

The agency has carefully considered the potential environmental effects of this action. FDA has concluded that the action will not have a significant impact on the human environment, and that an environmental impact statement is not required. The agency's finding of no significant impact and the evidence supporting that finding, contained in an environmental assessment, may be seen in the Dockets Management Branch (address above) between 9 a.m. and 4 p.m., Monday through Friday.

List of Subjects in 21 CFR Part 522

Animal drugs.

Therefore, under the Federal Food, Drug, and Cosmetic Act and under authority delegated to the Commissioner of Food and Drugs and redelegated to the Center for Veterinary Medicine, 21 CFR part 522 is amended as follows:

PART 522—IMPLANTATION OR INJECTABLE DOSAGE FORM NEW ANIMAL DRUGS

1. The authority citation for 21 CFR part 522 continues to read as follows:

Authority: Sec. 512 of the Federal Food, Drug, and Cosmetic Act (21 U.S.C. 360b).

2. Section 522.246 is amended in paragraph (a) by adding ", 2" after "0.5" and before the word "or", and by adding new paragraph (c)(3) to read as follows:

§ 522.246 Butorphanol tartrate injection.

* * * * *

(c) * * *

(3) *Cats*—(i) *Amount.* 0.2 milligram of butorphanol base activity per pound of body weight (0.4 milligram/kilogram), using 2 milligrams per milliliter solution.

(ii) *Indications for use.* For the relief of pain in cats caused by major or minor trauma, or pain associated with surgical procedures.

(iii) *Limitations.* For subcutaneous injection in cats only. Dose may be repeated up to 4 times per day. Do not treat for more than 2 days. Safety for use in pregnant female cats, breeding male cats or kittens less than 4 months of age has not been determined. Federal law restricts this drug to use by or on the order of a licensed veterinarian.

Dated: August 8, 1994.

Richard H. Teske,

Deputy Director, Premarket Review, Center for Veterinary Medicine.

[FR Doc. 94–19926 Filed 8–12–94; 8:45 am]

BILLING CODE 4160–01–F

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21 CFR Part 522

Animal Drugs, Feeds, and Related Products; Ceftiofur

AGENCY: Food and Drug Administration, HHS.

ACTION: Final rule.

SUMMARY: The Food and Drug Administration (FDA) is amending the animal drug regulations to reflect approval of a supplemental new animal drug application (NADA) filed by The Upjohn Co. The supplemental NADA provides for use of ceftiofur sterile powder intramuscularly in horses for treatment of respiratory infections associated with *Streptococcus zooepidemicus*.

EFFECTIVE DATE: August 15, 1994.

FOR FURTHER INFORMATION CONTACT: Charles W. Francis, Center for Veterinary Medicine (HFV–114), Food and Drug Administration, 7500 Standish

Pl., Rockville, MD 20855, 301–594–1617.

SUPPLEMENTARY INFORMATION: The Upjohn Co., Kalamazoo, MI 49001, filed supplemental NADA 140–338, which provides for use of Naxcel® Sterile Powder (ceftiofur sodium) in horses as a 50 milligrams per milliliter reconstituted injectable solution. The product is currently approved for use in cattle, swine, and day-old chicks. The supplemental NADA is approved as of July 13, 1994, and the regulations are amended in 21 CFR 522.313 to reflect the approval. The basis for approval is discussed in the freedom of information summary.

In accordance with the freedom of information provisions of part 20 (21 CFR part 20) and § 514.11(e)(2)(ii) (21 CFR 514.11(e)(2)(ii)), a summary of safety and effectiveness data and information submitted to support approval of this application may be seen in the Dockets Management Branch (HFA–305), Food and Drug Administration, rm. 1–23, 12420 Parklawn Dr., Rockville, MD 20857, between 9 a.m. and 4 p.m., Monday through Friday.

Under section 512(c)(2)(F)(iii) of the Federal Food, Drug, and Cosmetic Act (21 U.S.C. 360b(c)(2)(F)(iii)), this approval qualifies for 3 years of marketing exclusivity beginning July 13, 1994, because the application contains reports of new clinical or field investigations (other than bioequivalence or residue studies) essential to the approval of the application and conducted or sponsored by the applicant.

The agency has carefully considered the potential environmental effects of this action. FDA has concluded that the action will not have a significant impact on the human environment, and that an environmental impact statement is not required. The agency's finding of no significant impact and the evidence supporting that finding, contained in an environmental assessment, may be seen in the Dockets Management Branch (address above) between 9 a.m. and 4 p.m., Monday through Friday.

List of Subjects in 21 CFR Part 522

Animal drugs.

Therefore, under the Federal Food, Drug, and Cosmetic Act and under authority delegated to the Commissioner of Food and Drugs and redelegated to the Center for Veterinary Medicine, 21 CFR part 522 is amended as follows:

PART 522—IMPLANTATION OR INJECTABLE DOSAGE FORM NEW ANIMAL DRUGS

1. The authority citation for 21 CFR part 522 continues to read as follows:

Authority: Sec. 512 of the Federal Food, Drug, and Cosmetic Act (21 U.S.C. 360b).

2. Section 522.313 is amended by adding new paragraph (d)(4) to read as follows:

§ 522.313 Ceftiofur sterile powder for injection.

* * * * *

(d) * * *

(4) *Horses*—(i) *Amount.* 2.2 to 4.4 milligrams per kilogram (1.0 to 2.0 milligrams per pound) of body weight.

(ii) *Indications for use.* For treatment of respiratory infections in horses associated with *Streptococcus zooepidemicus.*

(iii) *Limitations.* For intramuscular use only. Treatment should be repeated every 24 hours, continued for 48 hours after clinical signs have disappeared, and should not exceed 10 days. A maximum of 10 milliliters should be administered per injection site. Not for use in horses intended for food. Do not use in animals previously found to be hypersensitive to the drug. Federal law restricts this drug to use by or on the order of a licensed veterinarian.

Dated: August 8, 1994.

Richard H. Teske,

Deputy Director, Premarket Review, Center for Veterinary Medicine.

[FR Doc. 94–19932 Filed 8–12–94, 8:45 am]

BILLING CODE 4160–01–F

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 8560]

RIN 1545–AQ69

Consolidated Returns—Stock Basis and Excess Loss Accounts, Earnings and Profits, Absorption of Deductions and Losses, Joining and Leaving Consolidated Groups, Worthless Stock Loss, Nonapplicability of Section 357(c)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations amending the consolidated return investment adjustment system, including the rules for earnings and profits and excess loss accounts. The amendments delink the adjustments to stock basis from the adjustments to earnings and profits. Stock basis is adjusted under rules similar to the rules for adjusting the basis of partnership interests and stock in S corporations, and earnings and profits are adjusted under a separate, parallel system. Amendments are also made to the rules limiting absorption of a member's deductions and losses when it leaves a consolidated group, modifying the stock basis and earnings and profits of members in certain group structure changes, allocating a corporation's tax items for the year it joins or leaves a consolidated group, allowing a worthless stock loss deduction with respect to the stock of members, and applying section 357(c) to transactions between members.

DATES: These regulations are effective January 1, 1995.

For dates of applicability, see the "Effective dates" section under the **SUPPLEMENTARY INFORMATION** portion of the preamble.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations relating to stock basis, excess loss accounts, and earnings and profits generally, absorption of deductions and losses, worthless stock loss and the nonapplicability of section 357(c), Steven B. Teplinsky, (202) 622–7770; concerning the regulations relating to group structure changes, Rose L. Williams (202) 622–7550; and concerning the regulations relating to the allocation of items for the year a corporation joins or leaves a group, Roy A. Hirschhorn, (202) 622–7770. (These numbers are not toll-free numbers.)

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 1545–1344. The estimated average annual burden per respondent is .6 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, PC: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. Background

This document contains final regulations for adjusting the stock basis and earnings and profits (E&P) of members of consolidated groups, and related rules.

Proposed regulations were issued in a Notice of Proposed Rulemaking published in the **Federal Register** on November 12, 1992. See 57 FR 53634. In addition to the originally scheduled public hearing, a second hearing was scheduled in a Notice of Additional Public Hearing on Proposed Regulations published in the **Federal Register** on November 23, 1992. See 57 FR 54957. In Notice 92–59, 1992–2 C.B. 386, the IRS delayed the repeal of the 30-day rules so that they would continue to apply to corporations becoming or ceasing to be members before February 15, 1993.

The IRS received many comments on the proposed regulations addressing both policy and technical matters, and held public hearings on December 18, 1992 and March 4, 1993. After consideration of the comments and the statements made at the hearings, the proposed regulations are adopted as modified by this Treasury decision. The modifications, as well as several comments and suggestions that are not adopted in the final regulations, are discussed below.

No inference is intended by the final regulations as to the operation of the current regulations.

C. The Proposed and Final Regulations

The final regulations retain the general approach of the proposed regulations, delinking stock basis adjustments from E&P adjustments and operating through uniform rules of general application rather than through mechanical rules. However, numerous changes have been made to clarify the regulations and to conform their style to that of other recent consolidated return regulations.

1. Delinking Stock Basis and E&P

The investment adjustment system of the current regulations requires an owning member (P) to adjust its basis in the stock of a subsidiary (S) to reflect S's current E&P (or E&P deficit). P's basis is also generally reduced by the amount of any dividend distributions by S to P. The adjustments have the effect of treating P and S as a single entity. To the extent E&P includes amounts such as tax-exempt interest income, the adjustments prevent the income from being taxed indirectly on the disposition of S's stock.

After S's E&P is taken into account by P in adjusting its basis in S's stock, the stock basis adjustment is taken into account to adjust P's own E&P. This adjustment ensures that S's E&P is taken into account by P for purposes of further stock basis adjustments if P is not the common parent, and for distributions by P to nonmembers.

The current regulations were adopted in 1966. It was appropriate at that time to link stock basis and E&P adjustments because the modifications to taxable income required to compute E&P were generally also necessary to compute stock basis. Differences between taxable income and E&P have substantially increased since 1966, however, and many changes in the rules for determining E&P are not appropriate to the determination of stock basis. The resulting confusion and conflict is evidenced by recent cases examining the investment adjustment system.

Section 1503(e) corrects many investment adjustment distortions resulting from the divergence of taxable income and E&P. It requires P to redetermine its basis in S's stock under modified rules at the time the stock is disposed of. The modifications eliminate the original rationale for a system linking stock basis to E&P. Moreover, because the modifications are not generally integrated into the investment adjustment regulations, significant complexity has resulted.

The proposed regulations comprehensively revise the investment adjustment system by delinking stock basis adjustments from E&P adjustments. Stock basis adjustments are determined by reference to a modified computation of S's taxable income, rather than to S's E&P. S's E&P continues to tier up to P, but under a separate E&P adjustment system. Separating the stock basis and E&P adjustment systems implements the intent of section 1503(e) and prevents policies specific to one system from distorting the other.

Some commentators argued that the current E&P-based system is simpler because it is familiar to practitioners, even though it requires taxpayers to determine investment adjustments first by reference to E&P, then by incorporating modifications under current regulations, and finally by incorporating modifications under the Code. These commentators contended that the effect of transactions on E&P was usually clear, and that changing the system resulted in more, rather than less, uncertainty. Most commentators, however, agreed that delinking stock basis and E&P is appropriate.

The E&P system is fundamentally concerned with measuring dividend paying capacity, while the investment adjustment system is concerned with measuring consolidated taxable income. The current system is overly complex because it provides different rules for different sources of E&P, the effect of many transactions on E&P is uncertain, and the E&P rules are already overridden by temporary consolidated return regulations and later enacted Code provisions. By contrast, proper investment adjustments for most subsidiaries under the proposed regulations generally will equal the change in the subsidiary's net asset basis for tax purposes during the period that it is a member.

One example of the distortions under the current regulations is the effect of S's unabsorbed loss on P's E&P. The positive investment adjustment for unabsorbed losses correctly prevents P's basis in S's stock from being reduced while the loss is carried over. However, because P's E&P is adjusted by the amount of the adjustment to P's basis in S's stock, the adjustment also has the effect of preventing P's E&P from reflecting S's loss even though the dividend paying capacity of the group has diminished. Thus, the proper timing of stock basis and E&P adjustments is in conflict. The distortion is increased if the amount of S's tax loss and E&P deficit do not correspond, and uncertainty is created if the loss has a special status.

Investment adjustments under the proposed regulations generally are based on items calculated annually and reflected in a taxpayer's tax return or permanent records, rather than on E&P items that may never have been calculated or recorded. Although the current regulations require taxpayers to adjust stock basis annually, annual E&P computations are otherwise generally unnecessary and commentators generally agree that most groups fail to make the adjustments annually. If stock basis adjustments are not determined until stock is to be disposed of, costly E&P studies are required to calculate items from prior periods for which records may no longer be available.

Even if S attempts to calculate its E&P annually for purposes of the current regulations, that calculation is subject to uncertainty in many cases despite the development over the years of a substantial body of E&P guidance. See, e.g., section 312(h) and §§ 1.312–10 and 1.312–11 (E&P allocations in corporate separations and reorganizations). New transactions and Code provisions continue to develop and require E&P guidance.

Because the proposed regulations delink stock basis and E&P determinations, the policies influencing

the development of E&P rules no longer affect the unrelated and potentially conflicting policies for stock basis adjustments. Section 1503(e) already mandates separate computations for purposes of adjusting stock basis and E&P, and the growing disparity between taxable income and E&P may preclude taxpayers from relying on E&P guidance in many instances. See, e.g., section 1503(e)(1)(B). Consequently, the best approach to the investment adjustment system is to begin the computation with taxable income or loss and make adjustments. Compare the systems for adjusting the basis of partnership interests (section 705) and stock in S corporations (section 1367).

The final regulations retain the approach of the proposed regulations. Investment adjustments are determined by reference to (i) taxable income or loss, (ii) tax-exempt income, (iii) noncapital, nondeductible expenses, and (iv) distributions.

2. Taxpayers' Ability To Override Specific Rules

Many of the proposed regulation sections begin with a general statement of the purposes of the section. Most commentators supported these statements. Commentators suggested that taxpayers should be able to use them to override specific rules (i) in general, (ii) if failure to override would result in duplicating items, (iii) if the taxpayer discloses the override in its return, or (iv) if the taxpayer receives an expedited ruling from the IRS expressly allowing the override (under procedures to be established). Some commentators suggested that the IRS should also have the authority to override specific rules in certain circumstances, and that the circumstances justifying an IRS override could be broader than those justifying a taxpayer override.

The proposed statements of purposes were intended to prevent the recurrence of historic problems associated with literal application of the consolidated return regulations, and they are retained in the final regulations. However, commentators expressed a diversity of views as to how the regulations could be interpreted to serve taxpayer purposes. Consequently, the final regulations do not authorize taxpayers to deviate from specific rules, except to prevent duplication of adjustments. For example, a negative stock basis adjustment is not made under section 301(c)(2) if the adjustment has already been taken into account under the final regulations.

The proposed regulations also contain statements describing rules of construction and identify factors to be weighed in making adjustments. Commentators requested that these statements and factors be clarified. The statements and factors are not retained in the final regulations because they merely restate generally applicable rules of construction. The final regulations remain subject to generally applicable rules of construction.

3. Negative Adjustments

In addition to reducing stock basis for tax losses, the proposed regulations reduce stock basis for noncapital, nondeductible amounts such as Federal income taxes, and for distributions. The IRS received numerous comments on specific applications of these adjustments, particularly the negative adjustments for expiring losses and for distributions of E&P from years when S was affiliated with P but filed separate returns.

The proposed regulations provide that noncapital, nondeductible expenses result in negative adjustments. Like positive adjustments for tax-exempt income, these negative adjustments are necessary to preserve the treatment of items under the Code. Similar treatment is required for certain direct, permanent adjustments to the basis of S's assets. For example, a reduction in the basis of S's assets under section 50(c) must be reflected by a corresponding reduction in P's basis in S's stock.

a. Expiring Losses

Many comments were received on the negative adjustment for the expiration of S's loss carryovers. Commentators generally agreed that losses arising while S is a member of the group should be treated as noncapital, nondeductible amounts in the year they expire, but disagreed with this treatment for losses that arose before S became affiliated with P.

For example, if P forms S with a $100 capital contribution and S generates a $60 net operating loss (NOL) carryover, P's basis in S's stock remains $100 under the proposed regulations. If the NOL subsequently expires under section 172, the expiration is a noncapital, nondeductible expense upon the expiration because S's loss is effectively disallowed at that time. P's basis in S's stock must be reduced to prevent the loss from effectively being preserved in the basis. Commentators generally agreed with this result, and it conforms to the results for partners and S corporation shareholders whose loss carryovers expire.

If instead P buys existing S stock for $100, and at that time S's assets have a $40 basis and value and S has a $60 NOL, many commentators argued that P's $100 cost basis in the S stock does not reflect the $60 NOL and that the NOL's subsequent expiration therefore should not reduce P's basis in the S stock (or should reduce basis only to a limited extent). No principles have been identified to distinguish an expiring NOL from other noncapital, nondeductible amounts that reduce P's basis in S's stock. Moreover, no meaningful distinction has been found between the case in which S has a separate built-in loss (in the form of the NOL) that corresponds to its built-in gain and the case in which S has no built-in loss or gain at the time of P's acquisition and S subsequently produces corresponding gain and an NOL that expires.

Some commentators acknowledged that, if S has a $60 NOL and $60 of corresponding built-in gain, as much as $21 of P's cost basis in S's stock may reflect the NOL (35% of $60), but suggested that much less than $21 is likely to be reflected, particularly if the use of the NOL is limited under section 382. These commentators suggested that the analysis should shift to determining possible after-tax benefits of the NOL to the P group that might be reflected in P's cost basis in S's stock (i.e., P's negative adjustment would be limited to the amount paid by P for the NOL—an amount not to exceed $21).

The final regulations do not adopt this suggestion. Determining after-tax amounts accurately is inherently complex. In addition, there is no apparent reason why adjustments for absorption of the NOL should differ from those for expiration of the NOL, or why subsequent positive adjustments for S's built-in gain should not also increase basis by only an after-tax amount. For example, although S's $60 built-in gain would be fully subject to tax following repeal of the *General Utilities* doctrine, commentators did not suggest that P's basis should be increased by only $39 for the gain (65% of $60, or $60 minus a $21 discount in the purchase price of the S stock to reflect the built-in tax).

Almost all commentators argued that a negative adjustment is inappropriate in some cases. For example, if P buys existing S stock for $40, and at that time S's assets have a $40 basis and value and S has a $60 NOL, commentators argued that the expiration of the NOL should not reduce P's basis in the S stock (to a $20 excess loss account) because P's $40 cost basis in the S stock does not reflect the $60 NOL.

Commentators identified the following general cases in which a negative adjustment may be warranted: (i) if S incurs the loss after P purchases

the S stock (because P's basis in the stock reflects an amount corresponding to the NOL); (ii) if P acquires S stock in a carryover basis transaction (because P may succeed to a prior shareholder's stock basis reflecting the NOL); and (iii) if P indirectly acquires S stock by purchasing S's parent (because the parent's basis in S's stock may reflect the NOL).

The proposed regulations do not predicate stock basis adjustments on presumptions as to whether amounts are already reflected in stock basis. Instead, they reflect the treatment under the Code of all changes in S's net asset basis while S is a member. Substantially altering this approach to take additional information into account would require significant modifications, including appraisals and tracing.

Nevertheless, the IRS and the Treasury Department believe that certain cases merit relief. For example, if P buys S's stock and S has a large NOL carryover subject to a section 382 limitation, expiration of the NOL could easily result in an unavoidable negative adjustment even though the NOL was of limited value. Solutions suggested by commentators included (i) never providing a negative adjustment (even if the NOL arises in P's group) because there is no tax benefit for the expiration, (ii) limiting the negative adjustment to $.35 for every $1 of NOL (based on the highest marginal tax rate), (iii) requiring a negative adjustment only if S becomes a member after the proposed regulations are finalized (or only if the NOL expires after the proposed regulations are finalized), (iv) limiting the negative adjustment to prevent it from reducing P's basis in S's stock below S's net asset basis immediately after the expiration, and (v) permitting P to waive S's NOL before S becomes a member (thereby preventing the NOL from expiring while P owns S).

The final regulations generally retain the proposed rule requiring a negative stock basis adjustment for expiring losses. However, the final regulations provide a special rule allowing an acquiring group to waive S's loss carryovers from separate return limitation years. In addition, if S became a member of a group before the effective date of the final regulations and had a loss carryover from a separate return limitation year at that time, a special rule provides that the group is not required to treat expiration of the loss carryover as a negative adjustment under this section (although if S becomes a member of a second group after the effective date and the loss carryover expires while S is a member of the second group, the special rule does not apply).

To more fully integrate expired losses into the investment adjustment system, the final regulations also add special rules treating expired loss carryovers as continuing to exist for purposes of determining whether a positive adjustment is permitted for cancellation of indebtedness income and whether an excess loss account must be taken into account because of S's worthlessness.

To waive a loss carryover, the final regulations require the group to identify the amount waived (or the amount not waived) in a statement filed with the group's consolidated return for the year S becomes a member. The group may waive any carryover that it chooses, and may waive amounts carried from different years. However, the final regulations do not permit groups to identify the waived amount (or the unwaived amount) through formulas. Comments are solicited as to whether the use of formulas should be permitted and as to any other rules that should be adopted in subsequent IRS guidance.

b. Adjustments for All Distributions

Because stock basis adjustments under the proposed regulations generally conform to changes in S's net asset basis, and S's distribution of $1 always decreases S's net asset basis by $1, the proposed regulations require that all distributions by S reduce P's basis in S's stock. By contrast, the current regulations do not reduce basis for distributions of E&P earned in affiliated, nonconsolidated years. Because the proposed rule is a significant change from current law, the proposed regulations require negative adjustments for distributions of this E&P only if the distribution is made after the proposed regulations are adopted.

Many commentators argued that no negative adjustment should be required for distributions by S of E&P from affiliated, nonconsolidated years. They viewed the approach of the current regulations as preferable because (i) no positive adjustment is made when the E&P is earned, (ii) sections 243 and 1502 were intended to reach comparable results for nonconsolidated and consolidated groups with respect to affiliated, nonconsolidated E&P, and section 243 allows a 100% dividends received deduction to nonconsolidated groups without a basis reduction, and (iii) section 1059 was intended by Congress to be the only source of additional basis reductions. Moreover, although taxpayers could avoid the proposed negative adjustment by making a distribution during the last separate return year, commentators maintained that the proposed negative adjustment was a trap for taxpayers unable or unwilling to make distributions before joining in a consolidated return.

Commentators advocated preserving the approach of the current regulations by providing an exception for distributions of E&P accumulated in affiliated, nonconsolidated years. Such an exception would require determining the amount of modified taxable income for investment adjustment purposes that corresponds to the E&P, and providing rules relating that income to the distributed E&P. Although section 301(e) already modifies the applicable E&P, additional modifications would be required to determine the modified taxable income under the proposed regulations for particular subsidiaries.

Preserving separate return treatment for distributions during consolidated return years is increasingly inappropriate as more distinctions are made under the Code and regulations between corporations filing separate and consolidated returns. The proposed regulations maintain the distinctions between separate and consolidated returns by effectively preserving the separate return double tax system for E&P not distributed in separate return years.

The absence of a negative adjustment under the current regulations appears to be based on a presumption that the distributed E&P is not reflected in stock basis. This presumption may be wrong if, for example, P purchases S's stock after the E&P economically accrues but before it is taken into account for Federal income tax purposes. To limit the negative adjustment would be inconsistent with the general approach of the regulations because it would require appraisals and tracing of E&P to provide different stock basis reductions depending on the nature of the distributed E&P.

Commentators also suggested that requiring a negative adjustment for distributions could be appropriate if the regulations also provided that P's basis in S's stock was automatically or electively adjusted in S's first consolidated return year to reflect S's E&P from affiliated, nonconsolidated years. Where taxpayers fail to make distributions in consolidated return years, however, the adjustment would have the effect of positive investment adjustments for earnings in separate return years even though the consolidated return rules do not generally apply to those years. This approach would have the effect of inappropriately applying a portion of

the consolidated return rules to periods for which separate returns are filed.

Accordingly, the final regulations retain the requirement of a negative stock basis adjustment for all distributions. However, S's stock basis is not reduced as a result of a distribution of E&P accumulated in separate return years, if the distribution is made in a tax year beginning before January 1, 1995 and the distribution does not cause a negative adjustment under the investment adjustment rules in effect at the time of the distribution.

4. Allocation of Adjustments

The proposed regulations provide limited rules for allocating stock basis adjustments to different shares of stock. Allocation issues arise if, for example, P owns less than all of S's stock, S has more than one class of stock, P's interest in S varies, or P has different bases in different blocks of S's stock.

The allocation rules of the proposed regulations are similar in effect to those of the current regulations. Under the proposed regulations, however, stock basis adjustments must be cumulatively redetermined whenever necessary to determine the tax liability of any person.

Most commentators agreed that the proposed allocation rules provide greater guidance than the current regulations. Commentators had mixed views on the proposed cumulative redetermination rule. Some stated that cumulative redeterminations are complex, but are nevertheless economically sound and appropriate. Others stated that taxpayers should not be required to redetermine their basis because the requirement is inconsistent with the proposed annual basis adjustment statement and imposes undue administrative difficulties on taxpayers. However, specific problems that would commonly result in undue difficulties were not identified.

The final regulations retain the allocation system of the proposed regulations, including the cumulative redetermination rule, but provide additional guidance for cumulative redeterminations. See "Annual reporting requirement," discussed at C.7. of this preamble, for the elimination of the annual reporting requirement.

5. Election to Reallocate Basis

The current regulations provide that if P disposes of S stock with an excess loss account, P may avoid including the excess loss account in income by electing to reduce its basis in any retained S stock or debt by an amount equal to the excess loss account. This election was substantially limited by section 1503(e)(4) and by recent amendments to the consolidated return regulations, and its remaining scope is unclear.

The proposed regulations eliminate the election. Negative adjustments (other than for distributions) are not allocated to preferred stock because of its similarity to debt, which receives no negative adjustments. S's losses should not be allocated to preferred shares until S is unable to satisfy their priority. S's ability to satisfy their priority can only be determined with appraisals, and the use of appraisals is contrary to the general approach of the regulations.

Commentators requested that the election be retained. The most common use of the election is where P holds both common and preferred stock of S, because all of S's negative adjustments are allocated to its common stock. The rationale for an election in these cases is to permit P to avoid income from an excess loss account in the common stock that may be attributable to P's investment in the preferred stock.

However, P's investment in S's preferred stock is distinct from its investment in common stock. If negative adjustments should not be initially allocated to the preferred stock (or reallocated on a cumulative redetermination), they should not effectively be reallocated to the preferred stock through an election.

In view of the limited scope of the election, the increased ability of the allocation rules to reflect economic interests, and the limitations on allocating negative adjustments to preferred stock, the final regulations continue the approach of the proposed regulations and eliminate the basis reallocation election of current law.

6. Anti-Avoidance Rules

The proposed investment adjustment regulations require overriding adjustments to carry out the purposes of the regulations if any person acts with a principal purpose to avoid the effect of the regulations, or uses the regulations to avoid the effect of any other provision of the consolidated return regulations. More specific rules are provided to take into account any difference between the basis and value of property transferred to (or from) S, and to continue making adjustments if a corporation becomes a nonmember. Commentators criticized the uncertainty caused by the proposed overriding adjustment rules.

Anti-avoidance rules are necessary if the regulations are to operate through uniform rules of general application that are subject to interpretation and juxtaposition with other rules. Because the purposes of the regulations are identified, taxpayers generally should be aware of inappropriate results. Limiting circumvention of the regulations through transactions having a principal purpose of avoidance is consistent with other recent consolidated return guidance and with regulations issued under Code provisions applicable to separate return taxpayers.

The final regulations retain the general approach of the proposed regulations but operate through a single rule. Many of the proposed examples are modified to reflect comments, and examples of permitted avoidance of the rules are added. In the new examples, all relevant aspects of the transactions take place under separate return rules, so that avoidance of the regulations is not inconsistent with the purposes of the regulations.

7. Annual Reporting Requirement

To ensure more accurate determinations of stock basis adjustments, the proposed regulations require that a statement be included in each year's return identifying the adjustments for that year. This annual reporting requirement was proposed because of the concern that most groups do not determine the amount of their investment adjustments annually as required by the current regulations and do not maintain adequate records to make accurate determinations at a later date. Ultimately, these groups determine stock basis through elaborate but often unreliable E&P studies performed in connection with a later stock disposition.

Commentators differed in their views on the proposed annual reporting requirement. While some agreed that the additional burden was worth the potential improvement in compliance with the annual adjustment requirement and in the accuracy of the adjustments, others contended that the information contained in the annual statements would not be useful. They asserted that (i) the reporting would be burdensome because it would be required for all subsidiaries even though many would never be disposed of, (ii) collecting information relevant only for future determinations of tax liability would do little to improve the accuracy of investment adjustments, and (iii) the lack of a noncompliance penalty would lead to noncompliance with the reporting requirement or to faulty reporting.

The final regulations do not retain the proposed annual reporting requirement. The elimination of the proposed reporting requirement does not,

however, reflect acceptance of the view that taxpayers need not make investment adjustments annually. There is continuing concern that investment adjustments often are not determined with reasonable accuracy, particularly in the case of long-held subsidiaries.

To increase the accuracy of investment adjustment determinations (and the ability to examine the group's returns based on those determinations), the final regulations expressly require taxpayers to maintain annual books and records necessary for accurate stock basis adjustments. This requirement is consistent with section 6001, which generally requires taxpayers to keep those records that the Secretary deems necessary to determine tax liability. Taxpayers are cautioned that they are subject to penalties for tax underpayments resulting from, among other things, negligence or substantial or gross misstatements of the adjusted basis of any property (including stock of subsidiaries). See, e.g., section 6662 (c), (e), and (h).

8. E&P Adjustments

a. General Rules

The proposed regulations tier up E&P directly from S to P under a system separate from, but parallel to, the stock basis adjustment system. By separating the two systems, the possibility of phantom E&P adjustments resulting from the stock basis rules is eliminated.

If S earns E&P in a consolidated return year, the E&P tiers up under the proposed regulations directly and is included in P's E&P. If S later distributes the E&P to P, P's E&P does not further increase because P's dividend income is offset by a decrease for the tier up of S's E&P reduction under section 312 from the distribution.

The proposed regulations generally did not intend to permit the complete elimination of S's E&P from affiliated, nonconsolidated years by offsetting P's dividend income with S's E&P reduction from the distribution. S's affiliated, nonconsolidated E&P was not included in P's E&P when earned (because no tier up occurs in affiliated, nonconsolidated years), and if it is not included in P's E&P when distributed, it would be eliminated entirely. Commentators questioned this result because it cannot be achieved under the Code if separate returns are filed and is inconsistent with both single entity and separate entity treatment of P and S.

Both the current and the proposed regulations permit E&P distributed by S to be eliminated if the E&P was earned in years before S became affiliated with P (SRLY E&P). Elimination of SRLY E&P is also possible under separate return rules. Because P generally has no negative stock basis adjustment for separate return distributions by S, P's E&P from the dividend ultimately may be offset by an E&P deficit (or less E&P) from a later disposition of S's stock. Whether the elimination of SRLY E&P is correct depends on the extent to which the E&P is already reflected in P's E&P. However, the elimination of affiliated, nonconsolidated E&P is incorrect.

The final regulations generally retain the approach of the proposed regulations. However, the final regulations provide additional rules to prevent the elimination of S's affiliated, nonconsolidated E&P by its distribution to P during a consolidated return year.

b. Dividend Stripping

Several rules of the proposed regulations limit P's ability to obtain unintended tax benefits by avoiding negative basis adjustments for certain distributions from S while claiming the dividends received deduction for the distributions. For example, (i) P takes into account S's distribution to which section 301 applies when P becomes entitled to the distribution (generally on the record date), (ii) S's E&P is eliminated immediately before S becomes a nonmember to the extent the E&P is reflected by another member under the proposed regulations, and (iii) if P succeeds another corporation as the common parent of a group, P's E&P is adjusted immediately after it becomes the new common parent to reflect the E&P of the former common parent.

The final regulations retain the approach of the proposed regulations. However, the final regulations apply the distribution entitlement rule for all Federal income tax purposes (not just for purposes of stock basis and E&P adjustments). Expansion of the rule is consistent in many respects with current § 1.1502–32(k).

Because the final regulations retain the proposed entitlement rule for all Federal income tax purposes, S's E&P is reduced at the time P becomes entitled to a distribution from S. Applying the entitlement rule for E&P purposes is consistent with its application for stock basis adjustments and is necessary to prevent distortions in the amount of S's E&P when S leaves the group.

For example, assume that S has $50 of E&P from separate return years and $30 of current consolidated return year E&P. If S distributes $30 to P before becoming a nonmember, this distribution is treated as being made out of consolidated E&P. Thus, S's consolidated E&P is reduced to $0 and S continues to have $50 of accumulated E&P as a nonmember. Applying the entitlement rule for E&P purposes ensures consistent results for any distribution to which P becomes entitled while S is a member. Otherwise, S's $30 of consolidated E&P would be eliminated under the final regulations when S becomes a nonmember, and its $50 of accumulated E&P would be reduced by the amount of the distribution (to $20) due to a delay of the dividend payment until after S becomes a nonmember.

In addition, the final regulations retain and clarify the current rules for making proper adjustments to E&P where the location of a member other than the common parent changes within the group.

c. Tax Sharing Agreements

The current and the proposed regulations permit groups to elect to treat as a tax liability any amounts owing from one member to another as compensation for the absorption of tax attributes. The proposed regulations also require compensating amounts to be reflected for purposes of determining stock basis adjustments. In response to comments, the final regulations permit groups to conform the determination of E&P to the amounts reflected in stock basis.

9. Circular Basis Adjustments

The "circular basis" provisions of the current regulations limit the use of S's deductions and losses to offset P's gain from the sale of S stock. Without these rules, the absorption of S's losses would reduce P's basis in S's stock under the stock basis adjustment rules and thereby correspondingly increase P's gain on the stock sale. Ultimately, S's losses could be completely absorbed without reducing the net amount of P's gain on the stock sale.

The proposed regulations generally restate and clarify the current rule, and continue to prevent S's losses from offsetting P's gain from the sale of S stock. The proposed regulations expand the current rule to prevent losses of S's wholly owned subsidiary from offsetting P's gain from the sale of S stock, because absorption of these losses similarly reduces the basis of S's stock and correspondingly increases P's gain.

Commentators suggested that the limitation be further expanded to include brother-sister cases. If P owns all of the stock of S1 and S2, the proposed regulations do not limit the use of S1's losses against P's gain from the sale of S2 stock or the use of S2's losses against P's gain from the sale of S1 stock. The final regulations do not extend the limitation because these

cases cannot readily be distinguished from cases to which commentators believe the rules should not apply, and from cases in which some taxpayers would be disadvantaged.

Assume that P owns the stock of S1 with a $100 basis and $100 value, and the stock of S2 with a $100 basis and $150 value. S1 has a $20 NOL and S2's assets have a $100 basis. In Year 1, P sells S2's stock at a $50 gain, S1's NOL offsets $20 of P's gain, and use of the NOL reduces P's basis in S1 from $100 to $80. In Year 2, P sells S1 at an additional $20 gain. The group's aggregate gain in Years 1 and 2 is $50, and S's NOL is effectively eliminated.

Although many commentators suggested that S1's NOL be limited if its stock is also sold in Year 1, none suggested that the NOL be limited if S1's stock is sold in a later year. In addition, none suggested that S1's NOL be limited in Year 1 if P causes S2 to sell its assets rather than selling the S2 stock.

The suggested extension of the current limitation would be unfavorable to P if, for example, P had a $120 basis in S1's stock and the $20 loss inherent in the S1 stock could not be deducted under § 1.1502–20. Extending the limitation would prevent the group from offsetting S1's NOL against S2's taxable income merely to preserve P's stock loss that will be disallowed.

The final regulations retain the proposed rules.

10. Group Structure Change Rules

The proposed regulations expand the rules of current temporary regulations for determining stock basis and E&P in certain group structure changes. For example, if P is the common parent and its shareholders form a holding company (H) by transferring their P stock to H in a transaction to which section 351 applies, the transaction is a group structure change and H's basis in the P stock is determined under the current regulations by reference to the net basis of P's assets (rather than the basis of P's former shareholders in their P stock). The proposed regulations expand the scope of the current rules by including group structure changes that involve recognition transactions and by requiring only a 50% continuity of shareholders (rather than 80%), because the existence of the group is preserved in these transactions.

Commentators criticized the expansion of the current rules. Some argued that the rules should not be extended to taxable transactions because those transactions do not represent a mere rearrangement of the group's structure. However, the extension is consistent with the general approach of the current regulations to preserving the group's identity, and taxable transactions are indistinguishable for this purpose from nonrecognition transactions that were preceded by taxable transactions.

Commentators also suggested that P's NOLs should be treated as additional basis in determining P's net asset basis. This approach was not followed in the proposed regulations because additional rules would have been required if an NOL could be duplicated in H's basis in P's stock (e.g., if the NOL is subject to limitation under section 382).

The final regulations retain the approach of the proposed regulations but, in response to comments, allow the group to waive any loss carryovers of the former common parent immediately before the group structure change. The waiver is intended to permit groups to avoid later negative adjustments to H's basis in P's stock from the expiration of the loss carryovers.

11. Elimination of the 30-day Rules

The proposed regulations (together with Notice 92–59) eliminate the 30-day rules under the current regulations for corporations becoming or ceasing to be members on or after February 15, 1993. The 30-day rules were intended to be rules of administrative convenience. However, they create numerous inconsistencies that are not easily resolved, can lead to substantial complexity, and create unintended tax planning opportunities.

Many problems are raised by the 30-day rules. The rules apply only for purposes of the consolidated return regulations and therefore may conflict with rules under the Code that rely on precise timing (e.g., the effective date of a statutory provision applicable to acquisitions, or the date of an ownership change under section 382 resulting from joining or leaving a group). The rules may result in anomalies (e.g., if an historic member liquidates within the first 30 days of the group's year, taxpayers may argue that the member could deconsolidate itself for the short year ending with the liquidation). The recast of the 30-day rules may conflict with other recasts under the Code (e.g., if P acquires S's stock in a section 338(g) transaction, accelerating the inclusion of S in the P group to before the qualified stock purchase is inconsistent with section 338 policy, which does not permit S's gain on the deemed asset sale to be included in the P group's return). The 30-day rules could affect the results of virtually any transaction between S and another member of the selling or buying group during the 30-day period (e.g., if S distributes a lower-tier member's stock to its parent before P's acquisition of S's stock, it is unclear whether the 30-day rules could cause S's distribution to be treated as made from the P group).

Several alternatives were considered in developing the proposed regulations, but each alternative presented additional problems. It is not feasible to apply the 30-day rules uniformly under the Code because of the many conflicts that arise whenever the ownership of S's stock is treated as other than where the benefits and burdens of stock ownership reside. Accordingly, the final regulations continue the approach of the proposed regulations, but eliminate the 30-day rules only for subsidiaries that become or cease to be members of consolidated groups on or after January 1, 1995.

To ameliorate the administrative burdens of eliminating the 30-day rules, the final regulations allow taxpayers to use new simplified rules for allocating items to the short period that the 30-day rules eliminate. The final regulations further simplify item allocations by permitting taxpayers to prorate a target's items for the month of its acquisition or disposition. Guidance is being considered that identifies circumstances in which a stock acquisition formally occurring on one date may be treated for all Federal income tax purposes as occurring as of another date, if the benefits and burdens of ownership are transferred on the other date.

12. Miscellaneous Changes

a. Intercompany Transaction Rules

The final regulations move certain basis rules from § 1.1502–31 to the related provisions in §§ 1.1502–13 and 1.1502–14. These changes were not included in the proposed regulations because they were to be more fully considered in connection with revisions to the intercompany transaction system. See CO–11–91, 59 FR 18011. No inference should be drawn from the relocation of these rules, which is now necessary because the proposed investment adjustment rules are being finalized before the proposed intercompany transaction rules.

b. Restoration of Excess Loss Accounts Due to Worthlessness

The final regulations provide an additional restoration provision related to S's worthlessness. Under the additional rule, P's excess loss account with respect to S's stock is restored if any member takes into account a deduction or loss for the uncollectibility of debt of S and S does not take into

account a corresponding amount of income or gain in determining consolidated taxable income.

c. Loss Disallowance

The final regulations make technical changes in § 1.1502–20. Most of these changes conform the rules to the revised investment adjustment system. For example, the final regulations remove § 1.1502–20(e)(3) Example 8 because it is no longer necessary under the revised investment adjustment system. The final regulations also remove § 1.1502–20(a)(5) Example 6(iii) because it incorrectly interprets § 1.267(f)–2T. Consideration will be given to relief under section 7805(b) for taxpayers adversely affected by the changes.

Commentators expressed concern that the statement of purposes set forth in the proposed investment adjustment rules had the effect of disallowing positive investment adjustments for S's built-in gains, so that its stock would be sold at an increased gain. The statement of purposes was not intended to have this effect and has been modified in the final regulations.

d. Amendments to the Basis Reduction Account

The current regulations originally provided that, if S became a nonmember but P continued to own S stock, P's basis in the stock would be reduced before S became a nonmember. This rule was intended to eliminate the dividend stripping potential created because P's basis in S's stock increases for S's E&P during consolidated return years but generally does not decrease for S's distributions to P after S becomes a nonmember.

Temporary consolidated return regulations were issued in 1988 to eliminate this adjustment. Under the temporary regulations, P's basis increases are not eliminated. Instead, P has a basis reduction account (BRA) in S's stock and reduces its basis in the stock to the extent P subsequently receives distributions from S not in excess of the BRA.

The final regulations replace this system with a simpler approach. However, the BRA continues to apply (together with the other consequences of S becoming a nonmember) if S becomes a nonmember before the final regulations are effective.

Commentators requested modifications to the BRA to eliminate anomalies. The proposed regulations did not modify the BRA because the approach of the proposed regulations to potential dividend stripping is inconsistent with the approach of the BRA, and the necessary corrections would have been complex and may have required amended returns for prior periods. For the same reasons, the final regulations do not amend the BRA rules for subsidiaries that ceased to be members before the final regulations are effective.

e. Becoming or Ceasing To Be a Member

Under the proposed regulations, if S becomes or ceases to be a member during the group's tax year, the periods ending and beginning with S's becoming or ceasing to be a member are separate tax years for all Federal income tax purposes. However, the proposed regulations provide an election for allocating S's nonextraordinary items of income, gain, deduction, loss, and credit between the group's year and S's separate return year. For this purpose, the proposed regulations identify extraordinary items that are not subject to this ratable allocation.

The final regulations continue the approach of the proposed regulations and, in response to comments, the list of extraordinary items not subject to the ratable allocation election is expanded. In response to comments, the final regulations also allow S's nonextraordinary items from the month that S becomes or ceases to be a member to be allocated ratably within the month.

The proposed regulations provide that S generally becomes a member or ceases to be a member at the end of the day on which its status as a member changes (rather than at a specific time during the day). In response to comments, the final regulations provide that transactions occurring on the day of the change, but after the event that results in the change, are treated as occurring at the beginning of the following day if they are properly allocable to the part of the day after the event.

f. Distributions

Under § 1.1502–14 of the current regulations, P recognizes no gain with respect to a distribution from S that is described in section 301(c)(3); instead, such a distribution contributes to an excess loss account in S's stock. The proposed intercompany transaction regulations fully address the treatment of these distributions and continue the treatment provided under current law. See CO–11–91, 59 FR 18011. Consequently, the proposed amendment to § 1.1502–80 providing for the nonapplicability of section 301(c)(3) is unnecessary and is not retained in these final regulations. The treatment under current law is therefore retained.

The final regulations also clarify that the negative stock basis adjustment for distributions applies to all amounts to which section 301 applies and all other amounts treated as dividends (e.g., under section 356(a)(2)).

13. Effective Dates

a. Disposition Approach

The final regulations generally apply to determinations and transactions in tax years beginning on or after January 1, 1995. Once the final regulations apply, stock basis and E&P are determined or redetermined as if the regulations had always been in effect. However, the final regulations are not taken into account for tax years beginning before January 1, 1995.

Among the reasons for adopting the disposition approach are: (i) it eliminates the need to perpetuate prior regulations to determine prior period adjustments (including the need for E&P studies required to make the determinations); (ii) it eliminates the need for transitional rules to prevent duplication or omission of items under the pre-1966, current, and final regulations; (iii) it incorporates the principles of section 1503(e)(1)(A), which would otherwise require stock basis modifications for periods since 1972; and (iv) it eliminates anomalies arising from the adoption in 1966 of the first complete stock basis adjustment system (e.g., the inability to reflect pre-1966 E&P in stock basis if the E&P is lost before a deemed dividend election).

The most frequently discussed alternative to the disposition approach is a "lock-in" approach, under which the new rules would apply only to adjustments arising after the effective date of the final regulations. Several commentators suggested using a lock-in approach, or a combination of approaches (e.g., permitting a group to apply the current rules for adjustments in prior years, provided S is sold within the next 3 to 5 years). Commentators cited concerns with the administrative burdens of recomputing prior period adjustments, preserving taxpayer expectations, and determining pre-1966 adjustments.

Many taxpayers will benefit from the elimination of anomalies under the new regulations, and some commentators requested an earlier effective date, at least on an elective basis (e.g., for determinations between the date the regulations were proposed and the date they are finalized).

Although a lock-in approach would avoid requiring groups to apply the new rules to prior period adjustments, and may protect taxpayer expectations, the IRS and the Treasury Department understand that few groups determine

their stock basis adjustments annually and therefore have any substantial expectation regarding stock basis before a stock disposition is contemplated. A lock-in approach cannot be applied without complex rules to prevent the duplication or omission of items that would result from inconsistencies between the current and proposed regulations. The lock-in approach is therefore inconsistent with the simplified general approach of the regulations. The final regulations retain the disposition approach of the proposed regulations.

The proposed regulations would have applied to basis determinations after the date of adoption of the final regulations. To give taxpayers advance notice of the final rules, and to avoid complexities from applying both the current and the final regulations in a single tax year, the final regulations apply to determinations in tax years beginning on or after January 1, 1995. For prior years for which information is incomplete (e.g., pre-1966 years), taxpayers should use reasonable methods to comply with the final regulations, based on available information, including income tax returns, financial statements and statements of retained earnings.

b. Elimination of the 30-day Rules

The proposed regulations, together with Notice 92–59, would have eliminated the 30-day rules effective February 15, 1993. In response to comments, the final regulations eliminate the 30-day rules for subsidiaries that become or cease to be members on or after January 1, 1995.

14. Commissioner's Permission To Deconsolidate

The current regulations generally authorize the Commissioner to grant all groups, or groups in a particular class, permission to discontinue filing consolidated returns if any provision of the Code or regulations has been amended and the amendment could have a substantial adverse effect.

Some commentators suggested that the proposed regulations warranted granting permission to deconsolidate because the effective date of the regulations is based on a disposition approach. Although permission to deconsolidate is rarely granted, guidance is anticipated to be issued on or before December 31, 1994, pursuant to which groups may receive permission to deconsolidate for their first taxable year beginning on or after January 1, 1995. Permission for a group to deconsolidate will only be granted, however, on a showing that the net effect of the final regulations on the group's consolidated tax liability is substantially adverse.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR 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 TAXES

Paragraph 1. The authority citation for Part 1 is amended by removing the entries for sections "1.1502–19", "1.1502–32(k)", "1.1502–32T", and "1.1502–80" and adding the following citations to read as follows:

Authority: 26 U.S.C. 7805 * * * Section 1.1502–11 also issued under 26 U.S.C. 1502. * * * Section 1.1502–19 also issued under 26 U.S.C. 301, 1502, and 1503. * * * Section 1.1502–31 also issued under 26 U.S.C. 1502. * * * Section 1.1502–32 also issued under 26 U.S.C. 301, 1502, and 1503. Section 1.1502–33 also issued under 26 U.S.C. 301, 1502, and 1503. * * * Section 1 1502–76 also issued under 26 U.S.C. 1502. * * * Section 1.1502–80 also issued under 26 U.S.C. 165, 304, and 1502. * * *

Par. 2. In the list below, for each location indicated in the left column, remove the language in the middle column, and add the language in the right column in its place.

Affected section	Remove	Add
1.167(c)–1(a)(5)	"and 1.1502–31"	", 1.1502–13, and 1.1502–14"
1.337(d)–1(a)(5) introductory text	"§§ 1.1502–32 and 1.1502–33(c)"	"§ 1.1502–32"
1.337(d)–2(c)(4) Example	§§ 1.1502–32 and 1.1502–33(c)"	"§ 1.1502–32"
1.469–1T(h)(7)	"1.1502–19(a)"	"1.1502–19"
1.1502–13(j) introductory text	", 1.1502–31,"	
1 1502–13(l)(2), Example (1)(i)	"under § 1.1502–31(a)"	
1 1502–13(m)(3), Example (3)(i)	"Under § 1.1502–31(a),"	
1.1502–13(o)(1)(i)	"1.1502–19(b)(2)"	"1.1502–19(c)(1) (ii) or (iii)"
1.1502–13(o)(1)(ii)	"1.1502–19(b)(2)"	"1.1502–19(c)(1) (ii) or (iii)"
1.1502–13(o)(2), Example (i)	"under § 1.1502–31(a)"	
1.1502–13(o)(2), Example (iii)	"1.1502–19(b)(2)(i)"	"1.1502–19"
1.1502–14(b)(3)(ii)	"1.1502–19(b)(2) (other than subdivision (ii) thereof)"	"1.1502–19(c)(1)(ii)(B) or (iii)"
1.1502–14(d)(3)(ii)	"1.1502–19(b)(2) (other than subdivision (ii) thereof)"	"1.1502–19(c)(1)(ii)(B) or (iii)"
1.1502–14(d)(4)(ii)(*b*)	"1.1502–19(b)(2) (other than subdivision (ii) thereof), determined without regard to § 1.1502–19(d) and (e)".	"1.1502–19(c)(1)(ii)(B) or (iii)"
1.1502–14(g)(1)(i)	"1.1502–19(b)(2)"	"1.1502–19(c)(1) (ii) or (iii)"
1.1502–14(g)(1)(ii)	"1.1502–19(b)(2)"	"1.1502–19(c)(1) (ii) or (iii)"
1.1502–14(g)(2), Example 1(ii)	"1.1502–19(b)(2)(i)"	"1.1502–19"
1.1502–43(a)(3)(ii)	"1.1502–33(c)(4)(ii)"	"1.1502–33(b)"
1.1502–43(a)(3)(iii)	"1.1502–33(c)(4)(i)(*b*)"	"1.1502–33(c)(1)"
1.1502–47(e)(4)(iii)(B)	"1.1502–19(b)(2)(vi)"	"1.1502–19(c)"

Affected section	Remove	Add
1.1502–75(d)(5)(viii)	"1.1502–32(b)(2)(iii)(c) and (c)(2)(iii)"	"1.1502–32(h)(5)"
1.1502–81T(a)	"1.1502–32(b)(1)"	"1.1502–32(b)"
1.1552–1(c)(2)	"paragraph (d)(3) of"	

Par. 3. Section 1.279–6 is amended by revising paragraph (b)(4) to read as follows:

§ 1.279–6 Application of section 279 to certain affiliated groups.

* * * * *

(b) * * *

(4) The basis of property in a transaction to which § 1.1502–13, § 1.1502–13T, § 1.1502–14, or § 1.1502–14T applies is the basis of the property determined under that section; and

* * * * *

Par. 4. Section 1.337(d)–1, paragraph (a)(5) is amended by removing paragraph (iii) of Example 8.

Par. 5. Section 1.1502–1 is amended by adding at the end of paragraph (a) a new sentence to read as follows:

§ 1.1502–1 Definitions.

(a) * * * Except as the context otherwise requires, references to a group are references to a consolidated group (as defined in paragraph (h) of this section).

* * * * *

Par. 6. Section 1.1502–11 is amended by revising paragraph (b) to read as follows:

§ 1.1502–11 Consolidated taxable income.

* * * * *

(b) *Elimination of circular stock basis adjustments*—(1) *In general.* If one member (P) disposes of the stock of another member (S), this paragraph (b) limits the use of S's deductions and losses in the year of disposition and the carryback of items to prior years. The purpose of the limitation is to prevent P's income or gain from the disposition of S's stock from increasing the absorption of S's deductions and losses, because the increased absorption would reduce P's basis (or increase its excess loss account) in S's stock under § 1.1502–32 and, in turn, increase P's income or gain. See paragraph (b)(3) of this section for the application of these principles to P's deduction or loss from the disposition of S's stock, and paragraph (b)(4) of this section for the application of these principles to multiple stock dispositions. See § 1.1502–19(c) for the definition of disposition.

(2) *Limitation on deductions and losses*—(i) *Determination of amount of limitation.* If P disposes of one or more shares of S's stock the extent to which S's deductions and losses for the tax year of the disposition (and its deductions and losses carried over from prior years) may offset income and gain is subject to limitation. The amount of S's deductions and losses that may offset income and gain is determined by tentatively computing taxable income (or loss) for the year of disposition (and any prior years to which the deductions or losses may be carried) without taking into account P's income and gain from the disposition.

(ii) *Application of limitation.* S's deductions and losses offset income and gain only to the extent of the amount determined under paragraph (b)(2)(i) of this section. To the extent S's deductions and losses in the year of disposition cannot offset income or gain because of the limitation under this paragraph (b), the items are carried to other years under the applicable provisions of the Internal Revenue Code and regulations as if they were the only items incurred by S in the year of disposition. For example, to the extent S incurs an operating loss in the year of disposition that is limited, the loss is treated as a separate net operating loss attributable to S arising in that year. The tentative computation does not affect the manner in which S's unlimited deductions and losses are absorbed or the manner in which deductions and losses of other members are absorbed. (If the amount of S's unlimited deductions and losses actually absorbed is less than the amount absorbed in the tentative computation, P's stock basis adjustments under § 1.1502–32 reflect only the amounts actually absorbed.)

(iii) *Examples.* For purposes of the examples in this paragraph (b), unless otherwise stated, P owns all of the only class of S's stock for the entire year, S owns no stock of lower-tier members, the tax year of all persons is the calendar year, all persons use the accrual method of accounting, the facts set forth the only corporate activity, all transactions are between unrelated persons, and tax liabilities are disregarded. The principles of this paragraph (b)(2) are illustrated by the following examples.

Example 1. Limitation on losses with respect to stock gain. (a) P has a $500 basis in S's stock. For Year 1, P has ordinary income of $30 (determined without taking P's gain or loss from the disposition of S's stock into account) and S has an $80 ordinary loss. P sells S's stock for $520 at the close of Year 1.

(b) To determine the amount of the limitation on S's loss under paragraph (b)(2)(i) of this section, and the effect under § 1.1502–32(b) of the absorption of S's loss or P's basis in S's stock, P's gain or loss from the disposition of S's stock is not taken into account. The group is tentatively treated as having a consolidated net operating loss of $50 (P's $30 of income minus S's $80 loss). Thus, $50 of S's loss is limited under this paragraph (b).

(c) Because $30 of S's loss is absorbed in the determination of consolidated taxable income under paragraph (b)(2)(ii) of this section, P's basis in S's stock is reduced under § 1.1502–32(b) from $500 to $470 immediately before the disposition. Consequently, P recognizes a $50 gain from the sale of S's stock and the group has consolidated taxable income of $50 for Year 1 (P's $30 of ordinary income and $50 gain from the sale of S's stock, less the $30 of S's loss). In addition, S's limited loss of $50 is treated as a separate net operating loss attributable to S and, because S ceases to be a member, the loss is apportioned to S under § 1.1502–79 and carried to its first separate return year.

Example 2. Carrybacks and carryovers. (a) For Year 1, the P group has consolidated taxable income of $30, and a consolidated net capital loss of $100 ($50 attributable to P and $50 to S). At the beginning of Year 2, P has a $300 basis in S's stock. For Year 2, P has ordinary income of $30, and a $20 capital gain (determined without taking the $100 consolidated net capital loss carryover or P's gain or loss from the disposition of S's stock into account), and S has a $100 ordinary loss. P sells S's stock for $280 at the close of Year 2.

(b) To determine the amount of the limitation under paragraph (b)(2)(i) of this section on S's losses, and the effect of the absorption of S's losses on P's basis in S's stock under § 1.1502–32(b), P's gain or loss from the disposition of S's stock is not taken into account. For Year 2, the P group is tentatively treated as having a $70 consolidated net operating loss (S's $100 ordinary loss, less P's $30 of ordinary income). The P group is also treated as having no consolidated net capital gain in Year 2, because P's $20 capital gain is reduced by $20 of the consolidated net capital loss carryover from Year 1 under section 1212(a) (the absorption of which is attributed equally to P and S). In addition, of the $70 consolidated net operating loss, $30 is carried back to Year 1 and offsets P's ordinary income in that year, and $40 is carried forward. Consequently, $40 of S's operating loss from Year 2, and $40 of the consolidated net capital loss carryover from Year 1 attributable to S, are limited under this paragraph (b).

(c) Under paragraph (b)(2)(ii) of this section, the limitation under this paragraph (b) does not affect the absorption of any deductions and losses attributable to P, $60 of S's operating loss from Year 2, and $10 of the consolidated net capital loss from Year 1 attributable to S. Consequently, P's basis in S's stock is reduced under § 1.1502–32(b) by $70, from $300 to $230, and P recognizes a $50 gain from the sale of S's stock in Year 2. Thus, the P group is treated as having a $20 unlimited net operating loss that is carried back to Year 1

Ordinary income:	
P	$30
S (excluding the $40 limited loss)	(60)
Sub Total	$(30)
Consolidated net capital gain:	
P ($20 + $50 from S stock − $50 from Year 1)	$20
S (−$10 from Year 1)	(10)
Sub Total	$10
Consolidated taxable income	$(20)

(d) Under paragraph (b)(2)(ii) of this section, S's $40 ordinary loss from Year 2 that is limited under this paragraph (b) is treated as a separate net operating loss arising in Year 2. Similarly, $40 of the consolidated net capital loss from Year 1 attributable to S is treated as a separate net capital loss carried over from Year 1. Because S ceases to be a member, the $40 net operating loss from Year 2 and the $40 consolidated net capital loss from Year 1 are allocated to S under § 1.1502–79 and are carried to S's first separate return year.

Example 3. Allocation of basis adjustments. (a) For Year 1, the P group has consolidated taxable income of $100. At the beginning of Year 2, P has a $40 basis in each of the 10 shares of S's stock. For Year 2, P has an $80 ordinary loss (determined without taking into account P's gain or loss from the disposition of S's stock) and S has an $80 ordinary loss. P sells 2 shares of S's stock for $85 each at the close of Year 2.

(b) Under paragraph (b)(2)(i) of this section, the amount of the limitation on S's loss is determined by tentatively treating the P group as having a $160 consolidated net operating loss for Year 2. Of this amount, $100 is carried back under section 172 and absorbed in Year 1 ($50 attributable to S and $50 attributable to P). Consequently, $30 of S's loss is limited under this paragraph (b).

(c) Under paragraph (b)(2)(ii) of this section, the limitation under this paragraph (b) does not affect the absorption of P's $80 ordinary loss or $50 of S's ordinary loss. Consequently, P's basis in each share of S's stock is reduced from $40 to $35 under § 1.1502–32(b), and P recognizes a $100 gain from the sale of the 2 shares. Thus, the P group is treated as having a $30 unlimited net operating loss:

Ordinary loss:	
P	$(80)
S (excluding the $30 limited loss)	(50)
Sub Total	$(130)
Consolidated net capital gain.	
P	$100
S	0
Sub Total	$100
Unlimited consolidated net operating loss	$(30)

(d) A portion of the $130 of unlimited operating losses for Year 2 is fully absorbed in that year, and a portion is carried back to Year 1. Thus, $61.50 of P's $80 loss ($100 multiplied by $80/$130) and $38.50 of S's $50 unlimited loss ($100 multiplied by $50/$130) are absorbed in Year 2. P's remaining $18.50 of loss and S's remaining $11.50 of loss are not subject to limitation and are carried back and absorbed in Year 1.

(e) Under paragraph (b)(2)(ii) of this section, S's $30 of loss limited under this paragraph (b) is treated as a separate net operating loss and, because S ceases to be a member, the loss is apportioned to S under § 1.1502–79 and carried to its first separate return year.

(3) *Loss dispositions*—(i) *General rule.* The principles of paragraph (b)(2) of this section apply to the extent necessary to carry out the purposes of paragraph (b)(1) of this section if P recognizes a deduction or loss from the disposition of S's stock.

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

Example. (a) P has a $400 basis in S's stock. For Year 1, P has a capital gain of $100 (determined without taking P's gain or loss from the disposition of S's stock into account) and S has both a $60 capital loss and a $200 ordinary loss. P sells S's stock for $140 at the close of Year 1.

(b) Under paragraph (b)(3) of this section, the amount of S's ordinary and capital losses that may offset income and gain is determined by tentatively computing the group's consolidated net operating loss and consolidated net capital loss without taking into account P's loss from the disposition of S's stock. The limitation is necessary to prevent P's loss from the disposition of S's stock from affecting the absorption of S's losses and thereby the adjustments to P's basis in S's stock under § 1.1502–32(b) (which would, in turn, affect P's loss).

(c) Under the principles of paragraph (b)(2)(i) of this section, the amount of the limitation on S's loss is determined by tentatively treating the P group as having a $40 consolidated net capital gain and a $200 ordinary loss, which results in a $160 consolidated net operating loss for Year 1, all of which is attributable to S. Thus, $160 of S's ordinary loss is limited under this paragraph (b). See also § 1.1502–20 for rules applicable to losses from the sale of stock of subsidiaries.

(4) *Multiple dispositions*—(i) *Stock of a member.* To the extent income, gain, deduction, or loss from a prior disposition of S's stock is deferred under any rule of law, the limitation under paragraph (b)(2) of this section is determined by treating the year the deferred amount is taken into account as the year of the disposition.

(ii) *Stock of different members.* If S is a higher-tier corporation with respect to another member (T), and all of T's items of income, gain, deduction, and loss (including the absorption of T's deduction or loss) would be fully reflected in P's basis in S's stock under § 1.1502–32, the limitation under paragraph (b)(2)(i) of this section with respect to T's deductions and losses is determined without taking into account any income, gain, deduction, or loss from the disposition of the stock of S or T (or of the stock of members owned in the chain connecting S and T). However, this paragraph (b) does not otherwise limit the absorption of one member's deduction or loss with respect to the disposition of another member's stock.

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

Example 1. Chain of subsidiaries. (a) P owns all of S's stock with a $500 basis, and S owns all of T's stock with a $500 basis. For Year 1, P has ordinary income of $30, S has no income or loss, and T has an $80 ordinary loss. P sells S's stock for $520 at the close of Year 1.

(b) Under paragraph (b)(4) of this section, to determine the amount of the limitation under paragraph (b) of this section on T's loss, and the effect of the absorption of T's loss on P's basis in S's stock under § 1.1502–32(b), P's gain or loss from the disposition of S's stock is not taken into account. The group is tentatively treated as having a consolidated net operating loss of $50 (P's $30 of income minus T's $80 loss). Because only $30 of T's loss offsets income or gain, P's basis in S's stock is reduced under § 1.1502–32(b) from $500 to $470 immediately before the disposition of S's stock. Thus, P takes into account a $50 gain from the sale of S's stock.

(c) The facts are the same as in paragraph (a) of this *Example 1*, except that S has a $10 excess loss account in T's stock (rather than a $500 basis). Under paragraph (b)(4) of this section, neither P's gain or loss from the disposition of S's stock nor S's gain or loss from the disposition of T's stock (under § 1.1502–19) are taken into account for purposes of the tentative computations and the effect of any absorption under § 1.1502–32(b) on P's basis in S's stock and S's excess loss account in T's stock. The group is tentatively treated as having a consolidated net operating loss of $50 (P's $30 of income minus T's $80 loss), and only $30 of T's loss may offset the group's income or gain. Under § 1.1502–32(b), the absorption of $30 of T's loss increases S's excess loss account in T's stock to $40 and, under § 1.1502–19, the excess loss account is taken into account. Moreover, under § 1.1502–32(b), P's basis in S's stock is increased immediately before the sale by $10 (S's $40 gain under § 1.1502–19(b) minus T's $30 loss absorbed and tiered up under § 1.1502–32(b)), from $500 to $510. Thus, P takes into account a $10 gain from the sale of S's stock, and S takes into account a $40 gain from its excess loss account in T's stock.

Example 2. Brother-sister subsidiaries. (a) P owns all of the stock of S1 and S2, each with a $50 basis. For Year 1, the group has a $100 consolidated net operating loss ($50 of which is attributable to S1, and $50 to S2) determined without taking gain or loss from the disposition of member stock into account. At the close of Year 1, P sells the stock of S1 and S2 for $100 each.

(b) Paragraph (b)(4) of this section does not limit the loss of S1 or S2 with respect to the disposition of stock of the other. Consequently, each subsidiary's loss may offset P's gain from the disposition of the stock of the other subsidiary. Because this absorption results in a $50 reduction in P's basis in the stock of each subsidiary under § 1.1502–32(b), P's aggregate gain from the stock dispositions is increased from $100 to $200, $100 of which is offset by the losses of the subsidiaries.

(5) *Effective date.* This paragraph (b) applies to stock dispositions occurring in consolidated return years beginning on or after January 1, 1995. For prior years, see § 1.1502–11(b) as contained in the 26 CFR part 1 edition revised as of April 1, 1994.

Par. 7. Section 1.1502–13 is amended as follows:

1. In paragraph (c)(1)(iii), the second sentence is removed.
2. Paragraph (c)(7) is redesignated as paragraph (c)(8).
3. New paragraph (c)(7) is added.
4. In paragraph (h), *Example* (17)(ii) is revised.
5. The added and revised provisions read as follows:

§ 1.1502–13 Intercompany transactions.

* * * * *

(c) * * *

(7) *Basis.* The basis of property acquired by a purchasing member in a deferred intercompany transaction is determined as if separate returns were filed. For example, if S owns property with an adjusted basis of $80 and sells it to P for $100 in a deferred intercompany transaction, P's basis in the property is $100 even though S defers its $20 gain on the sale under this paragraph (c).

* * * * *

(h) * * *

Example (17). * * *

(ii) P takes the entire $44,000 gain ($104,000 less $60,000) on the land into account for 1966 since the deferral and basis rules provided in paragraph (c) of this section were not effective with respect to the sale of such land.

* * * * *

Par. 8. Section 1.1502–14 is amended as follows:

1. Paragraph (a)(2) is revised.
2. Paragraph (a)(4) is redesignated as paragraph (a)(6).
3. New paragraph (a)(4) is added.
4. Paragraph (a)(5) is revised.
5. In newly designated paragraph (a)(6), the *Example* is amended by revising the last sentence.
6. New paragraph (b)(4) is added.
7. The revised and added provisions read as follows:

§ 1.1502–14 Stock, bonds, and other obligations of members.

(a) * * *

(2) *Nondividend distributions.* No gain is recognized to the distributee on a distribution with respect to stock, from one member to another member during a consolidated return year, which is described in section 301(c) (2) or (3). See §§ 1.1502–19 and 1.1502–32 for adjustments to stock basis (including negative adjustments in excess of basis).

* * * * *

(4) *Basis of property distributed in kind.* The basis of property received in a distribution to which section 301 applies is determined under section 301(d)(2)(B).

(5) *Entitlement rule*—(i) *In general.* This paragraph (a)(5)(i) applies for consolidated return years beginning on or after January 1, 1995. For all Federal income tax purposes, a distribution to which this paragraph (a) applies is treated as taken into account when the shareholding member becomes entitled to it (generally on the record date). For example, if the distributee member becomes entitled to a cash distribution before it is made, the distribution is treated as made when the distributee member becomes entitled to it. For this purpose, stock is treated as entitled to a distribution no later than the time the distribution is taken into account under the Code (e.g., under section 305). Appropriate adjustments must be made, as of the date the distribution was taken into account, if a distribution is not made.

(ii) *Minority shareholders.* If nonmembers own stock of the distributing corporation at the time the distribution is treated as occurring under paragraph (a)(5)(i) of this section, appropriate adjustments must be made to prevent acceleration of the members' portion of the distribution from affecting the earnings and profits consequences of distributions to nonmembers.

(iii) *Prior period distributions.* For rules relating to distributions before paragraph (a)(5)(i) of this section applies, see §§ 1.1502–14(a) (intercompany distributions generally) and 1.1502–32(k) (distributions declared before, but paid after, a stock disposition) as contained in the 26 CFR part 1 edition revised as of April 1, 1994.

(6) * * *

Example. * * * P's basis in the land is $6,000.

* * * * *

(b) * * *

(4) *Basis after liquidation or distribution.* The basis of property acquired in a transaction to which this paragraph (b) applies is determined as follows:

(i) *Section 332.* The basis of property acquired in a liquidation to which section 332 applies is determined as if separate returns were filed.

(ii) *Other liquidations and distributions.* This paragraph (b)(4)(ii) determines the aggregate basis of all property acquired in a distribution in cancellation or redemption of stock to which paragraph (b)(1) of this section applies, other than a liquidation to which section 332 applies. Once the amount of aggregate basis is determined, it is allocated among the assets received (except cash) in proportion to the fair market values of the assets on the date received. The aggregate amount of basis equals—

(A) The adjusted basis of the stock exchanged therefor (determined after taking into account the adjustments under § 1.1502–32); increased by

(B) The amount of any liabilities of the distributing corporation assumed by the distributee or to which the property acquired is subject; reduced by

(C) The amount of cash received in the distribution.

* * * * *

Par. 9. Section 1.1502–19 is revised to read as follows:

§ 1.1502–19 Excess loss accounts.

(a) *In general*—(1) *Purpose.* This section provides rules for a member (P) to include in income its excess loss account in the stock of another member (S). The purpose of the excess loss account is to recapture in consolidated taxable income P's negative adjustments with respect to S's stock (e.g., under § 1.1502–32 from S's deductions, losses, and distributions), to the extent the negative adjustments exceed P's basis in the stock.

(2) *Excess loss accounts*—(i) *In general.* P's basis in S's stock is adjusted under the consolidated return regulations and other rules of law. Negative adjustments may exceed P's basis in S's stock. The resulting negative amount is P's excess loss account in S's stock. For example:

(A) Once P's negative adjustments under § 1.1502–32 exceed its basis in S's stock, the excess is P's excess loss account in the S stock. If P has further adjustments, they first increase or decrease the excess loss account.

(B) If P forms S by transferring property subject to liabilities in excess of basis, § 1.1502–80(d) provides for the nonapplicability of section 357(c) and the resulting negative basis under section 358 is P's excess loss account in the S stock.

(ii) *Treatment as negative basis.* P's excess loss account is treated for all Federal income tax purposes as basis that is a negative amount, and a reference to P's basis in S's stock includes a reference to P's excess loss account.

(3) *Application of other rules of law.* The rules of this section are in addition to other rules of law. See, e.g., §§ 1.1502–32 (investment adjustment rules establishing and adjusting excess loss accounts) and 1.1502–80(d) (nonapplicability of section 357(c)). The provisions of this section and other rules of law must not be applied to recapture the same amount more than once. For purposes of this section, the definitions in § 1.1502–32 apply.

(b) *Excess loss account taken into account as income or gain*—(1) *General rule.* If P is treated under this section as disposing of a share of S's stock, P takes into account its excess loss account in the share as income or gain from the disposition. Except as provided in paragraph (b)(4) of this section, the disposition is treated as a sale or exchange for purposes of determining the character of the income or gain.

(2) *Nonrecognition or deferral*—(i) *In general.* P's income or gain under paragraph (b)(1) of this section is subject to any nonrecognition or deferral rules applicable to the disposition. For example, if S liquidates and the exchange of P's stock in S is subject to section 332, or P transfers all of its assets (including S's stock) to S in a reorganization to which section 361(a) applies, P's income or gain from the excess loss account is not recognized under these rules.

(ii) *Nonrecognition or deferral inapplicable.* If P's income or gain under paragraph (b)(1) of this section is from a disposition described in paragraph (c)(1) (ii) or (iii) of this section (relating to deconsolidations and worthlessness), the income or gain is taken into account notwithstanding any nonrecognition or deferral rules (even if the disposition is also described in paragraph (c)(1)(i) of this section). For example, if P transfers S's stock to a nonmember in a transaction to which section 351 applies, P's income or gain from the excess loss account is taken into account.

(3) *Tiering up in chains.* If the stock of more than one subsidiary is disposed of in the same transaction, the income or gain under this section is taken into account in the order of the tiers, from the lowest to the highest.

(4) *Insolvency*—(i) *In general.* Gain under this section is treated as ordinary income to the extent of the amount by which S is insolvent (within the meaning of section 108(d)(3)) immediately before the disposition. For this purpose S's liabilities include any amount to which preferred stock would be entitled if S were liquidated immediately before the disposition, and any former liabilities that were discharged to the extent the discharge was treated as tax-exempt income under § 1.1502–32(b)(3)(ii)(C) (special rule for discharges).

(ii) *Reduction for amount of distributions.* The amount treated as ordinary income under this paragraph (b)(4) is reduced to the extent it exceeds the amount of P's excess loss account redetermined without taking into account S's distributions to P to which § 1.1502–32(b)(2)(iv) applies.

(c) *Disposition of stock.* For purposes of this section:

(1) *In general.* P is treated as disposing of a share of S's stock:

(i) *Transfer, cancellation, etc.* At the time—

(A) P transfers or otherwise ceases to own the share for Federal income tax purposes, even if no gain or loss is taken into account; or

(B) P takes into account gain or loss (in whole or in part) with respect to the share.

(ii) *Deconsolidation.* At the time—

(A) P becomes a nonmember, or a nonmember determines its basis in the share (or any other asset) by reference to P's basis in the share, directly or indirectly, in whole or in part (e.g., under section 362); or

(B) S becomes a nonmember, or P's basis in the share is reflected, directly or indirectly, in whole or in part, in the basis of any asset other than member stock (e.g., under section 1071).

(iii) *Worthlessness.* At the time—

(A) Substantially all of S's assets are treated as disposed of, abandoned, or destroyed for Federal income tax purposes (e.g., under section 165(a) or § 1.1502–80(c), or, if S's asset is stock of a lower-tier member, the stock is treated as disposed of under this paragraph (c)). An asset of S is not considered to be disposed of or abandoned to the extent the disposition is in complete liquidation of S or is in exchange for consideration;

(B) An indebtedness of S is discharged, if any part of the amount discharged is not included in gross income and is not treated as tax-exempt income under § 1.1502–32(b)(3)(ii)(C); or

(C) A member takes into account a deduction or loss for the uncollectibility of an indebtedness of S, and the deduction or loss is not matched in the same tax year by S's taking into account a corresponding amount of income or gain from the indebtedness in determining consolidated taxable income.

(2) *Becoming a nonmember.* A member is treated as becoming a nonmember if it has a separate return year (including another group's consolidated return year). For example, S may become a nonmember if it issues additional stock to nonmembers, but S does not become a nonmember as a result of its complete liquidation. A disposition under paragraph (c)(1)(ii) of this section must be taken into account in the consolidated return of the group. For example, if a group ceases under § 1.1502–75(c) to file a consolidated return as of the close of its consolidated return year, the disposition under paragraph (c)(1)(ii) of this section is treated as occurring immediately before the close of the year. If S becomes a nonmember because P sells S's stock to a nonmember, P's sale is a disposition under both paragraphs (c)(1) (i) and (ii) of this section. If a group terminates under § 1.1502–75(d) because the common parent is the only remaining member, the common parent is not treated as having a deconsolidation event under paragraph (c)(1)(ii) of this section.

(3) *Exception for acquisition of group*—(i) *Application.* This paragraph (c)(3) applies only if a consolidated group (the terminating group) ceases to exist as a result of—

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

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

(ii) *General rule.* Paragraph (c)(1)(ii) of this section does not apply solely by reason of the termination of a group in a transaction to which this paragraph (c)(3) applies, if there is a surviving group that is, immediately thereafter, a consolidated group. Instead, the surviving group is treated as the terminating group for purposes of applying this section to the terminating group. This treatment does not apply, however, to members of the terminating group that are not members of the surviving group immediately after the terminating group ceases to exist (e.g.,

under section 1504(a)(3) relating to reconsolidation, or section 1504(c) relating to includible insurance companies).

(d) *Special allocation of basis adjustments or determinations.* If a member has an excess loss account in shares of a class of S's stock at the time of a basis adjustment or determination under the Internal Revenue Code with respect to other shares of the same class of S's stock owned by the member, the adjustment or determination is allocated first to equalize and eliminate that member's excess loss account. For example, if P owns 50 shares of S's only class of stock with a $100 basis and 50 shares with a $100 excess loss account, and P contributes $200 to S without receiving additional shares, the contribution first eliminates P's excess loss account, then increases P's basis in each share by $1. (If P transfers the $200 in exchange for an additional 100 shares of S's stock in a transaction to which section 351 applies, P's excess loss account is first eliminated, and P's basis in the additional shares is $100.) See § 1.1502–32(c) for similar allocations of investment adjustments to prevent or eliminate excess loss accounts.

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

(f) *Predecessors and successors.* For purposes of this section, any reference to a corporation (or to a share of the corporation's stock) includes a reference to a successor or predecessor (or to a share of stock of a predecessor or successor), as the context may require.

(g) *Examples.* For purposes of the examples in this section, unless otherwise stated, P owns all of the only class of S's stock and S owns all of the only class of T's stock, the stock is owned for the entire year, T owns no stock of lower-tier members, the tax year of all persons is the calendar year, all persons use the accrual method of accounting, the facts set forth the only corporate activity, all transactions are between unrelated persons, and tax liabilities are disregarded. The principles of this section are illustrated by the following examples.

Example 1. Taxable disposition of stock. (a) *Facts.* P has a $150 basis in S's stock, and S has a $100 basis in T's stock. For Year 1, P has $500 of ordinary income, S has no income or loss, and T has a $200 ordinary loss. S sells T's stock to a nonmember for $60 at the close of Year 1.

(b) *Analysis.* Under paragraph (c) of this section, the sale is a disposition of T's stock at the close of Year 1 (the day of the sale). Under § 1.1502–32(b), T's loss results in S having a $100 excess loss account in T's stock immediately before the sale. Under paragraph (b)(1) of this section, S takes into account the $100 excess loss account as an additional $100 of gain from the sale. Consequently, S takes into account a $160 gain from the sale in determining the group's consolidated taxable income. Under § 1.1502–32(b), T's $200 loss and S's $160 gain result in a net $40 decrease in P's basis in S's stock as of the close of Year 1, from $150 to $110.

(c) *Intercompany sale followed by sale to nonmember.* The facts are the same as in paragraph (a) of this *Example 1*, except that S sells T's stock to P for $60 at the close of Year 1, and P sells T's stock to a nonmember at a gain at the beginning of Year 5. Under paragraph (c) of this section, S's sale is treated as a disposition of T's stock at the close of Year 1 (the day of the sale). Under § 1.1502–13 and paragraph (b)(2) of this section, S's $160 gain from the sale is deferred and taken into account in Year 5 as a result of P's sale of the T stock. Under § 1.1502–32(b), the absorption of T's $200 loss in Year 1 results in P having a $50 excess loss account in S's stock at the close of Year 1. In Year 5, S's $160 gain taken into account eliminates P's excess loss account in S's stock and increases P's basis in the stock to $110.

(d) *Intercompany distribution followed by sale to a nonmember.* The facts are the same as in paragraph (a) of this *Example 1*, except that the value of the T stock is $60 and S declares and distributes a dividend of all of the T stock to P at the close of Year 1, and P sells the T stock to a nonmember at a gain at the beginning of Year 5. Under paragraph (c) of this section, S's distribution is treated as a disposition of T's stock at the close of Year 1 (the day of the distribution). S's $100 excess loss account in T's stock is treated as additional gain under section 311(b) from the distribution. Under § 1.1502–14(a), P's basis in the T stock is $60. Under § 1.1502–14, § 1.1502–14T, and paragraph (b)(2) of this section, S's $160 gain from the distribution is deferred and taken into account in Year 5 as a result of P's sale of the T stock. Under § 1.1502–32(b), T's $200 loss and S's $60 distribution result in P having a $110 excess loss account in S's stock at the close of Year 1. In Year 5, S's $160 gain taken into account eliminates P's excess loss account in S's stock and increases P's basis in the stock to $50.

Example 2. Basis determinations under the Internal Revenue Code in intercompany reorganizations. (a) *Facts.* P owns all of the stock of S and T. P has a $150 basis in S's stock and a $100 excess loss account in T's stock. P transfers T's stock to S without receiving additional S stock, in a transaction to which section 351 applies.

(b) *Analysis.* Under paragraph (c) of this section, P's transfer is treated as a disposition of T's stock. Under section 351 and paragraph (b)(2) of this section, P does not recognize gain from the disposition. Under section 358 and paragraph (a)(2)(ii) of this section, P's $100 excess loss account in T's stock decreases P's $150 basis in S's stock to $50. In addition, S takes a $100 excess loss account in T's stock under section 362. (If P had received additional S stock, paragraph (d) of this section would not apply to shift basis from P's original S stock because the basis of the original stock is not adjusted or determined as a result of the contribution; but paragraph (d) would apply to shift basis if P had transferred S's stock to T in exchange for additional T stock, because the basis of the additional T stock would be determined when P has an excess loss account in its original T stock.)

(c) *Intercompany merger.* The facts are the same as in paragraph (a) of this *Example 2*, except that T merges into S in a reorganization described in section 368(a)(1)(A) (and in section 368(a)(1)(D)), and P receives no additional S stock in the reorganization. Under section 354 and paragraph (b)(2) of this section, P does not recognize gain. Under section 358 and paragraph (a)(2)(ii) of this section, P's $100 excess loss account in T's stock decreases P's $150 basis in the S stock to $50. (Similarly, if S merges into T and P does not receive additional T stock, P's $150 basis in S's stock eliminates P's excess loss account in T's stock, and increases P's basis in T's stock to $50.)

(d) *Liquidation of only subsidiary.* Assume instead that P and S are the only members of the P group, P has a $100 excess loss account in S's stock, and S liquidates in a transaction to which section 332 applies. Under paragraph (c)(2) of this section, the liquidation is not a deconsolidation event under paragraph (c)(1)(ii) of this section merely because P is the only remaining member. Under section 332 and paragraph (b)(2) of this section, P does not recognize gain. Under section 334(b), P succeeds to S's basis in the assets it receives from S in the liquidation. (P would also not recognize gain if P transferred all of its assets (including S's stock) to S in a reorganization to which section 361(a) applied, because S would be a successor to P under paragraph (f) of this section.)

Example 3. Section 355 distribution of stock with an excess loss account. (a) *Facts.* P has a $30 excess loss account in S's stock, and S has a $90 excess loss account in T's stock. S distributes the T stock to P in a transaction to which section 355 applies, and neither P nor S recognizes any gain or loss. At the time of the distribution, the T stock represents 33% of the value of the S stock. Following the distribution, P's basis in the S stock is allocated under § 1.358–2 in proportion to the fair market values of the S stock and the T stock.

(b) *Analysis.* Under paragraph (c) of this section, S's distribution of the T stock is treated as a disposition. Under section 355(c) and paragraph (b)(2) of this section, S does not recognize any gain from the distribution. Under section 358, S's excess loss account in the T stock is eliminated, and P's $30 excess loss account in the S stock is treated as basis allocated between the S stock and the T stock based on their relative values. Consequently, P has a $20 excess loss account in the S stock and a $10 excess loss account in the T stock.

(If P had a $30 basis rather than a $30 excess loss account in the S stock, S would not recognize gain, its excess loss account in the T stock would be eliminated, and P's basis in the stock of S and T would be $20 and $10, respectively.)

(c) *Section 355 distribution to nonmember.* The facts are the same as in paragraph (a) of this *Example 3*, except that P also distributes the T stock to its shareholders in a transaction to which section 355 applies. Under paragraph (c) of this section, P's distribution is treated as a disposition of T's stock. Under paragraph (b)(2) of this section, because P's disposition is described in paragraph (c)(1)(ii) of this section, P's $10 excess loss account in the T stock must be taken into account at the time of the distribution, notwithstanding the nonrecognition rules of section 355(c).

Example 4. Deconsolidation of a member. (a) *Facts.* P has a $50 excess loss account in S's stock, and S has a $100 excess loss account in T's stock. T issues additional stock to a nonmember and, as a consequence, T becomes a nonmember.

(b) *Analysis.* Under paragraph (c)(2) of this section, S is treated as disposing of T's stock immediately before T becomes a nonmember. Under paragraph (b)(1) of this section, S takes into account its $100 excess loss account as gain from the sale or exchange of T's stock. Under § 1.1502–32(b) of this section, S's $100 gain eliminates P's excess loss account in S's stock and increases P's basis in S's stock to $50.

(c) *Deconsolidation of a higher-tier member.* The facts are the same as in paragraph (a) of this *Example 4*, except that S (rather than T) issues the stock and, as a consequence, both S and T become nonmembers. Under paragraph (c)(2) of this section, P is treated as disposing of S's stock and S is treated as disposing of T's stock immediately before S and T become nonmembers. Under § 1.1502–32(b) and paragraph (b)(3) of this section, because S and T become nonmembers in the same transaction and T is the lower-tier member, S is first treated under paragraph (b)(1) of this section as taking into account its $100 excess loss account as gain from the sale or exchange of T's stock. Under § 1.1502–32(b), S's $100 gain eliminates P's excess loss account in S's stock and increases P's basis in S's stock to $50 immediately before S becomes a nonmember. Thus, only S's $100 gain is taken into account in the determination of the group's consolidated taxable income.

(d) *Intercompany gain and deconsolidation.* The facts are the same as in paragraph (c) of this *Example 4*, except that T has $30 of gain that is deferred under § 1.1502–13 and taken into account in determining consolidated taxable income immediately before T becomes a nonmember. Under § 1.1502–32(b), T's $30 gain decreases S's excess loss account in T's stock from $100 to $70 immediately before S is treated as disposing of T's stock. Under paragraph (b)(1) of this section, S is treated as taking into account its $70 excess loss account as gain from the disposition of T's stock. Under § 1.1502–32(b), S's $70 gain from the excess loss account and T's $30 deferred gain that is taken into account eliminate P's $50 excess loss account in S's stock and increase P's basis in S's stock to $50 immediately before S becomes a nonmember.

Example 5. Worthlessness. (a) *Facts.* P forms S with a $150 contribution, and S borrows $150. For Year 1, S has a $50 ordinary loss that is carried over as part of the group's consolidated net operating loss. For Year 2, P has $160 of ordinary income, and S has a $160 ordinary loss. Under § 1.1502–32(b), S's loss results in P having a $10 excess loss account in S's stock. During Year 3, the value of S's assets (without taking S's liabilities into account) continues to decline and S's stock becomes worthless within the meaning of section 165(g) (without taking into account § 1.1502–80(c)). For Year 4, S has $10 of ordinary income.

(b) *Analysis.* Under paragraph (c)(1)(iii)(A) of this section, P is not treated as disposing of S's stock in Year 3 solely because S's stock becomes worthless within the meaning of section 165(g) (taking S's liabilities into account). In addition, because S's stock is not treated as worthless, section 382(g)(4)(D) does not prevent the Year 1 consolidated net operating loss carryover from offsetting S's $10 of income in Year 4.

(c) *Discharge of indebtedness.* The facts are the same as in paragraph (a) of this *Example 5*, except that, instead of S's stock becoming worthless within the meaning of section 165(g), S's creditor discharges $40 of S's indebtedness during Year 3, S is insolvent by more than $40 before the discharge, the discharge is excluded from the P group's gross income under section 108(a), and $40 of the $50 consolidated net operating loss carryover attributable to S is eliminated under section 108(b). Under § 1.1502–32(b)(3)(ii)(C), S's $40 of discharge income is treated as tax-exempt income because there is a corresponding decrease under § 1.1502–32(b)(3)(iii) for elimination of the loss carryover. Under paragraph (c)(1)(iii)(B) of this section, P is treated as disposing of S's stock if the amount discharged is not included in gross income and is not treated as tax-exempt income under § 1.1502–32(b)(3)(ii)(C). Because the discharge is treated as tax-exempt income, P is not treated as disposing of S's stock by reason of the discharge.

Example 6. Avoiding worthlessness. (a) *Facts.* P forms S with a $100 contribution and S borrows $150. For Years 1 through 5, S has a $210 ordinary loss that is absorbed by the group. Under § 1.1502–32(b), S's loss results in P having a $110 excess loss account in S's stock. S defaults on the indebtedness, but the creditor does not discharge the debt (or initiate collection procedures). At the beginning of Year 6, S ceases any substantial operations with respect to the assets, but maintains their ownership with a principal purpose to avoid P's taking into account its excess loss account in S's stock.

(b) *Analysis.* Under paragraph (c)(1)(iii)(A) of this section, P's excess loss account ordinarily is taken into account at the time substantially all of S's assets are treated as disposed of, abandoned, or destroyed for Federal income tax purposes. Under paragraph (e) of this section, however, S's assets are not taken into account at the beginning of Year 6 for purposes of applying paragraph (c)(1)(iii)(A) of this section. Consequently, S is treated as worthless at the beginning of Year 6, and P's $110 excess loss account is taken into account.

(h) *Effective date*—(1) *Application.* This section applies with respect to determinations of the basis of (including an excess loss account in) the stock of a member in consolidated return years beginning on or after January 1, 1995. If this section applies, basis (and excess loss accounts) must be determined or redetermined as if this section were in effect for all years (including, for example, the consolidated return years of another consolidated group to the extent adjustments during those consolidated return years are still reflected). Any such determination or redetermination does not, however, affect any prior period.

(2) *Dispositions of stock before effective date*—(i) *In general.* If P was treated as disposing of stock of S in a tax year beginning before January 1, 1995 (including, for example, a deemed disposition because S was worthless) under the rules of this section then in effect, the amount of P's income, gain, deduction, or loss, and the stock basis reflected in that amount, are not redetermined under paragraph (h)(1) of this section. See paragraph (h)(3) of this section for the applicable rules.

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

(3) *Prior law.* For prior determinations, see prior regulations under section 1502 as in effect with respect to the determination. See, e.g., § 1.1502–19 as contained in the 26 CFR part 1 edition revised as of April 1, 1994.

Par. 10. Section 1.1502–20 is amended as follows:

1. Paragraphs (a)(1) and (a)(3)(ii) are revised.

2. The last sentence of paragraph (a)(4) is removed.

3. The introductory text in paragraph (a)(5) is revised.

4. In paragraph (a)(5), paragraph (iii) in *Example 6* is removed.

5. The last sentence of paragraph (b)(4) is removed.

6. In paragraph (b)(6), the last sentence of paragraph (iv) in *Example 5* is revised.

7. Paragraphs (c)(1) (i) and (ii) are revised.

8. Paragraphs (c)(2)(i)(A)(*1*), (B), and (D) are revised.

9. The first sentence of the concluding text of paragraph (c)(2)(i) appearing immediately after paragraph (c)(2)(i)(D) is revised.

10. Paragraphs (c)(2) (ii) and (iii) are revised.

11. Paragraph (c)(2)(vii) is added.

12. Paragraph (c)(4) is amended as follows:

a. The heading for *Example 1* and paragraphs (ii) and (iii) of *Example 1* are revised.

b. *Example 2* is revised.

c. The fifth sentence of paragraph (i) of *Example 3* is revised.

d. Paragraphs (ii) and (iii) of *Example 3* are revised.

e. Paragraph (ii) of *Example 6* is revised.

f. *Example 7* is revised.

13. Paragraph (e)(3) is amended as follows:

a. *Example 1* is revised.

b. *Example 2* is amended by replacing the reference to "§ 1.267(f)–2T(d)(2)" in paragraph (ii) with "section 267(f)".

c. *Example 8* is removed.

14. Paragraph (f) is revised.

15. Paragraph (g)(3) is removed, and paragraph (g)(4) is redesignated as paragraph (g)(3).

16. Newly designated paragraph (g)(3) is amended by revising paragraphs (i) and (iii) of *Example 1*, paragraphs (i) and (iv) of *Example 2*, and paragraph (iv) of *Example 3*.

17. The added and revised provisions read as follows:

§ 1.1502–20 Loss disallowance.

(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. See also §§ 1.1502–15(b) (stock losses attributable to certain pre-1966 distributions) and 1.1502–80(c) (deferring the treatment of stock of members as worthless under section 165(g)).

* * * * *

(3) * * *

(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 canceled or redeemed (regardless of whether it is retired or held as treasury stock).

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

* * * * *

(5) *Examples.* For purposes of the examples in this section, unless otherwise stated, all corporations have only one class of stock outstanding, all groups file consolidated returns on a calendar-year basis, the facts set forth the only corporate activity, all transactions are between unrelated persons, and tax liabilities are disregarded. The basis of each asset is the same for determining earnings and profits adjustments and taxable income. References to the investment adjustment system are references to the rules of §§ 1.1502–19, 1.1502–32 and 1.1502–33. The principles of this paragraph (a) are illustrated by the following examples.

* * * * *

(b) * * *

(6) * * *

* * * * *

Example 5. * * *

(iv) * * * However, the subsequent deconsolidation of the T stock is an overriding event under paragraph (a)(3)(ii) of this section, and paragraph (a)(1) of this section applies to the loss immediately before the deconsolidation.

* * * * *

(c) * * *

(1) * * *

(i) *Extraordinary gain dispositions.* The amount of income or gain (or its equivalent), net of directly related expenses, that is allocated to the share from extraordinary gain dispositions.

(ii) *Positive investment adjustments.* The amount of the positive adjustment (if any) with respect to the share under § 1.1502–32 for each consolidated return year, but only to the extent the amount exceeds the amount described in paragraph (c)(1)(i) of this section for the year.

* * * * *

(2) * * *

(i) * * *

(A) * * *

(*1*) A capital asset as defined in section 1221 (determined without the application of any other rules of law).

* * * * *

(B) A positive section 481(a) adjustment.

* * * * *

(D) Any other event (or item) identified in guidance published in the Internal Revenue Bulletin.

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. * * *

(ii) *Positive investment adjustments.* For purposes of paragraph (c)(1)(ii) of this section, a positive adjustment under § 1.1502–32 is the sum of the amounts under § 1.1502–32(b)(2) (i) through (iii) for the consolidated return year (the adjustment determined without taking distributions into account). However, amounts included in any loss carryover are taken into account in the year they arise rather than the year absorbed.

(iii) *Applicable amounts.* Amounts 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. For this purpose, an amount is reflected in the basis of a share if the share's basis would have been different without the amount. However, amounts included in any loss carryover are taken into account in the year they arise rather than the year absorbed.

* * * * *

(vii) *Disallowance amounts applied only once.* The amounts described in paragraph (c)(1) of this section are not applied more than once to disallow a loss, reduce basis, or reattribute loss under this section.

* * * * *

(4) * * *

Example 1. Allowable loss attributable to lost built-in gain. * * *

(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. Under paragraphs (c)(2) (i) and (iii) of this section, T's $40 gain is from an extraordinary gain disposition and the amount is reflected in the basis of the T stock under § 1.1502–32 immediately before the disposition. Thus, the gain is 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 under section 704(b). Under paragraphs (c)(2) (i) and (iii) of this section, T's $40 gain is from an extraordinary gain disposition, and the gain is reflected in the basis of the T stock under § 1.1502–32 immediately before the disposition.

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. For Year 2, asset 2 produces $30 of gross operating income and $20 of cost recovery deductions. On December 31 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 that is taken into account in the determination of taxable income or loss under § 1.1502–32(b)(2)(i) (the loss offsets T's $10 of operating income for 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 income and a $15 loss. P sells the T stock for $95 in Year 5 and recognizes a $100 loss.

(ii) Under paragraphs (c)(2) (i) and (iii) of this section, the $100 gain from the disposition of asset 1 is from an extraordinary gain disposition and is reflected in the basis of the T stock. Thus, the gain is described in paragraph (c)(1)(i) of this section. The sale of asset 2 is not taken into account under paragraph (c)(1)(i) of this section because, net of directly related expenses, T does not have income or gain from the sale. (No amount is described under paragraph (c)(1)(ii) of this section because T's positive investment adjustments are taken into account 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 the T stock, all of the loss is disallowed.

Example 3. * * * (i) * * * T invests the operating income in another asset that produces a $25 operating loss for Year 2.

* * *

(ii) Under paragraph (c)(1)(ii) of this section, the $100 of income from Year 1 is a positive investment adjustment. The amount is not reduced by the $25 operating loss for Year 2. Because the $100 amount described under paragraph (c)(1)(ii) of this section equals S's $100 loss from the disposition of the T stock, all of the loss is disallowed.

(iii) Under paragraph (c)(2)(iv) of this section, the results 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 an unrelated buyer for $75 (after the $100 decline in the value of the asset and the $25 operating loss) and recognized a $100 loss. T had $100 of income that resulted in a positive adjustment under the investment adjustment system and is reflected, within the meaning of paragraph (c)(2)(iii) of this section, in the basis of the T stock. The income and investment adjustments with respect to the T stock are not reduced or eliminated for purposes of paragraph (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 6. * * *

(ii) Although T has a $100 gain from extraordinary gain dispositions, the gain is not reflected in P's basis in the T stock within the meaning of paragraph (c)(2)(iii) of this section. P's basis reflects the stock's value at the time of P's purchase, and is determined without regard to whether T recognized the gain before the purchase. Thus, no part of T's gain is 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 rules of law. (i) Individual A forms T, and T's assets subsequently appreciate. T borrows $100 on a nonrecourse basis secured by the appreciated assets. P buys all of the stock of T from A for $150. After becoming a member of the P group, T has a $100 operating loss that is absorbed in the determination of consolidated taxable income and P's basis in the T stock is reduced to $50 under § 1.1502–32. Because T's assets have declined in value, T's creditors discharge $60 of T's indebtedness. The $60 discharge is not included in T's gross income under section 108(a), but no attributes are reduced under section 108(b).

(ii) Under paragraph (c)(2)(i) of this section, the discharge of indebtedness is an extraordinary gain disposition. Under § 1.1502–32(b)(3)(ii), however, the $60 discharge of indebtedness is not treated as tax-exempt income that increases P's basis in the T stock. Consequently, under paragraph (c)(2)(iii) of this section, T's discharge of indebtedness income is not reflected in P's basis in the T stock. Thus, there is no amount under paragraph (c)(1) of this section.

(iii) The facts are the same as in paragraph (i) of this *Example*, except that $60 of T's operating loss is not absorbed and is included in a consolidated net operating loss that is carried over under § 1.1502–21, and the $60 is eliminated from the carryover under section 108(b) as a result of T's discharge of indebtedness. The absorption of $40 of T's loss reduces P's basis in the T stock from $150 to $110. The $60 discharge of indebtedness is treated as tax-exempt income that increases P's basis in the T stock, and the $60 attribute reduction is treated as a noncapital, nondeductible expense that reduces P's basis in the T stock. Thus, P's basis in T's stock remains $110 following the discharge and attribute reduction. Because P's basis is $110, rather than $50, the discharge of indebtedness income is reflected in P's basis for purposes of paragraph (c)(2)(iii) of this section. Thus, the amount under paragraph (c)(1)(i) of this section is $60.

* * * * *

(e) * * *

(3) * * *

Example 1. Shifting of value. (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. With the view described in paragraph (e)(1) of this section, P transfers land with a value of $100 to T in exchange for preferred stock with a $200 redemption price and liquidation preference. The $100 redemption premium (the excess of the $200 redemption price over the $100 issue price) ultimately increases the value of the preferred stock from $100 to $200 (and decreases the value of the common stock). T sells the built-in gain asset for $100, and P's aggregate basis in S's common and preferred stock increases to $300. In addition, as a result of a cumulative redetermination under § 1.1502–32(c)(4), P's basis in the T preferred stock increases from $100 to $200 and P's basis in the common stock remains $100. P subsequently sells the common stock at a loss.

(ii) Under section 305, the redemption premium is treated as a distribution of property to which section 301 applies. Under §§ 1.1502–14 and 1.1502–32, P's aggregate basis in the preferred and common stock is unaffected by the deemed distributions.

(iii) P's loss on the sale of the common stock is disallowed under paragraph (e)(1) of this section. This disallowance prevents the preferred stock from shifting value and stock basis adjustments from the common stock to avoid the disallowance of loss under this section.

* * * * *

(f) *No tiering up of certain adjustments*—(1) *General rule.* If the basis of stock of a subsidiary (S) owned by a another member (P) is reduced under this section on the deconsolidation of the S stock, no corresponding adjustment is made under § 1.1502–32 to the basis of the stock of P if there is a disposition or deconsolidation of the P stock in the same transaction. If there is a disposition or deconsolidation in the same transaction of less than all the stock of P, appropriate adjustments must be made under § 1.1502–32 with respect to P (and any higher-tier members).

(2) *Example.* The principles of this paragraph (f) 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 tax year.

(ii) Under paragraph (a)(1) of this section, no deduction is allowed to S for its loss from the sale of the S1 stock. Under § 1.1502–32(b)(3)(iii), S's disallowed loss is treated as a noncapital, nondeductible expense for Year 6 that reduces P's basis in the S stock. (Under § 1.1502–33, S's earnings and profits for Year 6 are reduced by the amount of S's disallowed loss for earnings and profits purposes and, under § 1.1502–33(b), this reduction is reflected in P's earnings and profits.)

(iii) Under paragraphs (b)(1) and (f)(1) of this section, because the stock of T and S2 are deconsolidated as a result of S's sale of the S1 stock, the basis of their stock must be reduced immediately before the sale from $200 to $100 (the value immediately before the deconsolidation). Under § 1.1502–32(b)(3)(iii), the basis reductions are treated

as noncapital, nondeductible expenses for Year 6. Under paragraph (f)(2) of this section, however, because the S2 stock is deconsolidated in the same transaction, the basis reduction to the T stock does not tier up under § 1.1502–32(a)(3). Similarly, because the S1 stock is disposed of in the same transaction, the basis reduction to the S2 stock also does not tier up. (Comparable treatment applies for purposes of earnings and profits under § 1.1502–33.)

(g) * * *

(3) * * *

Example 1. * * * (i) P, the common parent of a group, forms S with a $100 contribution. For Year 1, S has a $60 operating loss that is not absorbed and is included in the group's consolidated net operating loss that is carried over under § 1.1502–21. Under § 1.1502–32(b)(3)(i), P's basis in the S stock is not reduced to reflect S's loss because the loss is not absorbed. Under § 1.1502–33(b), S's deficit in earnings and profits is reflected in P's earnings and profits even though the loss is not absorbed for tax purposes. During Year 2, S's remaining assets appreciate in value and P sells the S stock for $55. But for an election to reattribute losses under paragraph (g) of this section, P would have a $45 loss from the sale that would be disallowed.

* * * * *

(iii) Under § 1.1502–32(b)(3)(iii), the reattribution of $45 of loss is a noncapital, nondeductible expense that reduces P's basis in the S stock from $100 to $55 immediately before the disposition. Consequently, P does not recognize any gain or loss from the disposition.

* * * * *

Example 2. * * * (i) P, the common parent of a group, forms S with a $100 contribution. S then forms T with a $40 contribution and T borrows $60. For Year 1, S has a $30 operating loss and T has a $55 operating loss. The losses are not absorbed and are included in the group's consolidated net operating loss that is carried over under § 1.1502–21. Under § 1.1502–32(b)(3)(i), P's basis in the S stock, and S's basis in the T stock, are not reduced to reflect the S and T losses because the group is unable to absorb the losses. (Under § 1.1502–33(b), the deficits in earnings and profits of S and T are tiered up for earnings and profits purposes even though not absorbed for tax purposes.) During Year 2, P sells the S stock for $30 ($100 invested, minus S's $30 loss and $40 unrealized loss from its investment in the T stock). But for an election to reattribute losses under paragraph (g) of this section, P would have a $70 loss from the sale, which would be disallowed.

* * * * *

(iv) Under § 1.1502–32(b)(3)(iii), the reattribution of loss is a noncapital, nondeductible expense that reduces P's basis in the S stock to $60 immediately before the disposition. Consequently, P recognizes only a $30 loss from the disposition of its S stock ($30 sale proceeds and $60 basis), and this loss is disallowed.

Example 3. * * *

(iv) Under § 1.1502–32(b)(3)(iii), the reattribution of loss is a noncapital, nondeductible expense that reduces P's basis in the S stock to $60 immediately before the disposition. Consequently, P recognizes no gain or loss from the disposition of its S stock. For P's treatment of the $40 reattributed loss, see § 1.1502–1(f).

* * * * *

Par. 11. Section 1.1502–31 is revised to read as follows:

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

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

(2) *Application of other rules of law.* The rules of this section are in addition to other rules of law. The provisions of this section and other rules of law must not have the effect of duplicating an amount in P's basis in S's stock.

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

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

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

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

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

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

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

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

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

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

(ii) *Stock acquisitions.* If a corporation owns less than all of the former common parent's stock immediately after a group structure change described in paragraph (b)(2) of this section, the percentage of the former common parent's net asset basis taken into account equals the percentage (by fair market value) of the former common parent's stock owned immediately after the group structure change. For example, if P owns less than all of the former common parent's stock immediately after the group structure change, only an allocable part of the basis determined under this section is reflected in the shares owned by P (and the amount allocable to shares owned by nonmembers has no effect on the basis of their shares).

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(d) *Cross ownership.* The facts are the same as in paragraph (a) of this *Example 2*, except that S has owned 10% of T's stock for several years and, pursuant to the plan, S acquires the remaining 90% of T's stock in exchange for P stock. The results are the same as in paragraphs (b) and (c) of this *Example 2*, because S's basis in the initial 10% of T's stock is redetermined under this section.

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

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

(b) *Analysis.* Under paragraph (b)(2) of this section, P's basis in T's stock is adjusted to reflect T's net asset basis. Thus, although P's basis in T's stock would ordinarily be a cost basis of $100, P's basis in T's stock under this section is $60.

(h) *Effective date*—(1) *General rule.* This section applies to group structure changes occurring in consolidated return years beginning on or after January 1, 1995.

(2) *Prior law.* For prior years, see prior regulations under section 1502 as in effect with respect to the transaction. See, e.g., § 1.1502–31T as contained in the 26 CFR part 1 edition revised as of April 1, 1994.

§ 1.1502–31T [Removed]

Par. 12. Section 1.1502–31T is removed.

Par. 13. Section 1.1502–32 is revised to read as follows:

§ 1.1502–32 Investment adjustments.

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

(2) *Application of other rules of law.* The rules of this section are in addition to other rules of law. See, e.g., section 358 (basis determinations for distributees), section 1016 (adjustments to basis), § 1.1502–11(b) (limitations on the use of losses), § 1.1502–19 (treatment of excess loss accounts), § 1.1502–20 (additional rules relating to stock loss), and § 1.1502–31 (basis after a group structure change). P's basis in S's stock must not be adjusted under this section and other rules of law in a manner that has the effect of duplicating an adjustment. See also paragraph (h)(5) of this section for basis reductions applicable to certain former subsidiaries.

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

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

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

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

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

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

(i) Taxable income or loss;

(ii) Tax-exempt income;

(iii) Noncapital, nondeductible expenses; and

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

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

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

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

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

(ii) *Tax-exempt income*—(A) *In general.* S's tax-exempt income is its income and gain which is taken into account but permanently excluded from its gross income under applicable law, and which increases, directly or indirectly, the basis of its assets (or an equivalent amount). For example, S's dividend income to which § 1.1502–14(a) applies, and its interest excluded from gross income under section 103, are treated as tax-exempt income. However, S's income not recognized under section 1031 is not treated as tax-exempt income because the corresponding basis adjustments under section 1031(d) prevent S's nonrecognition from being permanent. Similarly, S's tax-exempt income does not include gain not recognized under section 332 from the liquidation of a lower-tier subsidiary, or not recognized under section 118 or section 351 from a transfer of assets to S.

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

(C) *Discharge of indebtedness income*—(*1*) *In general.* Discharge of indebtedness income of S that is excluded from gross income under section 108 is treated as tax-exempt income only to the extent the discharge is applied to reduce tax attributes (e.g., under section 108 or 1017). Discharge of S's indebtedness is treated as applied to reduce tax attributes only to the extent the attribute reduction is taken into account as a reduction under paragraph (b)(3)(iii) of this section.

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

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

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

(B) *Nondeductible basis recovery.* Any other decrease in the basis of S's assets (or an equivalent as described in paragraph (b)(3)(iv)(B) of this section) may be a noncapital, nondeductible expense to the extent that the decrease is not otherwise taken into account in determining stock basis and is permanently eliminated for purposes of determining S's taxable income or loss. Whether a decrease is so treated is determined by taking into account both the purposes of the Code or regulatory

provision resulting in the decrease and the purposes of this section. For example, S's noncapital, nondeductible expenses include any basis reduction under section 50(c)(1), section 1017, section 1059, § 1.1502–20(b), or § 1.1502–20(g). Also included as a noncapital, nondeductible expense is the amount of any gross-up for taxes paid by another taxpayer that S is treated as having paid (e.g., income included under section 78, or the portion of an undistributed capital gain dividend that is treated as tax deemed to have been paid by a shareholder under section 852(b)(3)(D)(ii), whether or not any corresponding amount is claimed as a tax credit). In contrast, a decrease generally is not a noncapital, nondeductible expense if it results because S redeems stock in a transaction to which section 302(a) applies, S receives assets in a liquidation to which section 332 applies and its basis in the assets is less than its basis in the stock canceled, or S distributes the stock of a subsidiary in a distribution to which section 355 applies.

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

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

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

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

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

(v) *Distributions.* Distributions taken into account under paragraph (b)(2) of this section are distributions with respect to S's stock to which section 301 applies and all other distributions treated as dividends (e.g., under section 356(a)(2)). See § 1.1502–14(a)(5) for taking into account distributions to which section 301 applies (but not other distributions treated as dividends) under the entitlement rule.

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

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

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

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

amount does not tier up to higher-tier members).

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

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

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

(iv) *Election.* The election described in this paragraph (b)(4) must be made in a separate statement entitled "ELECTION TO TREAT LOSS CARRYOVER AS EXPIRING UNDER § 1.1502–32(b)(4)." The statement must be filed with the consolidated group's return for the year S becomes a member, and it must be signed by the common parent and S. A separate statement must be made for each member whose loss carryover is deemed to expire. The statement must identify the amount of each loss carryover deemed to expire (or the amount of each loss carryover deemed not to expire, with any balance of any loss carryovers being deemed to expire), the basis of any stock reduced as a result of the deemed expiration, and the computation of the basis reduction.

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

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

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

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

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

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

(b) *Interim determination from stock sale.* The facts are the same as in paragraph (a) of this *Example 2*, except that S's Year 2 loss arises in the first half of the calendar year, P sells 50% of S's stock on July 1 of Year 2, and P's income for Year 2 does not arise until after the sale of S's stock. P's income for Year 2 (exclusive of the sale of S's stock) is offset by S's loss, even though the income arises after the stock sale, and no loss remains to be apportioned to S. See §§ 1.1502–11 and 1.1502–79. Under paragraph (b)(3)(i)(A) of this section, because S's $50 loss is absorbed in the year it arises, it reduces P's basis in the S shares sold by $25 immediately before the stock sale. Because S becomes a nonmember, the loss also reduces P's basis in the retained S shares by $25 immediately before S becomes a nonmember. See also § 1.1502–20(b) (possible stock basis reduction on the deconsolidation of S).

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

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

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

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

paragraph (b) of this section, P reduces its basis in S's stock as of the close of Year 1 by an $80 net amount (the $100 tax loss, less $80 of tax-exempt income, plus $60 of noncapital, nondeductible expenses).

Example 4. Discharge of indebtedness. (a) *Facts.* P forms S on January 1 of Year 1 and S borrows $200. During Year 1, S's assets decline in value and the P group has a $100 consolidated net operating loss when determined by including only S's items of income, gain, deduction, and loss taken into account. None of the loss is absorbed by the group in Year 1, and S is discharged from $100 of indebtedness at the close of Year 1. Under section 108(a), S's $100 of discharge of indebtedness income is excluded from gross income because of insolvency. Under section 108(b), S's $100 net operating loss is reduced to zero at the close of Year 1.

(b) *Analysis.* Under paragraph (b)(3)(iii)(B) of this section, the reduction of the net operating loss is treated as a noncapital, nondeductible expense in Year 1 because the net operating loss is permanently disallowed by section 108(b). Under paragraph (b)(3)(ii)(C) of this section, all $100 of S's discharge of indebtedness income is treated as tax-exempt income in Year 1 because the discharge results in a $100 reduction to S's net operating loss. Consequently, the loss and the cancellation of the indebtedness result in no net adjustment to P's basis in S's stock under paragraph (b) of this section. (If the basis of assets were reduced under section 1017, rather than S's loss, the reduction would not occur until the beginning of Year 2 and the discharge would not be treated as tax-exempt income until that time.)

(c) *Insufficient attributes.* The facts are the same as in paragraph (a) of this *Example 4*, except that $70 of S's net operating loss is absorbed in Year 1, offsetting P's income for that year, and the indebtedness is discharged at the beginning of Year 2. Under paragraph (b) of this section, the $70 of S's loss absorbed in Year 1 reduces P's basis in S's stock by $70 as of the close of Year 1. Under section 108(a), S's discharge of indebtedness income in Year 2 is excluded from the P group's gross income because of insolvency. Under section 108(b), the remaining $30 of S's net operating loss carryover from Year 1 is reduced to zero at the close of Year 2. No other attributes are reduced. Under paragraph (b)(3)(iii)(B) of this section, the elimination of the remaining $30 net operating loss by section 108(b) is treated as a noncapital, nondeductible expense. Under paragraph (b)(3)(ii)(C) of this section, only $30 of the discharge is treated as tax-exempt income because only that amount is applied to reduce tax attributes. See also § 1.1502–19(c)(1)(iii) (taking into account any excess loss account of P in S's stock). The remaining $70 of discharge income excluded under section 108(a) has no effect on P's basis in S's stock.

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

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

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

(c) *Amounts declared but not distributed.* The facts are the same as in paragraph (a) of this *Example 5*, except that, during December of Year 1, S declares (and P becomes entitled to) another $70 dividend distribution with respect to its stock, but P does not receive the distribution until after it sells all of S's stock at the close of Year 1. Under § 1.1502–14(a), S is treated as making a $70 distribution to P at the time P becomes entitled to the distribution. (If S is distributing an appreciated asset, its gain under section 311 is also taken into account under paragraph (b)(3)(i) of this section at the time P becomes entitled to the distribution.) Consequently, under paragraph (b) of this section, P increases its basis in S's stock as of the close of Year 1 by only a $40 net amount ($120 of taxable income, less two distributions totalling $80). Any further adjustments after S ceases to be a member and the $70 distribution is made would be duplicative, because the stock basis has already been adjusted for the distribution. Accordingly, the distribution will not result in further adjustments or gain, even if the distribution is a payment to which section 301(c)(2) or (3) applies.

Example 6. Reorganization with boot. (a) *Facts.* P owns all of the stock of S and T. On January 1 of Year 1, P has a $100 basis in the S stock and a $60 basis in the T stock. S and T have no items of income, gain, deduction, or loss for Year 1. S and T each have substantial earnings and profits. At the close of Year 1, T merges into S in a reorganization described in section 368(a)(1)(A) (and in section 368(a)(1)(D)). P receives no additional S stock, but does receive $10 which is treated as a dividend under section 356(a)(2).

(b) *Analysis.* Under section 358, P's basis in the S stock is increased by its basis in the T stock, decreased to reflect the money received, and increased to reflect treatment of the money as a dividend. Under paragraph (b)(3)(v) of this section, the $10 is also treated as a distribution to which paragraph (b)(2)(iv) of this section applies. Thus, under section 358 and paragraph (b) of this section, P's basis in the S stock is $150 immediately after the merger. (If there had been insufficient earnings and profits to treat the $10 as a dividend under section 356(a)(2), P's basis in the S stock would be $160 because the $10 would not be a distribution to which section 301 applies; but see § 1.1502–13 for the deferral and taking into account of P's $10 gain under section 356(a)(1).)

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

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

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

(c) *Absorption of loss carryovers.* Assume instead that S is a member of the P group at the beginning of Year 1 but ceases to be a member on June 30 as a result of P's sale of S's stock, and a $100 consolidated net operating loss attributable to S is carried over by the P group to Year 1. The consolidated net operating loss may be apportioned to S for its first separate return year only to the extent not absorbed by the P group during Year 1. Under paragraph (b)(3)(i) of this

section, if the loss is absorbed by the P group in Year 1, whether the offsetting income arises before or after P's sale of S's stock, the absorption of the loss carryover is included in the determination of S's taxable income or loss for Year 1. Thus, P's basis in S's stock is adjusted under paragraph (b) of this section to reflect any absorption of the loss by the P group.

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

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

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

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

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

(c) *Recapture.* Assume instead that S is a property and casualty company and, for Year 1, S accrues $100 of estimated salvage recoverable under section 832. Of this amount, $87 (87% of $100) is excluded from gross income because of the "fresh start" provisions of Sec. 11305(c) of P.L. 101–508 (the Omnibus Budget Reconciliation Act of 1990). Thus, S has $87 of tax-exempt income under paragraph (b)(3)(ii)(A) of this section that increases P's basis in S's stock for Year 1. (S also has $13 of taxable income over the period of inclusion under section 481.) In Year 5, S determines that the $100 salvage recoverable was overestimated by $30 and deducts $30 for the reduction of the salvage recoverable. However, S has $26.10 (87% of $30) of taxable income in Year 5 due to the partial recapture of its fresh start. Because S has no basis corresponding to this income, S is treated under paragraph (b)(3)(iii)(B) of this section as having a $26.10 noncapital, nondeductible expense in Year 5. This treatment is necessary to reflect the elimination of the erroneous fresh start in S's stock basis and causes a decrease in P's basis in S's stock by $30 for Year 5 (a $3.90 taxable loss and a $26.10 special adjustment).

(c) *Allocation of adjustments among shares of stock*—(1) *In general.* The portion of the adjustment under paragraph (b) of this section that is described in paragraph (b)(2)(iv) of this section (negative adjustments for distributions) is allocated to the shares of S's stock to which the distribution relates. The remainder of the adjustment, described in paragraphs (b)(2)(i) through (iii) of this section (adjustments for taxable income or loss, tax-exempt income, and noncapital, nondeductible expenses), is allocated among the shares of S's stock as provided in paragraphs (c)(2) through (4) of this section. If the remainder of the adjustment is positive, it is allocated first to any preferred stock to the extent provided in paragraph (c)(3) of this section, and then to the common stock as provided in paragraph (c)(2) of this section. If the remainder of the adjustment is negative, it is allocated only to common stock as provided in paragraph (c)(2) of this section. An adjustment under this section allocated to a share for the period the share is owned by a nonmember has no effect on the basis of the share. See paragraph (c)(4) of this section for the reallocation of adjustments, and paragraph (d) of this section for definitions. See § 1.1502-19(d) for special allocations of basis determined or adjusted under the Code with respect to excess loss accounts.

(2) *Common stock*—(i) *Allocation within a class.* The portion of the adjustment described in paragraphs (b)(2)(i) through (iii) of this section (the adjustment determined without taking distributions into account) that is allocable to a class of common stock is generally allocated equally to each share within the class. However, if a member has an excess loss account in shares of a class of common stock at the time of a positive adjustment, the portion of the adjustment allocable to the member with respect to the class is allocated first to equalize and eliminate that member's excess loss accounts and then to increase equally its basis in the shares of that class. Similarly, any negative adjustment is allocated first to reduce the member's positive basis in shares of the class before creating or increasing its excess loss account. Distributions and any adjustments or determinations under the Internal Revenue Code (e.g., under section 358, including any modifications under § 1.1502–19(d)) are taken into account before the allocation is made under this paragraph (c)(2)(i).

(ii) *Allocation among classes*—(A) *General rule.* If S has more than one class of common stock, the extent to which the adjustment described in paragraphs (b)(2)(i) through (iii) of this section (the adjustment determined without taking distributions into account) is allocated to each class is determined, based on consistently applied assumptions, by taking into account the terms of each class and all other facts and circumstances relating to the overall economic arrangement. The allocation generally must reflect the manner in which the classes participate in the economic benefit or burden (if any) corresponding to the items of income, gain, deduction, or loss allocated. In determining participation, any differences in voting rights are not taken into account, and the following factors are among those to be considered—

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

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

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

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

(3) *Preferred stock.* If the adjustment under paragraphs (b)(2)(i) through (iii) of this section (the adjustment determined without taking distributions into account) is positive, it is allocated to preferred stock to the extent required (when aggregated with prior allocations

to the preferred stock during the period that S is a member of the consolidated group) to reflect distributions described in section 301 (and all other distributions treated as dividends) to which the preferred stock becomes entitled, and arrearages arising, during the period that S is a member of the consolidated group. For this purpose, the preferred stock is treated as entitled to a distribution no later than the time the distribution is taken into account under the Internal Revenue Code (e.g., under section 305). If the amount of distributions and arrearages exceeds the positive amount (when aggregated with prior allocations), the positive amount is first allocated among classes of preferred stock to reflect their relative priorities, and the amount allocated to each class is then allocated pro rata within the class. An allocation to a share with respect to arrearages and distributions for the period the share is owned by a nonmember is not reflected in the basis of the share under paragraph (b) of this section. However, if P and S cease to be members of one consolidated group and remain affiliated as members of another consolidated group, P's ownership of S's stock during consolidated return years of the prior group is treated for this purpose as ownership by a member to the extent that the adjustments during the prior consolidated return years are still reflected in the basis of the preferred stock.

(4) *Cumulative redetermination*—(i) *General rule.* A member's basis in each share of S's preferred and common stock must be redetermined whenever necessary to determine the tax liability of any person. See paragraph (b)(1) of this section. The redetermination is made by reallocating S's net adjustment described in paragraphs (b)(2)(i) through (iii) of this section (the adjustment determined without taking distributions into account) for each consolidated return year (or other applicable period) of the group by taking into account all of the facts and circumstances affecting allocations under this paragraph (c) as of the redetermination date with respect to all of S's shares. For this purpose:

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

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

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

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

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

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

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

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

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

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

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

(b) *Analysis of arrearages.* Under paragraphs (c) (1) and (3) of this section, $20 of the $50 positive adjustment under

paragraph (b) of this section is allocated first to the preferred stock to reflect the dividend arrearage arising in Year 1. The remaining $30 of the positive adjustment is allocated to the common stock, increasing P's basis from $800 to $830 as of the close of Year 1. (The basis of the preferred stock owned by nonmembers is not adjusted under this section.)

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

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

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

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

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

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

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

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

(f) *Current distributions.* The facts are the same as in paragraph (a) of this *Example 3,* except that, during Year 1, S declares and makes a distribution to P of $100 as a dividend on the preferred stock and $100 as a dividend on the common stock. The taxable income and distributions result in no Year 1 adjustment under paragraph (b) of this section for either the common or preferred stock. However, as in paragraph (b) of this *Example 3,* the redetermination under paragraph (c)(4) of this section is made by reallocating a $200 positive adjustment for Year 1 (S's net adjustment described in paragraph (b) of this section, determined without taking distributions into account) to the preferred stock. Consequently, the preferred stock has a $100 positive cumulative adjustment ($200 of taxable income, less a $100 distribution with respect to the preferred stock) and the common stock has a $100 negative cumulative adjustment (for the distribution).

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

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

(i) *Lower-tier members.* The facts are the same as in paragraph (a) of this *Example 3,* except that P owns only S's common stock, and P is also a subsidiary. If there is a redetermination under paragraph (c)(4) of this section by a member owning P's stock,

a redetermination with respect to S's stock must be made first, and the effect of that redetermination on P's adjustments is taken into account under paragraph (b) of this section. However, as in paragraph (h) of this *Example 3*, to the extent an amount of the initial adjustments with respect to S's common stock have already been tiered up and used by a member owning P's stock, that amount remains with S's common stock (and the higher-tier member using the adjustment with respect to P's stock), and may not be reallocated to S's preferred stock.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Example 4. Post-deconsolidation basis adjustments. (a) *Facts.* For Year 1, the P group has $40 of taxable income when determined by including only S's items of income, gain, deduction, and loss taken into account, and P increases its basis in S's stock by $40 under paragraph (b) of this section. P anticipates that S will have a $40 ordinary loss for Year 2 that will be carried back and offset S's income in Year 1 and result in a $40 reduction to P's basis in S's stock for Year 2 under paragraph (b) of this section.

With a principal purpose to avoid the reduction, P causes S to issue voting preferred stock that results in S becoming a nonmember at the beginning of Year 2. (Section 1.1502–20(b) does not reduce P's basis in the S stock as a result of S's deconsolidation.) As anticipated, S has a $40 loss for Year 2, which is carried back to Year 1 and offsets S's income from Year 1.

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

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

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

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

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

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

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

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

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

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

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

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

(4) *Expiring loss carryovers.* If S became a member of a consolidated group in a consolidated return year beginning before January 1, 1995, and S had a loss carryover from a separate return limitation year at that time, the

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

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

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

§ 1.1502–32T [Removed]

Par. 14. Section 1.1502–32T is removed.

Par. 15. Section 1.1502–33 is revised to read as follows:

§ 1.1502–33 Earnings and profits.

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

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

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

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

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

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

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

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

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

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

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

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

(e) *Earnings and profits deficit.* Assume instead that after P forms S in Year 1 with a $100 contribution, S borrows additional funds and has a $150 deficit in earnings and profits for Year 1. The corresponding loss for

tax purposes is not absorbed in Year 1, and is included in the group's consolidated net operating loss carried forward to Year 2. Under paragraph (b)(1) of this section, however, S's $150 deficit in earnings and profits decreases P's earnings and profits for Year 1 by $150. (Absorption of the loss in a later tax year has no effect on the earnings and profits of P and S.)

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

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

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

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

(1) *Stock of members.* For purposes of determining P's earnings and profits from the disposition of S's stock, P's basis in S's stock is adjusted to reflect S's earnings and profits determined under paragraph (b) of this section, rather than under § 1.1502–32. For example, P's basis in S's stock is increased by positive earnings and profits and decreased by deficits in earnings and profits. Similarly, P's basis in S's stock is not reduced for distributions to which paragraph (b)(2) of this section applies (affiliated earnings and profits). P may have an excess loss account in S's stock for earnings and profits purposes (whether or not there is an excess loss account under § 1.1502–32), and the excess loss account is determined, adjusted, and taken into account in accordance with the principles of §§ 1.1502–19 and 1.1502–32.

(2) *Intercompany transactions.* Earnings and profits from a transaction to which § 1.1502–13, § 1.1502–13T, § 1.1502–14, or § 1.1502–14T applies are not reflected before they are taken into account under the applicable principles of those sections.

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

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

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

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

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

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

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

(2) *Wait-and-see method.* The wait-and-see method under this paragraph (d)(2) is derived from Securities and Exchange Commission procedures. In the year that a member's tax attribute is absorbed, the group's consolidated tax liability is allocated in accordance with the group's method under section 1552. When, in effect, the member with the tax attribute could have absorbed the attribute on a separate return basis in a later year, a portion of the group's consolidated tax liability for the later year that is otherwise allocated to members under section 1552 is reallocated. The reallocation takes into account all consolidated return years to which this paragraph (d) applies (the computation period), and is determined by comparing the tax allocated to a member during the computation period with the member's tax liability determined as if it had filed separate returns during the computation period.

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

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

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

(ii) *Reallocation of capped amounts.* To the extent that the amount allocated to a member under section 1552 exceeds the limitation under paragraph (d)(2)(i)

of this section, the excess is allocated among the remaining members in proportion to (but not to exceed the amount of) each member's excess, if any, of—

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

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

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

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

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

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

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

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

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

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

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

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

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

(D) If a method is permitted under paragraph (d)(4) of this section, attach evidence of approval of the method by the Commissioner.

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

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

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

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

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

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

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

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

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

(c) *Payment of tax liability.* If S1 pays the $340 tax liability of the P group and pays $340 to S2, the Year 1 tax liability results in no further adjustments to the income,

earnings and profits, or basis of any member's stock. If S1 pays the $340 tax liability of the P group and pays the other $340 to P instead of S2 because, for example, of an agreement among the members, S2 is treated as distributing $340 to P with respect to its stock in the year that S1 makes the payment to P. See § 1.1552–1(b)(2).

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Example. (a) *Facts.* X is the common parent of a consolidated group with $100 of earnings and profits, and P is the common parent of another consolidated group with $20 of

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

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

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

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

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

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

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

(i) [Reserved]

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

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

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

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

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

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

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

(5) *Prior law.* For prior determinations, see prior regulations under section 1502 as in effect with

respect to the determination. See, e.g., §§ 1.1502–33 and 1.1502–33T as contained in the 26 CFR part 1 edition revised as of April 1, 1994.

§ 1.1502–33T [Removed]

Par. 16. Section 1.1502–33T is removed.

Par. 17. Section 1.1502–75 is amended by revising the first sentence of paragraph (d)(1) to read as follows:

§ 1.1502–75 Filing of consolidated returns.

* * * * *

(d) * * *

(1) * * * A group remains in existence for a tax year if the common parent remains as the common parent and at least one subsidiary that was affiliated with it at the end of the prior year remains affiliated with it at the beginning of the year, whether or not one or more corporations have ceased to be subsidiaries at any time after the group was formed. * * *

* * * * * *

Par. 18. Section 1.1502–76 is amended by:

1. Revising paragraph (b).
2. Removing paragraph (d).
3. The revision reads as follows:

§ 1.1502–76 Taxable year of members of group.

* * * * *

(b) *Items included in the consolidated return*—(1) *General rules*—(i) *In general.* A consolidated return must include the common parent's items of income, gain, deduction, loss, and credit for the entire consolidated return year, and each subsidiary's items for the portion of the year for which it is a member. If the consolidated return includes the items of a corporation for only a portion of its tax year determined without taking this section into account, items for the portion of the year not included in the consolidated return must be included in a separate return (including the consolidated return of another group). The rules of this paragraph (b) must be applied to prevent the duplication or elimination of the corporation's items.

(ii) *The day a corporation becomes or ceases to be a member*—(A) *End of the day rule.* If a corporation (S) becomes or ceases to be a member during a consolidated return year, it becomes or ceases to be a member at the end of the day on which its status as a member changes, and its tax year ends for all Federal income tax purposes at the end of that day. Appropriate adjustments must be made if another provision of the Internal Revenue Code or the regulations thereunder contemplates the event occurring before or after S's change in status. For example, S's items restored under § 1.1502–13 immediately before it becomes a nonmember are taken into account in determining the basis of S's stock under § 1.1502–32. On the other hand, if a section 338(g) election is made in connection with S becoming a member, the deemed asset sale under that section takes place before S becomes a member. See § 1.338–1(e)(5) (deemed sale excluded from purchasing corporation's consolidated return.)

(B) *Next day rule.* If, on the day of S's change in status as a member, a transaction occurs that is properly allocable to the portion of S's day after the event resulting in the change, S and all persons related to S under section 267(b) immediately after the event must treat the transaction for all Federal income tax purposes as occurring at the beginning of the following day. A determination as to whether a transaction is properly allocable to the portion of S's day after the event will be respected if it is reasonable and consistently applied by all affected persons. In determining whether an allocation is reasonable, the following factors are among those to be considered—

(*1*) Whether income, gain, deduction, loss, and credit are allocated inconsistently (e.g., to maximize a seller's stock basis adjustments under § 1.1502–32);

(*2*) If the item is from a transaction with respect to S stock, whether it reflects ownership of the stock before or after the event (e.g., if a member transfers encumbered land to nonmember S in exchange for additional S stock in a transaction to which section 351 applies and the exchange results in S becoming a member of the consolidated group, the applicability of section 357(c) to the exchange must be determined under § 1.1502–80(d) by treating the exchange as occurring after the event; on the other hand, if S is a member but has a minority shareholder and becomes a nonmember as a result of its redemption of stock with appreciated property, S's gain under section 311 is treated as from a transaction occurring before the event);

(*3*) Whether the allocation is inconsistent with other requirements under the Internal Revenue Code (e.g., if a section 338(g) election is made in connection with a group's acquisition of S, the deemed asset sale must take place before S becomes a member and S's gain or loss with respect to its assets must be taken into account by S as a nonmember); and

(*4*) Whether other facts exist, such as a prearranged transaction or multiple changes in S's status, indicating that the transaction is not properly allocable to the portion of S's day after the event resulting in S's change.

(C) *Successor corporations.* For purposes of this paragraph (b)(1)(ii), any reference to a corporation includes a reference to a successor or predecessor as the context may require. A corporation is a successor if the basis of its assets is determined, directly or indirectly, in whole or in part, by reference to the basis of the assets of another corporation (the predecessor). For example, if a member forms S, S is treated as a member from the beginning of its existence.

(iii) *Group structure changes.* If the common parent ceases to be the common parent but the group remains in existence, adjustments must be made in accordance with the principles of § 1.1502–75(d)(2) and (3).

(2) *Determination of items included in separate and consolidated returns*—(i) *In general.* The returns for the years that end and begin with S becoming (or ceasing to be) a member are separate tax years for all Federal income tax purposes. The returns are subject to the rules of the Internal Revenue Code applicable to short periods, as if S ceased to exist on becoming a member (or first existed on becoming a nonmember). For example, cost recovery deductions under section 168 must be allocated for short periods. On the other hand, annualization under section 443 is not required of S solely because it has a short year as a result of becoming a member. (Similarly, section 443 applies with respect to a consolidated return only to the extent that the group's return is for a short period and section 443 applies without taking this paragraph (b) into account.)

(ii) *Ratable allocation of a year's items*—(A) *Application.* Although the periods ending and beginning with S's change in status are different tax years, items (other than extraordinary items) may be ratably allocated between the periods if—

(*1*) S is not required to change its annual accounting period or its method of accounting as a result of its change in status (e.g., because its stock is sold between consolidated groups that have the same annual accounting periods); and

(*2*) An irrevocable ratable allocation election is made under paragraph (b)(2)(ii)(D) of this section.

(B) *General rule*—(*1*) *Allocation within original year.* Under a ratable allocation election, paragraph (b)(2) of this section applies by allocating to each day of S's original year (S's tax year determined without taking this section

into account) an equal portion of S's items taken into account in the original year, except that extraordinary items must be allocated to the day that they are taken into account. All persons affected by the election must take into account S's extraordinary items and the ratable allocation of S's remaining items in a manner consistent with the election.

(2) *Items to be allocated.* Under ratable allocation, the items to be allocated and their timing, location, character, and source are generally determined by treating the original year as a single tax year, and the items are not subject to the rules of the Internal Revenue Code applicable to short periods (unless the original year is a short period). However, the years ending and beginning with S's change in status are treated as different tax years (and as short periods) with respect to any item carried to or from these years (e.g., a net operating loss carried under section 172) and with respect to the application of section 481.

(3) *Multiple applications.* If this paragraph (b) applies more than once with respect to an original year, adjustments must be made in accordance with the principles of this paragraph (b). For example, if S becomes a member of two different consolidated groups during the same original year and ratable allocation is elected with respect to both groups, ratable allocation is generally determined for both groups by treating the original year as a single tax year; however, if ratable allocation is elected only with respect to the first group, the ratable allocation is determined by treating the original year as a short period that does not include the period that S is a member of the second group. Ratable allocation is not a method of accounting, and ratable allocation with respect to one application of this paragraph (b) to S does not require ratable allocation to be subsequently applied with respect to S.

(C) *Extraordinary items.* An extraordinary item is—

(1) Any item from the disposition or abandonment of a capital asset as defined in section 1221 (determined without the application of any other rules of law);

(2) Any item from the disposition or abandonment of property used in a trade or business as defined in section 1231(b) (determined without the application of any holding period requirement);

(3) Any item from the disposition or abandonment of an asset described in section 1221(1), (3), (4), or (5), if substantially all the assets in the same category from the same trade or business are disposed of or abandoned in one transaction (or series of related transactions);

(4) Any item from assets disposed of in an applicable asset acquisition under section 1060(c);

(5) Any item carried to or from any portion of the original year (e.g., a net operating loss carried under section 172), and any section 481(a) adjustment;

(6) The effects of any change in accounting method initiated by the filing of the appropriate form after S's change in status;

(7) Any item from the discharge or retirement of indebtedness (e.g., cancellation of indebtedness income or a deduction for retirement at a premium);

(8) Any item from the settlement of a tort or similar third-party liability;

(9) Any compensation-related deduction in connection with S's change in status (including, for example, deductions from bonus, severance, and option cancellation payments made in connection with S's change in status);

(10) Any dividend income from a nonmember that S controls within the meaning of section 304 at the time the dividend is taken into account;

(11) Any deemed income inclusion from a foreign corporation, or any deferred tax amount on an excess distribution from a passive foreign investment company under section 1291;

(12) Any interest expense allocable under section 172(h) to a corporate equity reduction transaction causing this paragraph (b) to apply;

(13) Any credit, to the extent it arises from activities or items that are not ratably allocated (e.g., the rehabilitation credit under section 47, which is based on placement in service); and

(14) Any item which, in the opinion of the Commissioner, would, if ratably allocated, result in a substantial distortion of income in any consolidated return or separate return in which the item is included.

(D) *Election.* The election to ratably allocate items under this paragraph (b)(2)(ii) must be made in a separate statement entitled "THIS IS AN ELECTION UNDER § 1.1502–76(b)(2)(ii) TO RATABLY ALLOCATE THE YEAR'S ITEMS OF [insert name and employer identification number of the member]." The statement must be signed by the member and by the common parent of each affected group, and must be filed with the returns including the items for the year's ending and beginning with S's change in status. If two or more members of the same consolidated group, as a consequence of the same plan or arrangement, cease to be members of that group and remain affiliated as members of another consolidated group, an election under this paragraph (b)(2)(ii)(D) may be made only if it is made by each such member. The statement must provide all of the following:

(1) Identify the extraordinary items, their amounts, and the separate or consolidated returns in which they are included.

(2) Identify the aggregate amount to be ratably allocated, and the portion of the amount included in the separate and consolidated returns.

(3) Include the name and employer identification number of the common parent (if any) of each group that must take the items into account.

(iii) *Ratable allocation of a month's items.* If ratable allocation under paragraph (b)(2)(ii) of this section is not elected (e.g., because S is required to change its annual accounting period), this paragraph (b)(2)(iii) may be applied to ratably allocate only S's items taken into account in the month of its change in status, but only if the allocation is consistently applied by all affected persons. The ratable allocation is made by applying the principles of paragraph (b)(2)(ii) of this section under any reasonable method. For example, S may close its books both at the end of the preceding month and at the end of the month of the change, and allocate only its items (other than extraordinary items) from the month of the change. See paragraph (b)(1)(ii)(B) of this section for factors to be considered in determining whether the method is reasonable.

(iv) *Taxes.* To the extent properly taken into account during the member's tax year (determined without the application of this paragraph (b)), Federal, state, local, and foreign taxes are allocated under paragraph (b)(2) of this section on the basis of the items or activities to which the taxes relate. Thus, income tax is allocated based on the inclusion of the income (determined under the principles of this paragraph (b)) to which the tax relates. For example, if a calendar-year domestic corporation has $100 of foreign source dividend income (determined in accordance with United States tax accounting principles but without taking this paragraph (b) into account) that is passive income for purposes of section 904, and $60 of the income is allocated under this paragraph (b) to the period of the calendar year after it becomes a member of a consolidated group, then 60% of the corporation's deemed paid foreign tax credit

associated with its dividend income for the calendar year is taken into account in computing the group's passive basket consolidated foreign tax credit. Similarly, property taxes relate to the ownership of property and are allocated over the period that the property is owned. This paragraph (b)(2)(iv) applies without regard to any determination or allocation by another taxing jurisdiction.

(v) *Passthrough entities*—(A) *In general.* If S is a partner in a partnership or an owner of a similar interest with respect to which items of the entity are taken into account by S, S is treated, solely for purposes of determining the year to which the entity's items are allocated under paragraph (b)(2) of this section, as selling or exchanging its entire interest in the entity immediately before S's change in status.

(B) *Treatment as a conduit.* For purposes of this paragraph (b)(2), if a member (together with other members) would be treated under section 318(a)(2) as owning an aggregate of at least 50% of any stock owned by the passthrough entity, the method that is used to determine the inclusion of the entity's items in the consolidated or separate return must be the same method that is used to determine the inclusion of the member's items in the consolidated or separate return.

(C) *Exception for certain foreign entities.* This paragraph (b)(2)(v) does not apply to any foreign corporation generating the deemed inclusion of income, or to any passive foreign investment company generating a deferred tax amount on an excess distribution under section 1291.

(3) *Anti-avoidance rule.* If any person acts with a principal purpose contrary to the purposes of this paragraph (b), to substantially reduce the Federal income tax liability of any person, adjustments must be made as necessary to carry out the purposes of this section.

(4) *Examples.* For purposes of the examples in this paragraph (b), unless otherwise stated, P and X are common parents of calendar-year consolidated groups, P owns all of the only class of T's stock, T owns no stock of lower-tier members, all persons use the accrual method of accounting, the facts set forth the only corporate activity, all transactions are between unrelated persons, tax liabilities are disregarded, and any election required under paragraph (b)(2) of this section is properly made. The principles of this paragraph (b) are illustrated by the following examples.

Example 1. Items allocated between consolidated and separate returns. (a) *Facts.* P and S are the only members of the P group. P sells all of S's stock to individual A, and S becomes a nonmember on July 1 of Year 2.

(b) *Analysis.* Under paragraph (b)(1) of this section, the P group's consolidated return for Year 2 includes P's income for the entire tax year and S's income for the period from January 1 to June 30, and S must file a separate return for the period from July 1 to December 31.

(c) *Acquisition of another subsidiary before end of tax year.* The facts are the same as in paragraph (a) of this *Example 1*, except that P acquires all the stock of T (which filed a separate return for its year ending on November 30 of Year 1) and T becomes a member on August 1 of Year 2. Under § 1.1502–75(d) and paragraph (b)(1) of this section, the P group's consolidated return for Year 2 includes P's income for the entire year, S's income from January 1 to June 30, and T's income from August 1 to December 31. S must file a separate return that includes its income from July 1 to December 31, and T must file a separate return that includes its income from December 1 of Year 1 to July 31 of Year 2. (If P had acquired T after December 31, the P group that included S is a different group from the P group that includes T, and, for example, the P group that includes T must make a separate election under section 1501 and § 1.1502–75 if consolidated returns are to be filed.)

Example 2. Group structure change. (a) *Facts.* P owns all of the stock of S and T. Shortly after the beginning of Year 1, P merges into T in a reorganization described in section 368(a)(1)(A) (and in section 368(a)(1)(D)), and P's shareholders receive T's stock in exchange for all of P's stock. The P group is treated under § 1.1502–75(d)(2)(ii) as remaining in existence with T as its common parent.

(b) *Analysis.* Under paragraph (b)(1) of this section, the P group's return must include the common parent's items for the entire consolidated return year and, if the common parent ceases to be the common parent but the group remains in existence, appropriate adjustments must be made. Consequently, although P did not exist for all of Year 1, P's items for the portion of Year 1 ending with the merger are treated as the items of the common parent that must be included in the P group's return for Year 1.

(c) *Reverse acquisition.* Assume instead that X acquires all of P's assets in exchange for more than 50% of X's stock in a reorganization described in section 368(a)(1)(D). The reorganization constitutes a reverse acquisition under § 1.1502–75(d)(3), with the X group terminating and the P group surviving with X as its common parent. Consequently, P's items for the portion of Year 1 ending with the acquisition are treated as the items of the common parent that must be included in the P group's return for Year 1, and X's items are treated for purposes of paragraph (b)(1) of this section as the items of a subsidiary included in the P group's return for the portion of Year 1 for which X is a member.

Example 3. Ratable allocation. (a) *Facts.* P sells all of T's stock to X, and T becomes a nonmember on July 1 of Year 1. T engages in the production and sale of merchandise throughout Year 1 and is required to use inventories. The sale is treated as causing T's tax year to end on June 30, and the periods beginning and ending with the sale are treated as two tax years for Federal income tax purposes.

(b) *Analysis.* If ratable allocation under paragraph (b)(2)(ii) of this section is not elected, T must perform an inventory valuation as of the acquisition and also as of the end of Year 1. If ratable allocation is elected, T must perform an inventory valuation only as of the close of Year 1, and T's income from inventory is ratably allocated, along with T's other items that are not extraordinary items, between the P and X consolidated returns.

(c) *Merger into nonmember.* Assume instead that T merges into a wholly owned subsidiary of X in a reorganization described in section 368(a)(2)(D), and P receives 10% of X's stock in exchange for all of T's stock. Under paragraph (b)(2)(ii)(B) of this section, because T's tax year ends on June 30 under section 381(b)(1), T's original year determined without taking paragraph (b) of this section into account also ends on June 30. Consequently, a ratable allocation under paragraph (b)(2)(ii) of this section is the same as an allocation based on closing the books.

Example 4. Net operating loss. P sells all of T's stock to X, T becomes a nonmember on June 30 of Year 1, and ratable allocation under paragraph (b)(2)(ii) of this section is elected. Under ratable allocation, the X group has a $100 consolidated net operating loss for Year 1, all of which is attributable to T. However, because of extraordinary items, T has $100 of income for the portion of Year 1 that T is a member of the P group. Under paragraph (b)(2)(ii)(B)(*2*) of this section, T's loss may be carried back from the X group to the portion of Year 1 that T was a member of the P group. See also section 172 and § 1.1502–21(b). Under paragraph (b)(2)(ii)(C)(*5*) of this section, any item carried to or from any portion of the original year is an extraordinary item, and the loss therefore is not taken into account again in determining the ratable allocation under paragraph (b)(2)(ii) of this section.

Example 5. Employee benefit plans. (a) *Facts.* P sells all of T's stock to X, and T becomes a nonmember on June 30 of Year 1. On March 15 of Year 2, T contributes $100 to its retirement plan, which is a qualified plan under section 401(a). T is not required to make quarterly contributions to the plan for Year 1 under section 412(m). The contribution is made on account of T's taxable period beginning on July 1 of Year 1, and is deemed in accordance with section 404(a)(6) to have been made on the last day of T's taxable period beginning on July 1 of Year 1. Ratable allocation under paragraph (b)(2)(ii) of this section is not elected.

(b) *Analysis.* Under paragraph (b) of this section, the sale is treated as causing T's tax year to end on June 30, and the period beginning on July 1 is treated as a separate annual accounting period for all Federal income tax purposes. T's income from January 1 to June 30 is included in the P group's Year 1 return, and T's income from July 1 to December 31 is included in the X

group's Year 1 return. Thus, the $100 contribution is deductible by T for the period of Year 1 that it is a member of the X group, subject to the applicable limitations of section 404, if a contribution on the last day of that period would otherwise be deductible.

(c) The facts are the same as in paragraph (a) of this *Example 5*, except that, in accordance with section 404(a)(6), $40 of the $100 contribution is made on account of T's taxable period beginning on January 1 of Year 1 and is deemed to be made on the last day of T's taxable period beginning on January 1 of Year 1. The remaining $60 is made on account of T's taxable period beginning on July 1 of Year 1 and is deemed to be made on the last day of T's taxable period beginning on July 1 of Year 1. As in paragraph (b) of this *Example 5*, under paragraph (b) of this section, the sale is treated as causing T's tax year to end on June 30, and the period beginning on July 1 is treated as a separate annual accounting period for all Federal income tax purposes. The $40 portion of the contribution is deductible by T for the period of Year 1 that it is a member of the P group, subject to the applicable limitations of section 404 and provided that a $40 contribution on the last day of that period would otherwise be deductible for that period, and the $60 portion is deductible by T for the period of Year 1 that it is a member of the X group, subject to the same conditions.

(d) *Ratable allocation.* The facts are the same as in paragraph (a) of this *Example 5*, except that P, T, and X elect ratable allocation under paragraph (b)(2)(ii) of this section and T's deduction for the retirement plan contribution is not an extraordinary item. T's deduction may be ratably allocated, subject to the applicable limitations of section 404, and is allowable only if a contribution on the last day of Year 1 otherwise would be deductible for any period in the year. (The results would be the same if S were an unaffiliated corporation when acquired by X, and the due date of its last separate return (including extensions) were before the pension contribution was made on March 15 of Year 2.)

Example 6. Allocation of partnership items. (a) *Facts.* P sells all of T's stock to X, and T becomes a nonmember on June 30 of Year 1. T has a 10% interest in the capital and profits of a calendar-year partnership.

(b) *Analysis.* Under paragraph (b)(2)(v)(A) of this section, T is treated, solely for purposes of determining T's tax year in which the partnership's items are included, as selling or exchanging its entire interest in the partnership as of P's sale of T's stock. Thus, the deemed disposition is not taken into account under section 708, it does not result in gain or loss being recognized by T and T's holding period is unaffected. However, under section 706(a), in determining T's income, T is required to include its distributive share of partnership items for the partnership's year ending within or with T's tax year. Under section 706(c)(2), the partnership's tax year is treated as closing with respect to T for this purpose as of P's sale of T's stock. The allocation of T's distributive share of partnership items must be made under § 1.706–1(c)(2)(ii).

(c) *Controlled partnership.* The facts are the same as in paragraph (a) of this *Example 6*, except that T has a 75% interest in the capital and profits of the partnership. Under paragraph (b)(2)(v)(B) of this section, T's distributive share of the partnership's items is treated as T's items for purposes of paragraph (b)(2) of this section. Thus, if ratable allocation under paragraph (b)(2)(ii) of this section is not elected, T's distributive share of the partnership's items must be determined under § 1.706–1(c)(2)(ii) by an interim closing of the partnership's books. Similarly, if ratable allocation is elected for T's items that are not extraordinary items, T's distributive share of the partnership's nonextraordinary items must also be ratably allocated under § 1.706–1(c)(2)(ii).

(5) *Effective date*—(i) *General rule.* This paragraph (b) applies to corporations becoming or ceasing to be members of consolidated groups on or after January 1, 1995.

(ii) *Prior law.* For prior transactions, see prior regulations under section 1502 as in effect with respect to the transaction. See, e.g., § 1.1502–76(b) and (d) as contained in the 26 CFR part 1 edition revised as of April 1, 1994. However, § 1.1502–76(b)(5) and (6) as contained in the 26 CFR part 1 edition revised as of April 1, 1994 do not apply with respect to corporations becoming or ceasing to be members of consolidated groups on or after January 1, 1995. If both this paragraph (b) and prior law may apply to determine the inclusion of any amount in a return, appropriate adjustments must be made to prevent the omission or duplication of the amount.

* * * * *

Par. 19. Section 1.1502–80 is amended by adding paragraphs (c) and (d) to read as follows:

§ 1.1502–80 Applicability of other provisions of law.

* * * * *

(c) *Deferral of section 165.* For consolidated return years beginning on or after January 1, 1995, stock of a member is not treated as worthless under section 165 before the stock is treated as disposed of under the principles of § 1.1502–19(c)(1)(iii). See §§ 1.1502–15(b) and 1.1502–20 for additional rules relating to stock loss.

(d) *Non-applicability of section 357(c)*—(1) *In general.* Section 357(c) does not apply to any transaction to which § 1.1502–13, § 1.1502–13T, § 1.1502–14, or § 1.1502–14T applies, if it occurs in a consolidated return year beginning on or after January 1, 1995. For example, P, S, and T are members of a consolidated group, P owns all of the stock of S and T with bases of $30 and $20, respectively, S has a $30 basis in its assets and $40 of liabilities, and S merges into T in a transaction described in section 368(a)(1)(A) (and in section 368(a)(1)(D)); section 357(c) does not apply to the merger, P's basis in T's stock increases to $50 ($30 plus $20), and T succeeds to S's $30 basis in the assets transferred subject to the $40 liability. Similarly, if S instead transferred its assets and liabilities to a newly formed subsidiary in a transaction to which section 351 applies, section 357(c) does not apply and S's basis in the subsidiary's stock is a $10 excess loss account. This paragraph (d) does not apply to a transaction if the transferor or transferee becomes a nonmember as part of the same plan or arrangement. The transferor (or transferee) is treated as becoming a nonmember once it is no longer a member of a consolidated group that includes the transferee (or transferor).

(2) *Prior period transactions.* If, in a tax year beginning before January 1, 1995, a member's stock with an excess loss account is transferred in a transaction to which § 1.1502–13, § 1.1502–13T, § 1.1502–14, or § 1.1502–14T applies, paragraph (d)(1) of this section applies to the stock transfer to the extent that the income, gain, deduction, or loss (if any) is not taken into account in a tax year beginning before January 1, 1995. For example, if P, S, and T, are members of a consolidated group, T's stock has an excess loss account, and P transfers the T stock to S in 1993 in a transaction to which section 351 and § 1.1502–13 apply, section 357(c) applies to the transfer only to the extent P's gain is taken into account in tax years beginning before January 1, 1995.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 20. The authority citation for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

§ 602.101 [Amended]

Par. 21. Section 602.101(c) is amended by removing the entries for §§ 1.1502–31T, 1.1502–32T, and 1.1502–33T from the table, adding in numerical order, the entry for § 1.1502–31, and revising the entries for §§ 1.1502–32, 1.1502–33, and 1.1502–76.

CFR part or section where identified and described	Current OMB control No.
. . . . .	
1.1502–31	1545–1344
1.1502–32	1545–*344

CFR part or section where identified and described	Current OMB control No.
1.1502–33	1545–1344
. . . .	.
1.1502–76	1545–1344
. . . .	.

Approved: June 29, 1994.

Margaret Milner Richardson,

Commissioner of Internal Revenue.

Cynthia G. Beerbower,

Deputy Assistant Secretary of the Treasury (Tax Policy).

[FR Doc. 94–19548 Filed 8–12–94; 8:45 am]

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PENSION BENEFIT GUARANTY CORPORATION

29 CFR Parts 2619 and 2676

Valuation of Plan Benefits in Single-Employer Plans; Valuation of Plan Benefits and Plan Assets Following Mass Withdrawal; Amendments Adopting Additional PBGC Rates

AGENCY: Pension Benefit Guaranty Corporation.

ACTION: Final rule.

SUMMARY: This final rule amends the Pension Benefit Guaranty Corporation's ("PBGC's") regulations on Valuation of Plan Benefits in Single-Employer Plans and Valuation of Plan Benefits and Plan Assets Following Mass Withdrawal. The former regulation contains the interest assumptions that the PBGC uses to value benefits under terminating single-employer plans. The latter regulation contains the interest assumptions for valuations of multiemployer plans that have undergone mass withdrawal. The amendments set out in this final rule adopt the interest assumptions applicable to single-employer plans with termination dates in September 1994, and to multiemployer plans with valuation dates in September 1994. The effect of these amendments is to advise the public of the adoption of these assumptions.

EFFECTIVE DATE: September 1, 1994.

FOR FURTHER INFORMATION CONTACT: Harold J. Ashner, Assistant General Counsel, Office of the General Counsel, Pension Benefit Guaranty Corporation, 1200 K Street, NW., Washington, DC 20005, 202–326–4024 (202–326–4179 for TTY and TDD). (These are not toll-free numbers.)

SUPPLEMENTARY INFORMATION: This rule adopts the September 1994 interest assumptions to be used under the Pension Benefit Guaranty Corporation's ("PBGC's") regulations on Valuation of Plan Benefits in Single-Employer Plans (29 CFR part 2619, the "single-employer regulation") and Valuation of Plan Benefits and Plan Assets Following Mass Withdrawal (29 CFR part 2676, the "multiemployer regulation").

Part 2619 sets forth the methods for valuing plan benefits of terminating single-employer plans covered under title IV of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). Under ERISA section 4041(c), all single-employer plans wishing to terminate in a distress termination must value guaranteed benefits and "benefit liabilities," *i.e.*, all benefits provided under the plan as of the plan termination date, using the formulas set forth in part 2619, subpart C. (Plans terminating in a standard termination may, for purposes of the Standard Termination Notice filed with PBGC, use these formulas to value benefit liabilities, although this is not required.) In addition, when the PBGC terminates an underfunded plan involuntarily pursuant to ERISA section 4042(a), it uses the subpart C formulas to determine the amount of the plan's underfunding. Part 2676 prescribes rules for valuing benefits and certain assets of multiemployer plans under sections 4219(c)(1)(D) and 4281(b) of ERISA.

Appendix B to part 2619 sets forth the interest rates and factors under the single-employer regulation. Appendix B to part 2676 sets forth the interest rates and factors under the multiemployer regulation. Because these rates and factors are intended to reflect current conditions in the financial and annuity markets, it is necessary to update the rates and factors periodically.

The PBGC issues two sets of interest rates and factors, one set to be used for the valuation of benefits to be paid as annuities and one set for the valuation of benefits to be paid as lump sums. The same assumptions apply to terminating single-employer plans and to multiemployer plans that have undergone a mass withdrawal. This amendment adds to appendix B to parts 2619 and 2676 sets of interest rates and factors for valuing benefits in single-employer plans that have termination dates during September 1994 and multiemployer plans that have undergone mass withdrawal and have valuation dates during September 1994.

For annuity benefits, the interest rates will be 6.90% for the first 25 years following the valuation date and 5.25% thereafter. For benefits to be paid as lump sums, the interest assumptions to be used by the PBGC will be 5.50% for the period during which benefits are in pay status, 4.75% during the seven years directly preceding the benefit's placement in pay status, and 4.0% during any other years preceding the benefit's placement in pay status. (ERISA section 205(g) and Internal Revenue Code section 417(e) provide that private sector plans valuing lump sums not in excess of $25,000 must use interest assumptions at least as generous as those used by the PBGC for valuing lump sums (and for lump sums exceeding $25,000 must use interest assumptions at least as generous as 120% of the PBGC interest assumptions).) The above annuity interest assumptions represent a decrease (from those in effect for August 1994) of .10 percent for the first 25 years following the valuation date and are otherwise unchanged. The lump sum interest assumptions represent a decrease (from those in effect for August 1994) of .25 percent for the period during which benefits are in pay status and the seven years directly preceding that period; they are otherwise unchanged.

Generally, the interest rates and factors under these regulations are in effect for at least one month. However, the PBGC publishes its interest assumptions each month regardless of whether they represent a change from the previous month's assumptions. The assumptions normally will be published in the **Federal Register** by the 15th of the preceding month or as close to that date as circumstances permit.

The PBGC has determined that notice and public comment on these amendments are impracticable and contrary to the public interest. This finding is based on the need to determine and issue new interest rates and factors promptly so that the rates and factors can reflect, as accurately as possible, current market conditions.

Because of the need to provide immediate guidance for the valuation of benefits in single-employer plans whose termination dates fall during September 1994, and in multiemployer plans that have undergone mass withdrawal and have valuation dates during September 1994, the PBGC finds that good cause exists for making the rates and factors set forth in this amendment effective less than 30 days after publication.

The PBGC has determined that this action is not a "significant regulatory action" under the criteria set forth in Executive Order 12866, because it will not have an annual effect on the economy of $100 million or more or adversely affect in a material way the economy, a sector of the economy,