Section 1502.— Regulations

26 CFR 1.1502–13: Intercompany transactions.

T.D. 8660

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Consolidated Groups— Intercompany Transactions and Related Rules

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations disallowing losses and excluding gain for certain dispositions and other transactions involving stock of the common parent of a consolidated group.

DATES: These regulations are effective March 14, 1996.

For dates of applicability, see the effective date provision of these regulations.

FOR FURTHER INFORMATION CONTACT: Victor Penico or Richard Osborne of the Office of Assistant Chief Counsel (Corporate), (202) 622-7750 or (202) 622-7770 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

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 Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1433. Responses to these collections of information are required to obtain a benefit, the avoidance of a possible gain because of basis adjustments relating to built-in loss.

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

The estimated average annual burden per respondent is 15 minutes.

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, T:FP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, D.C. 20503.

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

Background

On July 12, 1995, the IRS and Treasury issued proposed and temporary regulations disallowing loss incurred by a member (M) of a consolidated group with respect to the stock of the common parent (P stock). The regulations also eliminate gain in certain transactions by M with respect to P stock. The regulations are effective for transactions occurring on or after July 12, 1995.

The IRS received comments on the proposed regulations and held a public hearing on December 11, 1995. After consideration of the comments and the statements made at the hearing, the IRS and Treasury adopt the proposed regulations with revisions in this Treasury decision. The significant comments and changes are discussed below.

Explanation of provisions

Scope of the regulations

The proposed regulations disallow all losses on P stock and eliminate gain in specified circumstances. Some commentators suggested that the regulations should treat gain and loss more symmetrically. Some suggested the regulations should achieve this goal by eliminating gain in all circumstances. Others suggested the regulations should disallow loss only in ''abusive'' circumstances.

Eliminating gain in all circumstances would effectively require complete single entity treatment of P stock. Implementing such a system would significantly increase the complexity of the consolidated return regulations. Notice 94–49 (1994–1 C.B. 358), included a detailed discussion of issues relating to the single entity treatment of P stock.

Limiting the loss disallowance rule to ''abusive situations'' would allow consolidated groups to rely on the separate-entity treatment of stock to claim losses and single-entity treatment to avoid gains. For example, taxpayers might plan to take advantage of separate entity treatment by having M purchase P stock. If the value of the stock has gone down at a time when the group wants to issue equity, M will sell its P stock at a loss (and claim the loss). If the value of the stock has gone up, the group can take advantage of single entity treatment by having P sell the stock, and no gain would be recognized under section 1032. The same would hold true if instead P had acquired M already owning P stock. Commentators did not suggest any generally applicable method of distinguishing between transactions in which loss should be allowed and those in which loss should not be allowed.

The IRS and Treasury have therefore concluded that the final regulations should retain the general approach of the proposed regulations.

Built-in losses

Some commentators suggested that if M joins the group at a time when it holds P stock with a built-in loss the loss should be allowed because it accrued outside the group. The final regulations do not allow this loss because doing so without ensuring that the built-in gain is taxed would allow the same selectivity and inconsistencies that the regulation is designed to prevent. In addition, allowing the loss would require tracing, which is inconsistent with the approaches to similar issues in §§1.1502–20 and 1.1502–32.

Commentators further suggested that interactions between the proposed regulations and §1.1502–32 could cause the group to recognize an artificial gain from the purchase of a corporation owning depreciated P stock. If M joins the group at a time when it holds P

stock with a built-in loss and M subsequently sells the stock, P will have a downward basis adjustment in its M stock because of the disallowed loss. See §1.1502–32(b)(3)(iii)(A). The commentators asserted that this basis adjustment would be inappropriate if the group has a cost basis in M stock because the basis of M will reflect the value of the P stock at the time of acquisition (rather than M's basis in the P stock). To address this problem, the final regulations allow the built-in loss to be waived immediately before M joins the group. The loss waiver is modeled after a similar provision in §1.1502–32(b)(4). The election, however, is limited to direct acquisitions of a corporation holding P stock in a cost basis transaction.

Gain relief

Commentators suggested that the gain relief should be broadened. Some suggested that the requirement that M receive the P stock in a capital contribution or section 351(a) transaction be eliminated. Others suggested elimination of the requirement that M dispose of the P stock immediately. Commentators also suggested that the gain relief should apply to options and warrants in P stock, and not merely to P stock.

The final regulations retain the requirements for gain relief but extend the relief to positions in P stock. Any further expansion of the gain relief would require additional limitations and complexities.

For instance, if M were not required to dispose of the P stock immediately, the regulations would have to require that M have no minority shareholders. If M had minority shareholders, the gain relief mechanism (treating cash as contributed to M followed by a purchase of the stock by M) would allow P a full basis adjustment in M stock for post-contribution appreciation rather than a pro rata adjustment as required by §1.1502–32 in the case of minority shareholders. Amending the mechanism to allow only pro rata adjustments (for example, through a direct basis adjustment rather than a cash transaction) would create further complexities, such as the interaction with §1.1502–20.

Expanding gain relief would require further adjustments if M stock were sold to another member of the group. For example, if B purchases the stock of M from another member, B's basis in M will reflect the value of any P stock held by M. Thus, an increase to B's basis in the stock of M when M disposes of P stock would be unwarranted. Additional special rules would be needed if M were permitted to acquire P stock by purchase rather than through a capital contribution. Moreover, the IRS and Treasury believe that in many cases gain on P stock is avoidable without further expansion of the regulations. See, *e.g.*, §1.1032–2(b) (no gain or loss on M's use of certain P stock in triangular reorganizations). Therefore, the final regulations retain the requirements of the proposed regulations for gain relief.

In addition, commentators claimed that the relief when M is newly formed was unclear. The final regulations clarify that M can be newly formed as part of the plan to dispose of P stock.

Dealers in P stock

Some commentators suggested that if a subsidiary is a dealer in P stock, it should be allowed to recognize losses from its dealing activity. They argued that dealing in P stock increases the liquidity of the stock and that the proposed regulations would curtail this activity by forcing the recognition of gain but disallowing loss with respect to P stock.

In response to these comments, the final regulations include an exception for dealers in P stock or positions in P stock. Under the final regulations, a dealer in P stock or positions recognizes both gain and loss on shares of the stock to the extent taken into account because of section 475(a) (or 1256(a) in the case of dealer equity options). To be eligible for this exception, M must regularly trade in P stock (of the same class) in the ordinary course of its business as a dealer. In addition, the gain or loss on a share is eligible only to the extent it is taken into account under section 475(a) (or in the case of dealer equity options, section 1256(a) to the extent that it would be taken into account under the principles of section 475), and the basis of the share of stock must not be adjusted by reference to the basis of any other property (for example, under §1.302–2) or by reference to income, gain, deduction or loss from other property. For example, loss that is suspended under section 475(b)(3) and that is recognized under section 1001 as the result of a disposition of the security is not eligible for the relief, but loss taken into account under section 475(a) immediately before a taxpayer ceases to be the owner of the security is eligible for relief. Finally, relief is not available if either M or any other member of the group has structured or engaged in any transaction while a member (or in anticipation of becoming a member) during the taxable year or in any year within the preceding five taxable years that is open for assessment under section 6501 with a principal purpose of avoiding gain or creating loss on P stock subject to section 475(a).

Positions in P stock

In response to comments, the final regulations clarify that the scope of loss disallowance is coextensive with the scope of section 1032. For example, cash-settled options are within the scope of loss disallowance. See Rev. Rul. 88–31 (1988–1 C.B. 302). No inference is intended as to the extent to which section 1032 and these regulations apply to derivative positions in P stock other than options.

One commentator argued that the loss disallowance rule should not apply to options in P stock because the selectivity available for stock is not present with respect to options. The final regulations do not adopt this approach. If M purchases an option to acquire P stock and the option expires when it is worthless, M has a loss. If the option is in the money, M can purchase the P stock and hold it indefinitely. Thus, the group would have the ability to recognize losses while avoiding gains.

Effective dates

The final regulations apply to gain or loss taken into account on or after July 12, 1995, and to transactions (such as a member leaving the group) occurring on or after July 12, 1995. Thus, the regulations are intended to cover the same gain, loss and transactions covered by the rules published in 1995–32 I.R.B. 47. If, however, a taxpayer takes a gain or loss into account, or engages in a transaction, on or after July 12, 1995, during a tax year ending prior to December 31, 1995, the taxpayer may treat the gain, loss or transaction under

the rules of the temporary rules published in 1995–32 I.R.B. 47 instead of under the rules of the final regulations.

Special Analysis

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 is hereby certified that these regulations do not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations will primarily affect affiliated groups of corporations that have elected to file consolidated returns, which tend to be larger businesses. The regulations do not significantly alter the reporting or recordkeeping duties of small entities. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) 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.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by revising the entry for §1.1502–13 to read as follows:

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

Section 1.1502–13 also issued under 26 U.S.C. 1502. * * *

Par. 2. In §1.267(f)–1(k), the first sentence is amended by removing the reference ''1.1502–13T(f)(6)'' and adding ''1.1502–13(f)(6)'' in its place.

Par. 3. Section 1.1502–13(f)(6) is added to read as follows:

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* * * * * *

(f) * * *

(6) *Stock of common parent*. In addition to the general rules of this section, this paragraph (f)(6) applies to parent stock (P stock) and positions in P stock held or entered into by another member. For this purpose, P stock is any stock of the common parent held by another member or any stock of a member (the issuer) that was the common parent if the stock was held by another member while the issuer was the common parent.

(i) *Loss stock*—(A) *Recognized loss*. Any loss recognized, directly or indirectly, by a member with respect to P stock is permanently disallowed and does not reduce earnings and profits. See §1.1502–32(b)(3)(iii)(A) for a corresponding reduction in the basis of the member's stock.

(B) *Other cases*. If a member, M, owns P stock, the stock is subsequently owned by a nonmember, and, immediately before the stock is owned by the nonmember, M's basis in the share exceeds its fair market value, then, to the extent paragraph (f)(6)(i)(A) of this section does not apply, M's basis in the share is reduced to the share's fair market value immediately before the share is held by the nonmember. For example, if M owns shares of P stock with a $100x basis and M becomes a nonmember at a time when the P shares have a value of $60x, M's basis in the P shares is reduced to $60x immediately before M becomes a nonmember. Similarly, if M contributes the P stock to a nonmember in a transaction subject to section 351, M's basis in the shares is reduced to $60x immediately before the contribution. See §1.1502–32(b)(3)(iii)(B) for a corresponding reduction in the basis of M's stock.

(C) *Waiver of built-in loss on P stock*—(*1*) *In general*. If a nonmember that owns P stock with a basis in excess of its fair market value becomes a member of the P consolidated group in a qualifying cost basis transaction, the group may make an irrevocable election to reduce the basis of the P stock to its fair market value immediately before the nonmember becomes a member of the P group. If the nonmember was a member of another consolidated group immediately before becoming a member of the P group, the reduction in basis is treated as occurring immediately after it ceases to be a member of the prior group. A qualifying cost basis transaction is the purchase (*i.e.*, a transaction in which basis is determined under section 1012) by members of the P consolidated group (while they are members) in a 12–month period of an amount of the nonmember's stock satisfying the requirements of section 1504(a)(2).

(*2*) *Election*. The election described in this paragraph (6)(i)(C) must be made in a separate statement entitled ''ELECTION TO REDUCE BASIS OF P STOCK UNDER §1.1502–13(f)(6).'' The statement must be filed with the P consolidated group's return for the year in which the nonmember becomes a member, and it must be signed by both P and the nonmember. The statement must identify the fair market value of, and the amount of the basis reduction in, the P stock.

(ii) *Gain stock*. If a member, M, would otherwise recognize gain on a qualified disposition of P stock, then immediately before the qualified disposition, M is treated as purchasing the P stock from P for fair market value with cash contributed to M by P (or, if necessary, through any intermediate members). A disposition is a qualified disposition only if—

(A) The member acquires the P stock directly from the common parent (P) through a contribution to capital or a transaction qualifying under section 351(a) (or, if necessary, through a series of such transactions involving only members);

(B) Pursuant to a plan, the member transfers the stock immediately to a nonmember that is not related, within the meaning of section 267(b) or 707(b), to any member of the group;

(C) No nonmember receives a substituted basis in the stock within the meaning of section 7701(a)(42);

(D) The P stock is not exchanged for P stock;

(E) P neither becomes nor ceases to be the common parent as part of, or in contemplation of, the disposition or plan; and

(F) M is neither a nonmember that becomes a member nor a member that becomes a nonmember as part of, or in contemplation of, the disposition or plan.

(iii) *Mark-to-market of P stock*. Paragraphs (f)(6)(i) and (ii) of this section shall not apply to any gain or loss from a share of P stock held by a member, M, if—

(A) M regularly trades in P stock (of the same class) with customers in the ordinary course of its business as a dealer;

(B) The gain or loss on the share is taken into account by M pursuant to section 475(a);

(C) M's basis in the share is not adjusted by reference to the basis of any other property or by reference to income, gain, deduction, or loss from other property; and

(D) Neither M nor any other member of the group has structured or engaged in any transaction while a member (or in anticipation of becoming a member), during the taxable year or in any year within the preceding five taxable years that is open for assessment under section 6501, with a principal purpose of avoiding gain or creating loss on P stock subject to section 475(a).

(iv) *Options, warrants, and other positions*—(A) *In general*. This paragraph (f)(6) applies with appropriate adjustments to positions in P stock to the extent that P's gain or loss from an equivalent position would not be recognized under section 1032. Thus, if M purchases an option to buy or sell P stock and sells the option at a loss, the loss is permanently disallowed under paragraph (f)(6)(i)(A) of this section. Similarly, if M is the grantor of such an option and becomes a nonmember, then the principles of paragraph (f)(6)(i)(B) of this section apply to the extent that M would recognize loss from cash settlement of the option at its fair market value immediately before M becomes a nonmember, and proper adjustments must be made in the amount of any gain or loss subsequently realized from the position by M. If P grants M an option to acquire P stock in a transaction meeting the requirements of paragraph (f)(6)(ii) of this section, M is treated as having purchased the option from P for fair market value with cash contributed to M by P.

(B) *Mark-to-market of positions in P stock*. For purposes of paragraph (f)(6)(iii) of this section, gain or loss with respect to a position taken into account under section 1256(a) is treated as taken into account under section 475(a) to the extent that the gain or loss would be taken into account under the principles of section 475.

(v) *Effective date*. This paragraph (f)(6) applies to gain or loss taken into account on or after July 12, 1995, and to transactions occurring on or after July 12, 1995. For example, if S sells P stock to B at a loss prior to July 12, 1995, and B sells the P stock to a nonmember after July 12, 1995, S's loss is disallowed because it is taken into account after July 12, 1995. If a taxpayer takes a gain or loss into account or engages in a transaction on or after July 12, 1995, during a tax year ending prior to December 31, 1995, the taxpayer may treat the gain or loss or the transaction under the rules of §1.1502–13T(f)(6) (published in 1995–32 I.R.B. 47), instead of under the rules of this paragraph (f)(6).

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Par. 5. In §1.1502–13(g)(2)(i)(B), the last sentence is amended by removing the language ''paragraph (f)(4) of this section and §1.1502–13T(f)(6)'' and adding ''paragraphs (f)(4) and (6) of this section.''

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved March 8, 1996.

Leslie Samuels,
Assistant Secretary of the Treasury
(Tax Policy).

(Filed by the Office of the Federal Register on March 13, 1996, 8:45 a.m., and published in the issue of the Federal Register for March 14, 1996, 61 F.R. 10447)