

# Notice of Proposed Rulemaking and Notice of Public Hearing

## Consolidated Returns; Applicability of Other Provisions of Law; Non-Applicability of Section 357(c)

REG-137519-01

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document proposes amendments relating to the consolidated return regulations dealing with the non-applicability of section 357(c) in a consolidated group. The proposed amendments clarify that, in certain transfers described in section 351 between members of a consolidated group, a transferee's assumption of certain liabilities described in section 357(c)(3) will not reduce the transferor's basis in the transferee's stock received in the transfer. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments and requests to speak (with outlines of oral comments to be discussed) at the public hearing scheduled for March 21, 2002, must be submitted by February 28, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU (REG-137519-01), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (REG-137519-01), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS internet site at [http://www.irs.ustreas.gov/tax\\_regs/reglist.html](http://www.irs.ustreas.gov/tax_regs/reglist.html). The public hearing will be held in room 4718, Internal Rev-

enue Building, 1111 Constitution Avenue, NW, Washington, DC.

### FOR FURTHER INFORMATION

CONTACT: Concerning the regulations, T. Ian Russell of the Office of Associate Chief Counsel (Corporate), (202) 622-7930; concerning submissions, the hearing, and/or to be placed on the building access list to attend the hearing, Donna M. Poindexter (202-622-7180) (not toll-free numbers).

### SUPPLEMENTARY INFORMATION:

#### Background

Section 357(c)(1) generally provides that, in the case of certain exchanges described in section 351, if the sum of the amount of the liabilities assumed by the transferee corporation exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as gain from the sale or exchange of a capital asset or of property that is not a capital asset. Section 357(c)(3), however, excludes from the computation of liabilities assumed liabilities the payment of which would give rise to a deduction, provided that the incurrence of such liabilities did not result in the creation of, or an increase in, the basis of any property.

Section 358(a) generally provides that, in the case of an exchange to which section 351 applies, the basis of the property permitted to be received without the recognition of gain or loss is decreased by the amount of any money received by the transferor. For this purpose, under section 358(d)(1), the transferee's assumption of a liability of the transferor is treated as money received by the transferor on the exchange. Section 358(d)(2), however, provides an exception for liabilities excluded under section 357(c)(3).

On August 15, 1994, final regulations (T.D. 8560) adding paragraph (d) to §1.1502-80 were published in the **Federal Register** (59 FR 41666). A correcting amendment adding a sentence to the end of paragraph (d) of §1.1502-80 was published in the **Federal Register** for March 14, 1997 (62 FR 12096). As currently in effect, §1.1502-80(d) provides that "[s]ection 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." The example in that regulation contemplates that, to the extent that the transferor does not recognize gain under section 357(c) by reason of the rule of §1.1502-80(d), the transferor's basis in the stock of the transferee that it receives in the exchange is reduced, with the result that an excess loss account may arise.

A concern has been raised that, as currently drafted, §1.1502-80(d) may produce an unintended basis result in certain intragroup transfers described in section 351. In particular, it is possible that one might conclude that, because §1.1502-80(d) provides that section 357(c) does not apply to certain intragroup section 351 exchanges, no liabilities can technically be excluded under section 357(c)(3). If that analysis were correct, in the case of a transfer described in section 351 between members of a consolidated group, the transferor's basis in the stock of the transferee received in the transfer would be reduced by liabilities assumed by the transferee, including those liabilities described in section 357(c)(3) that would not have reduced basis had section 357(c) applied. Assuming the transferor and the transferee are members of the consolidated group at the time the liability does in fact give rise to a deduction on the part of the transferee and is taken into account on the consolidated return, the transferor's basis in the stock of the transferee would be reduced a second time under the principles of §1.1502-32. This duplicated basis reduction, *i.e.*, once at the time of the transfer described in section 351 and again at the time the liability is taken into account by the consolidated group, may ultimately cause the transferor to recognize an amount of gain on the sale of the stock of the transferee that does not clearly reflect income.

#### Explanation of Provisions

These proposed regulations clarify that, in certain transfers described in section 351 between members of a consolidated group, a transferee's assumption of liabilities described in section 357(c)(3)(A), other than those also described in section 357(c)(3)(B), will not reduce the transferor's basis in the transferee's stock received in the exchange.

## Proposed Effective Date

These regulations are proposed to apply to transactions occurring in consolidated return years beginning on or after the date these regulations are published as final regulations in the **Federal Register**.

## Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations 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 affect affiliated groups of corporations that have elected to file consolidated returns, which tend to be larger businesses. 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, these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

## Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (preferably a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and Treasury request comments on the clarity of the proposed regulations and how it may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for March 21, 2002, beginning at 10 a.m., in room 4718, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC.

Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit timely written comments and an outline of the

topics to be discussed and the time to be devoted to each topic (preferably a signed original and eight (8) copies) by February 28, 2002.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

## Drafting Information

The principal author of these regulations is T. Ian Russell, Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

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## Proposed Amendments to the Regulations

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

### PART 1 — INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:  
Authority: 26 U.S.C. 7805 \* \* \*

Par. 2. In §1.1502–80, paragraph (d) is revised to read as follows:

*§1.1502–80 Applicability of other provisions of law.*

\* \* \* \* \*

(d) *Non-applicability of section 357(c)–(1) In general.* Section 357(c) does not apply to cause the transferor to recognize gain in any transaction to which §1.1502–13 applies, if such transaction occurs in a consolidated return year beginning on or after the date these regulations are published as final regulations in the **Federal Register**. Notwithstanding the foregoing, for purposes of determining the transferor's basis in property under section 358(a) received in a transfer described in section 351, section 358(d)(2) shall operate to exclude liabilities described in section 357(c)(3)(A), other than those also described in section 357(c)(3)(B), from the computation of the amount of liabilities assumed that is treated as money received under section

358(d)(1), if such transfer occurs in a consolidated return year beginning on or after the date these regulations are published as final regulations in the **Federal Register**. This paragraph (d)(1) 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). For purposes of this paragraph (d)(1), any reference to a transferor or transferee includes, as the context may require, a reference to a successor or predecessor. For rules regarding the application of section 357(c) to transactions occurring in consolidated return years beginning on or after January 1, 1995, but before the date these regulations are published as final regulations in the **Federal Register**, see §1.1502–80(d) in effect prior to the date these regulations are published as final regulations in the **Federal Register** (see 26 CFR part 1 revised April 1, 2001).

(2) *Examples.* The principles of paragraph (d)(1) of this section are illustrated by the following examples:

*Example 1.* 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 assets with a total fair market value equal to \$100 and an aggregate basis of \$30 and liabilities of \$40. 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 cause S to recognize gain in 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 and the \$40 of liabilities.

*Example 2.* P owns all the stock of S1. S1 has assets with a total fair market value equal to \$100 and an aggregate basis of \$30. S1 has \$40 of liabilities, \$5 of which are described in section 357(c)(3)(A), but not section 357(c)(3)(B), and \$35 of which are not described in section 357(c)(3)(A). S1 transfers its assets to a newly formed subsidiary, S2, in exchange for stock of S2 and S2's assumption of the liabilities of \$40 in a transaction to which section 351 applies. Section 357(c) does not apply to cause S1 to recognize gain in connection with the transfer. For purposes of determining S1's basis in the S2 stock it received in the exchange, section 358(d)(2) operates to exclude \$5 of the liabilities from the computation of the amount of liabilities assumed that are treated as money received under section 358(d)(1). S1's basis in the S2 stock received in the exchange is a \$5 excess loss account (reflecting its \$30 basis in the assets transferred reduced by \$35, the amount of liabilities assumed that are not described in section 357(c)(3)(A)).