

Section 1502.—Regulations

26 CFR 1.1502–21: Net operating losses.

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

**Guidance Under Section
1502; Suspension of Losses
on Certain Stock Dispositions**

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations under section 1502 that redetermine the basis of stock of a subsidiary member of a consolidated group immediately prior to certain transfers of such stock and certain deconsolidations of a subsidiary member. In addition, this document contains temporary regulations that suspend certain losses recognized on the disposition of stock of a subsidiary member. The regulations apply to corporations filing consolidated returns. The text of the temporary regulations serves as the text of the proposed regulations (REG-131478-02) on page 669 of this issue of the Bulletin.

DATES: *Effective Date:* These regulations are effective March 14, 2003.

Applicability Date: For dates of applicability, see §§ 1.1502-21T(h)(7), 1.1502-32T(h)(6), and 1.1502-35T(j).

FOR FURTHER INFORMATION CONTACT: Aimee K. Meacham, (202) 622-7530 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

These regulations are being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. 553). For this reason, the collection of information contained in these temporary regulations has been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget (OMB) under 44 U.S.C. 3507 and assigned control number 1545-1828. Responses to this collection of information are voluntary.

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 OMB control number.

For further information concerning this collection of information, and where to submit comments on the collection of information and the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the cross-referencing notice of proposed rulemaking published in this issue of the Bulletin.

Books or records relating to a 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 and Explanation of Provisions

On October 18, 2002, the IRS and Treasury Department issued a notice of proposed rulemaking (REG-131478-02, 2002-47 I.R.B. 892 [67 F.R. 65060]) that included proposed regulations reflecting the principle set forth in Notice 2002-18, 2002-12 I.R.B. 644, that a consolidated group should not be able to obtain more than one tax benefit from a single economic loss. The rules in the proposed regulations were intended to address at least two situations in which a group may obtain more than one tax benefit from a single economic loss. In one situation, a group first recognizes and absorbs a subsidiary member's inside loss (e.g., a loss carryforward, a deferred deduction, or a loss inherent in an asset) and a member of the group later recognizes a loss on the subsidiary member's stock that is duplicative of the previously recognized and absorbed inside loss. In the second situation, a member of the group recognizes a loss on a non-deconsolidating disposition of the subsidiary member's stock, the stock loss duplicates an unrecognized or unabsorbed loss of the subsidiary member, and the group later recognizes and absorbs the subsidiary's inside loss.

The proposed regulations consist primarily of two rules: a basis redetermination rule and a loss suspension rule. The proposed regulations also include a basis reduction rule that addresses certain cases of

loss duplication that are not within the scope of the loss suspension rule, such as losses arising from the worthlessness of subsidiary member stock.

No public hearing regarding the proposed regulations was requested or held. Comments, however, were submitted.

The IRS and Treasury Department have studied, and are continuing to study, the comments received. The IRS and Treasury Department believe that the comments received, as well as the issues more generally raised by Notice 2002-18 and the proposed regulations, require significant further consideration. Accordingly, the IRS and Treasury Department will continue to study these issues and, as more fully set forth below, request comments on, and suggestions for possible alternative approaches to, the issues addressed in the regulations. Nonetheless, the IRS and Treasury Department believe that immediately effective rules are necessary to address the duplication of loss within a consolidated group so as to clearly reflect the income tax liability of the group. Accordingly, the IRS and Treasury Department are promulgating the proposed regulations as temporary regulations in this Treasury decision. The temporary regulations are substantially similar to the proposed regulations, but reflect certain revisions that were made based on comments received. The following sections describe these revisions.

A. Application of Basis Redetermination Rule Upon Deconsolidation of a Subsidiary Member

The proposed regulations require the reallocation of the basis of subsidiary member stock held by members of the group upon certain dispositions and deconsolidations of subsidiary member stock. The rule applies differently when the subsidiary remains a member of the group from when the subsidiary does not remain a member of the group. The IRS and Treasury Department received several technical comments regarding the basis redetermination rule applicable when a subsidiary member leaves the group. The temporary regulations revise that rule in a manner that addresses these comments and clarifies its application.

In particular, under the temporary regulations, subject to certain exceptions, the rule applies upon a deconsolidation of a sub-

subsidiary member when any stock of the subsidiary member owned by a member of the group has a basis in excess of value. The revised rule generally applies regardless of whether the subsidiary member is deconsolidated as a result of a transfer of a gain share, a transfer of a loss share, or a stock issuance because, in each case, the effect is the same, *i.e.*, each share of subsidiary member stock owned by group members is deconsolidated. Further, in computing the basis that is reallocated, the revised rule takes into account all loss on members' shares of the subsidiary's stock and all prior negative basis adjustments to members' shares of the subsidiary stock that are not loss shares. The revised rule reflects that, unless all deconsolidations and all deconsolidated shares are treated similarly, opportunities to duplicate losses will continue to exist.

B. Application of Loss Suspension Rule

Under the loss suspension rule, if, after application of the basis redetermination rule, a member of a consolidated group recognizes a loss on the disposition of stock of a subsidiary member of the same group, and the subsidiary member is a member of the same group immediately after the disposition, then the selling member's stock loss is suspended to the extent of the duplicated loss with respect to such stock. Because a suspended stock loss reflects the subsidiary member's unrecognized or unabsorbed deductions and losses, under the proposed regulations, the suspended loss is reduced, with the result that it will not later be allowed, as the subsidiary member's deductions and losses are taken into account (*i.e.*, absorbed) in determining the group's consolidated taxable income (or loss). One comment received regarding the proposed regulations was that, in certain cases, the loss suspension rule could disallow a tax loss for an economic loss. This result was not intended. Accordingly, these temporary regulations include two changes from the proposed regulations that are intended to prevent this result.

First, the temporary regulations provide that the amount by which a suspended stock loss is reduced cannot exceed the excess of the amount of the subsidiary member's items of loss and deduction over the amount of such items that are taken into account in determining the basis adjustments made to stock of the subsidiary member (or

any successor) owned by members of the group under the investment adjustment rules.

Second, they also include a provision stating that the loss suspension rule is not to be applied in a manner that permanently disallows an otherwise allowable deduction for an economic loss. Whether the loss suspension rule has resulted in such a disallowance is determined on the earlier of the date of the deconsolidation of the subsidiary (or any successor) the stock of which gave rise to the suspended stock loss and the date on which the stock of such subsidiary is determined to be worthless. When it is determined that the application of the loss suspension rule has permanently disallowed a deduction for an economic loss, the taxpayer will be permitted to treat the suspended stock loss as restored to the extent of such disallowance. The restoration of the suspended loss is deemed to occur immediately prior to the deconsolidation of the subsidiary or the determination of worthlessness.

C. Basis Reduction Rule For Worthless Stock and Stock of a Subsidiary With No Separate Return Year

The proposed regulations include a basis reduction rule intended to prevent the duplication of unabsorbed losses generated by a subsidiary member and loss with respect to the stock of that member if either (i) the stock of the subsidiary member becomes worthless or (ii) the stock of the subsidiary is disposed of and, immediately after the disposition, the subsidiary is no longer a member of the group and does not have a separate return year. Under this rule, immediately before a determination of worthlessness, or immediately before a disposition of a subsidiary that is not followed by a separate return year, the basis of the subsidiary's stock is reduced by the amount of any loss carryforwards that would be treated as attributable to the subsidiary under the principles of §1.1502-21. This provision was included because neither situation was subject to the loss suspension rule and, without such a rule, taxpayers might take the position that a group is entitled to a subsidiary member's loss carryforwards even after the group has enjoyed full basis recovery through a worthless stock or other deduction. Such a result, however, would be in contravention of the principles of Notice 2002-18.

The proposed provision raised questions about the operation of the existing rules governing this situation. Commentators contended that the basis reduction rule could deny the group a single tax loss for its economic loss. As stated above, the proposed regulations, including the basis reduction rule, were not intended to disallow a tax loss for an economic loss, but rather were intended only to ensure that a group obtains no more than a single tax loss for an economic loss.

The temporary regulations address this situation by providing that the unabsorbed losses generated by the subsidiary do not remain available to the group. Specifically, the temporary regulations provide that, if stock of a subsidiary member is treated as worthless under section 165 (taking into account the provisions of §1.1502-80(c)), or if a member of a group disposes of subsidiary member stock and on the following day the subsidiary is not a member of the group and does not have a separate return year, then all losses treated as attributable to the subsidiary member under the principles of §1.1502-21, after computing the taxable income of the group, the subsidiary member, or a group of which the subsidiary member was previously a member for the taxable year that includes the determination of worthlessness or the disposition and any prior taxable year, shall be treated as expired, but not as absorbed by the group, as of the beginning of the group's taxable year that follows the taxable year that includes the determination of worthlessness or the disposition. Under this rule, the stock loss (or reduced stock gain), unreduced by any loss carryforwards attributable to the subsidiary member, is allowed. Moreover, because the losses are treated as expired, there is no possibility of a later, duplicative use of the loss carryforwards. This approach is consistent with the nature of a loss realized upon such a determination or disposition, *i.e.*, a loss on an investment in the subsidiary member.

Because the provisions of the proposed regulations raised questions about the operation of the existing rules, the temporary regulations include a special election for determinations of worthlessness and dispositions that occurred on or after March 7, 2002, and before March 14, 2003. In such cases, as an alternative to the treatment described above, the common parent of the group may make an irrevocable

election to reattribute to itself all or a portion of the losses attributable to the subsidiary member under the principles of §1.1502-21. For purposes of applying the investment adjustment rules to stock of the subsidiary member owned by the group, the reattributed losses are treated as absorbed by the group immediately prior to the allowance of any loss or inclusion of any income or gain with respect to the determination of worthlessness or the disposition. The common parent, however, is treated as succeeding to the subsidiary's losses in a transaction described in section 381.

The IRS and Treasury Department request comments regarding whether a subsidiary member the stock of which is determined to be worthless (under the standards of §1.1502-80(c)) should be treated as a new corporation for purposes of the Internal Revenue Code as of the date of the determination of worthlessness. In addition, the IRS and Treasury Department request comments regarding the desirability of further clarification or changes regarding the standards that govern determinations of worthlessness and the deductibility of losses (or the inclusion of excess loss accounts) when stock of a subsidiary member is determined to be worthless.

D. *Deferral and Elimination of Gain*

One comment noted that the basis redetermination rule of the proposed regulations could be used to shift the location of gain and loss within a consolidated group and even to eliminate gain in a manner that is unintended and contrary to the purposes underlying section 337(d). The following example illustrates this concern.

P, the common parent of a consolidated group, owns all of the stock of S1 and S2. The S2 stock has a basis of \$400 and a value of \$500. S1 owns 50% of the stock of the S3 common stock with a basis of \$150 and value equal to such amount. S2 owns the remaining 50% of the S3 common stock with a basis of \$100 and a value of \$200 and one share of S3 preferred stock with a basis of \$10 and a value of \$9. P intends to sell all of its S2 stock to an unrelated buyer that does not want to acquire S3. P, therefore, engages in the following steps to dispose of S2 without recognizing

ing a substantial portion of the built-in gain in S2. First, P causes a recapitalization of S3 in which S2's S3 common stock is exchanged for new S3 preferred shares. P then sells all of its S2 stock. Although the sale does not deconsolidate S3 (because all the S3 common stock is still held by S1), it does deconsolidate the S3 preferred shares held by S2, including the one share with a built-in loss. Accordingly, under the proposed regulations, the bases of all shares of S3 stock must be redetermined immediately before P's sale of S2. Under the basis redetermination rule, the total basis of S3 stock held by members of the P group is allocated first to the S3 preferred shares, up to their value of \$209, and then to the remaining shares of S3 common held by S1. S2's aggregate basis in the S3 preferred stock is increased from \$110 to \$209. This increase tiers up and increases P's basis in the S2 stock from \$400 to \$499. Accordingly, P will recognize only \$1 of gain on the sale of its S2 stock. Afterwards, P can cause S3 to redeem its preferred stock for \$209. S2 will recognize no gain or loss from the redemption. Although the unrecognized gain is preserved in P's basis in S1, and S1's basis in S3, the group can defer or avoid recognizing that gain.

In this case, there is no significant duplication of loss. Moreover, the steps were structured with a view to avoiding the recognition of gain on a disposition of stock. The IRS and Treasury Department do not intend that the basis redetermination rule be applied to defer or eliminate gain in such cases. The IRS and Treasury Department considered adopting a mechanical test to prevent the application of the basis redetermination rule in such cases. They concluded that such a rule would not provide the flexibility necessary to obtain an appropriate balancing of the concerns underlying this regulation and those underlying section 337(d). Therefore, these temporary regulations include an anti-abuse rule that provides that, if a transaction is structured with a view to, and has the effect of, deferring or avoiding the recognition of gain on a disposition of stock by invoking application of the basis redetermination rule, and the stock loss attributable to the transferred shares or the duplicated loss of the subsidiary member that is reflected in subsidiary member stock owned by members

of the group is not significant, the basis redetermination and loss suspension rules will not apply.

E. *Request For Comments*

As described above, the IRS and Treasury Department are continuing to study the comments received regarding the proposed regulations. In addition, the IRS and Treasury Department are considering alternative regimes that would prevent the duplication of loss within the group.

In particular, the IRS and Treasury Department are studying a comment that suggested applying the principles of section 704(c) to allocate negative investment adjustments arising from loss items at the subsidiary member level where there have been transfers of loss property to the subsidiary member. The comment asserts that this approach would address the case where the recognition and absorption of the inside loss precedes the recognition of the stock loss. The IRS and Treasury Department are concerned that this alternative approach addresses only duplicative losses that arise as a result of contributions of loss property, not duplicative losses that arise as a result of a loss incurred by a subsidiary member. In addition, the IRS and Treasury Department are concerned that the application of the principles of section 704(c) may be complex, especially in cases where there have been issuances of subsidiary member stock at different times. The IRS and Treasury Department request comments regarding how the principles of section 704(c) should be applied in the consolidated return context to prevent the duplication of loss.

The IRS and Treasury Department are also studying a suggestion that the type of transaction in which the stock loss is recognized prior to the absorption of the inside loss be addressed by a rule that allows the stock loss but limits the use of the subsidiary member's items of loss and deduction if there have been contributions of loss property with respect to the subsidiary member and there is any loss duplication at the subsidiary member level at the time the stock loss is recognized. That rule would not permit the use of the subsidiary's items of loss and deduction that are duplicative of the stock loss to offset income of an

other member of the group, but would permit such items to offset income of the subsidiary.

This rule effectively would permit the acceleration of stock loss. The IRS and Treasury Department request comments regarding whether permitting such acceleration would clearly reflect the income of the group.

In addition, because this rule would permit the subsidiary's losses to offset its items of income and gain, it would not prevent the duplication of losses within the group to that extent. The IRS and Treasury Department request comments regarding whether this duplication is appropriate given that the benefits associated with the subsidiary and its shareholder being members of the group (e.g., positive basis adjustments to the shareholder member's stock of the subsidiary member that reflect income of the subsidiary member and the group's ability to use the loss recognized by another member to offset income of the subsidiary member of the group) have been enjoyed by the group.

Finally, this rule would address only cases of duplication where there have been contributions of loss property. As described above, the IRS and Treasury Department are concerned that contributions of loss property are not the only types of transactions in which a group can obtain more than one tax benefit from a single economic loss.

The IRS and Treasury Department are considering a variation of this suggested rule to address the situation where the stock loss is recognized prior to the absorption of the inside loss. This variation would allow the stock loss when recognized, but would disallow the inside losses of the subsidiary to the extent that such losses reflect losses that were duplicate losses at the time of the recognition of the stock loss. Such losses may be attributable to contributed property or losses that arose in the subsidiary member. The IRS and Treasury Department request comments regarding this variation.

Finally, the IRS and Treasury Department continue to request comments regarding any other approaches that could be implemented to address the duplication of loss within a consolidated group.

Special Analyses

In *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001), the United States Court of Appeals for the Federal Circuit held that the duplicated loss component of §1.1502-20 was an invalid exercise of regulatory authority. In response to the *Rite Aid* decision, the IRS and Treasury Department issued Notice 2002-11, 2002-7 I.R.B. 526, stating that the interests of sound tax administration would not be served by the continued litigation of the validity of the duplicated loss component of §1.1502-20. Notice 2002-11 also announced that because of the interrelationship in the operation of all of the loss disallowance factors, new rules governing loss disallowance on sales of subsidiary stock by members of consolidated groups should be implemented.

In Notice 2002-18, 2002-12 I.R.B. 644, the IRS and Treasury Department stated that regulations would be promulgated that would defer or otherwise limit the utilization of a loss on stock (or another asset that reflects the basis of stock) in transactions that facilitate the group's utilization of a single economic loss more than once. Notice 2002-18 further stated that such regulations would apply to dispositions occurring on or after March 7, 2002. These temporary regulations implement Notice 2002-18 and are necessary to provide taxpayers with immediate guidance regarding stock basis and allowable loss in connection with transfers of subsidiary member stock. Accordingly, good cause is found for dispensing with a delayed effective date pursuant to 5 U.S.C. 553(d)(3).

It has been determined that this Treasury decision 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 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, which tend to be larger businesses. Moreover, the number of taxpayers affected and the average burden are minimal. Therefore, a Regulatory Flexibility Analysis 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 businesses.

Drafting Information

The principle author of these regulations is Aimee K. Meacham of the Office of Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

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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 adding entries in numerical order to read in part as follows:

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

Section 1.1502-21T(b)(1) and (b)(3)(v) also issued under 26 U.S.C. 1502. * * *

Section 1.1502-32T(a)(2), (b)(3)(iii)(C), (b)(3)(iii)(D), and (b)(4)(vi) also issued under 26 U.S.C. 1502. * * *

Section 1.1502-35T also issued under 26 U.S.C. 1502. * * *

Par. 2. In the list below, for each section indicated in the left column, remove the wording indicated in the middle column, and add the wording indicated in the right column.

<i>Affected Section</i>	<i>Remove</i>	<i>Add</i>
§1.267(f)-1(k)	§§1.337(d)-1, 1.337(d)-2, 1.1502-13(f)(6), and 1.1502-20	§§1.337(d)-2T, 1.1502-13(f)(6), and 1.1502-35T

<i>Affected Section</i>	<i>Remove</i>	<i>Add</i>
§1.597-3(e)	<i>Loss disallowance.</i> For purposes of §1.1502-20, FFA and the amount described in §1.597-4(g)(3) are treated as an extraordinary gain disposition within the meaning of §1.1502-20(c)(2)(i) and a Taxable Transfer is treated as an applicable asset acquisition under section 1060(c) within the meaning of §1.1502-20(c)(2)(i)(A)(4).	[Reserved].
§1.597-4(g)(2)(v), second sentence	(See §§1.337(d)-1 and 1.1502-20 for potential limitations on the group's worthless stock deduction.)	(See §§1.337(d)-2T and 1.1502-35T(f) for rules applicable when a member of a consolidated group is entitled to a worthless stock deduction with respect to stock of another member of the group.)
§1.1502-11(b)(3)(ii) Example (c), third sentence.	See also §1.1502-20 for rules applicable to losses from the sale of stock of subsidiaries.	See also §§1.337(d)-2T and 1.1502-35T for rules relating to basis adjustments and allowance of stock loss on dispositions of stock of a subsidiary member.
§1.1502-12(r)	For rulings relating to loss disallowance or basis reduction on the disposition or deconsolidation of stock of a subsidiary, see §§1.337(d)-1, 1.337(d)-2 and 1.1502-20.	See §§1.337(d)-2T and 1.1502-35T(f) for rules relating to basis adjustments and allowance of stock loss on dispositions of stock of a subsidiary member.
§1.1502-13(f)(7), Example 1(e), sixth sentence	See also §1.1502-20(b) (additional stock basis reductions applicable to certain deconsolidations).	
§1.1502-15(b)(2)(iii), first sentence	(e.g., under §1.1502-20 or section 267)	(e.g., under §§1.337(d)-2T, 1.1502-35T, or section 267)
§1.1502-21(b)(2)(i), third sentence	For rules permitting the reattribution of losses of a subsidiary to the common parent when loss is disallowed on the disposition of subsidiary stock, see §1.1502-20(g).	
§1.1502-32(b)(3)(iii)(B), third sentence	§1.1502-20(b), or §1.1502-20(g)	§1.1502-35T(b) or (f)(2)
§1.1502-32(b)(5)(ii), Example 2(b), last sentence	See also §1.1502-20(b) (possible stock basis reduction on the deconsolidation of S).	
§1.1502-32(e)(2), Example 4(a), fourth sentence	(Section §1.1502-20(b) does not reduce P's basis in the S stock as a result of S's deconsolidation.)	
§1.1502-80(c), last sentence	See §1.1502-11(c) and 1.1502-20 for additional rules relating to stock loss.	See §1.1502-11(c) and 1.1502-35T for additional rules relating to stock loss.
§1.1502-91(h)(2), first sentence	(unless disallowed under §1.1502-20 or otherwise)	(unless disallowed under §1.337(d)-2T, 1.1502-35T, or otherwise)

Par. 3. Section 1.1502-21 is amended by:

1. Revising paragraph (b)(1).

2. Adding paragraphs (b)(3)(v) and (h)(7).

The revisions and addition read as follows:

§1.1502-21 Net operating losses.

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(b) * * *

(1) [Reserved]. For further guidance, see §1.1502-21T(b)(1).

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(3) * * *

(v) [Reserved]. For further guidance, see §1.1502-21T(b)(3)(v).

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(h) * * *

(7) [Reserved]. For further guidance, see §1.1502-21T(h)(7).

Par. 4. Section 1.1502-21T is revised to read as follows:

§1.1502-21T Net operating losses (temporary).

(a) [Reserved]. For further guidance, see §1.1502-21(a).

(b) [Reserved]. For further guidance, see §1.1502-21(b).

(1) *Carryovers and carrybacks generally.* The net operating loss carryovers and carrybacks to a taxable year are determined under the principles of section 172 and this section. Thus, losses permitted to be absorbed in a consolidated return year generally are absorbed in the order of the taxable years in which they arose, and losses carried from taxable years ending on the same date, and which are available to offset consolidated taxable income for the year, generally are absorbed on a *pro rata* basis. Additional rules under the Internal Revenue Code or regulations also apply. See, e.g., section 382(l)(2)(B) (if losses are carried from the same taxable year, losses subject to limitation under section 382 are absorbed before losses that are not subject to limitation under section 382). See *Example 2* of paragraph (c)(1)(iii) of this section for an illustration of *pro rata* absorption of losses subject to a SRLY limitation. See paragraph (b)(3)(v) of this section regarding the treatment of any loss that is treated as expired under §1.1502-35T(f)(1).

(b)(2) through (b)(3)(iv) [Reserved]. For further guidance, see §1.1502-21(b)(2) through (b)(3)(iv).

(b)(3)(v) *Losses treated as expired under §1.1502-35T(f)(1).* No loss treated as expired by §1.1502-35T(f)(1) may be carried over to any consolidated return year of the group.

(c) through (h)(6) [Reserved]. For further guidance, see §1.1502-21(c) through (h)(6).

(h)(7) *Losses treated as expired under §1.1502-35T(f)(1).* Paragraph (b)(3)(v) of this section is effective for losses treated as expired under §1.1502-35T(f)(1) on and after March 7, 2002, and no later than March 11, 2006.

Par. 5. Section 1.1502-32 is amended by:

1. Revising paragraph (a)(2).

2. Adding paragraphs (b)(3)(iii)(C), (b)(3)(iii)(D), (b)(4)(vi), and (h)(6).

The revision and additions read as follows:

§1.1502-32 Investment adjustments.

* * * * *

(a)(2) [Reserved]. For further guidance, see §1.1502-32T(a)(2).

(b)(3)(iii)(C) and (D) [Reserved]. For further guidance, see §1.1502-32T(b)(3)(iii)(C) and (D).

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(b)(4)(vi) [Reserved]. For further guidance, see §1.1502-32T(b)(4)(vi).

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(h)(6) [Reserved]. For further guidance, see §1.1502-32T(h)(6).

Par. 6. Section 1.1502-32T is revised to read as follows:

§1.1502-32T Investment adjustments (temporary).

(a) and (a)(1) [Reserved]. For further guidance, see §1.1502-32(a) and (a)(1).

(a)(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), §1.1502-31 (basis after a group structure change), and §1.1502-35T (additional rules relating to stock loss, including losses attributable to worthlessness and certain dispositions not followed by a separate return year). 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. For example, if pursuant to §1.1502-35T(c)(3) and paragraph (b)(3)(iii)(C) of this section the basis in stock is reduced to take into account a loss suspended under §1.1502-35T(c)(1), such basis shall not be further reduced to take into account such loss, or a portion of such loss, if any, that is later allowed pursuant to §1.1502-35T(c)(5). See also paragraph (h)(5) of this section for basis reductions applicable to certain former subsidiaries.

(b) through (b)(3)(iii)(B) [Reserved]. For further guidance, see §1.1502-32(b) through (b)(3)(iii)(B).

(b)(3)(iii)(C) *Loss suspended under §1.1502-35T(c).* Any loss suspended pursuant to §1.1502-35T(c) is treated as a non-capital, nondeductible expense incurred during the taxable year that includes the date of the disposition to which such section applies. See §1.1502-35T(c)(3). Consequently, the basis of a higher-tier member's stock of P is reduced by the suspended loss in the year it is suspended.

(D) *Loss disallowed under §1.1502-35T(g)(3)(iii).* Any loss or deduction the use of which is disallowed pursuant to §1.1502-35T(g)(3)(iii) (other than a loss or deduction described in §1.1502-35T(g)(3)(i)(B)(II)), and with respect to

which no waiver described in paragraph (b)(4) of this section is filed, is treated as a noncapital, nondeductible expense incurred during the taxable year that such loss would otherwise be absorbed. See §1.1502-35T(g)(3)(iv).

(b)(4) through (b)(4)(v) [Reserved]. For further guidance, see §1.1502-32(b)(4) through (b)(4)(v).

(b)(4)(vi) *Special rules in the case of certain transactions subject to §1.1502-35T.* If a member of a consolidated group transfers stock of a subsidiary member and such stock has a basis that exceeds its value immediately before such transfer or a subsidiary member is deconsolidated and any stock of such subsidiary member owned by members of the group immediately before such deconsolidation has a basis that exceeds its value, all members of the group are subject to the provisions of §1.1502-35T(b), which generally require a redetermination of members' basis in all shares of subsidiary stock. In addition, if stock of a subsidiary member is treated as worthless under section 165 (taking into account the provisions of §1.1502-80(c)), or if a member of a group disposes of subsidiary member stock and on the following day the subsidiary is not a member of the group and does not have a separate return year, and the common parent makes an election under §1.1502-35T(f)(2) to reattribute to itself the losses treated as attributable to such subsidiary member, §1.1502-35T(f)(2) requires a reduction of members' basis in shares of subsidiary stock.

(c) through (h)(5)(ii) [Reserved]. For further guidance, see §1.1502-32(c) through (h)(5)(ii).

(h)(6) *Loss suspended under §1.1502-35T(c) or disallowed under §1.1502-35T(g)(3)(iii).* Paragraphs (a)(2), (b)(3)(iii)(C), (b)(3)(iii)(D), and (b)(4)(vi) of this section are effective on and after March 7, 2002, and expire on March 11, 2006.

Par. 7. Section 1.1502-35T is added to read as follows:

§1.1502-35T Transfers of subsidiary member stock and deconsolidations of subsidiary members (temporary).

(a) *Purpose.* The purpose of this section is to prevent a group from obtaining more than one tax benefit from a single economic loss. The provisions of this section shall be construed in a manner consistent

with that purpose and in a manner that reasonably carries out that purpose.

(b) *Redetermination of basis on certain nondeconsolidating transfers of subsidiary member stock and on certain deconsolidations of subsidiary members*—

(1) *Redetermination of basis on certain nondeconsolidating transfers of subsidiary member stock.* Except as provided in paragraph (b)(3)(i) of this section, if, immediately after a transfer of stock of a subsidiary member that has a basis that exceeds its value, the subsidiary member remains a member of the group, then the basis in each share of subsidiary member stock owned by each member of the group shall be redetermined in accordance with the provisions of this paragraph (b)(1) immediately before such transfer. All of the members' bases in the shares of subsidiary member stock immediately before such transfer shall be aggregated. Such aggregated basis shall be allocated first to the shares of the subsidiary member's preferred stock that are owned by the members of the group immediately before such transfer, in proportion to, but not in excess of, the value of those shares at such time. After allocation of the aggregated basis to all shares of the preferred stock of the subsidiary member pursuant to the preceding sentence, any remaining basis shall be allocated among all common shares of subsidiary member stock held by members of the group immediately before the transfer, in proportion to the value of such shares at such time.

(2) *Redetermination of basis on certain deconsolidations of subsidiary members.*—(i) *Allocation of reallocable basis amount.* Except as provided in paragraph (b)(3)(ii) of this section, if, immediately before a deconsolidation of a subsidiary member, any share of stock of such subsidiary owned by a member of the group has a basis that exceeds its value, then the basis in each share of the subsidiary member's stock owned by each member of the group shall be redetermined in accordance with the provisions of this paragraph (b)(2) immediately before such deconsolidation. The basis in each share of the subsidiary member's stock held by members of the group immediately before the deconsolidation that has a basis in excess of value at such time shall be reduced, but not below such share's value, in a manner that, to the greatest extent possible, causes the ratio of the basis to the value of

each such share to be the same; provided, however, that the aggregate amount of such reduction shall not exceed the reallocable basis amount (as computed pursuant to paragraph (b)(2)(ii) of this section). Then, to the extent of the reallocable basis amount, the basis of each share of the preferred stock of the subsidiary member that are held by members of the group immediately before the deconsolidation shall be increased, but not above such share's value, in a manner that, to the greatest extent possible, causes the ratio of the basis to the value of each such share to be the same. Then, to the extent that the reallocable basis amount does not increase the basis of shares of preferred stock of the subsidiary member pursuant to the third sentence of this paragraph (b)(2)(i), such amount shall increase the basis of all common shares of the subsidiary member's stock held by members of the group immediately before the deconsolidation in a manner that, to the greatest extent possible, causes the ratio of the basis to the value of each such share to be the same.

(ii) *Calculation of reallocable basis amount.* The reallocable basis amount shall equal the lesser of—

(A) The aggregate of all amounts by which, immediately before the deconsolidation, the basis exceeds the value of a share of subsidiary member stock owned by any member of the group at such time; and

(B) The total of the subsidiary member's (and any predecessor's) items of deduction and loss, and the subsidiary member's (and any predecessor's) allocable share of items of deduction and loss of all lower-tier subsidiary members, that were taken into account in computing the adjustment under §1.1502-32 to the bases of shares of stock of the subsidiary member (and any predecessor) held by members of the group immediately before the deconsolidation, other than shares that have bases in excess of value immediately before the deconsolidation.

(3) *Exceptions to application of redetermination rules.* (i) Paragraph (b)(1) of this section shall not apply to a transfer of subsidiary member stock if —

(A) during the taxable year of such transfer, in one or more fully taxable transactions, the members of the group dispose of all of the shares of the subsidiary member stock that they own immediately before the transfer, other than the shares the

transfer of which would otherwise trigger the application of paragraph (b)(1) of this section, to a person or persons that are not members of the group;

(B) during the taxable year of such transfer, the members of the group are allowed a worthless stock loss under section 165(g) (taking into account the provisions of §1.1502-80(c)) with respect to all of the shares of subsidiary member stock that they own immediately before the transfer, other than the shares the transfer of which would otherwise trigger the application of paragraph (b)(1) of this section; or

(C) such transfer is to a member of the group and section 332 (provided the stock is transferred to an 80-percent distributee), section 351, or section 361 applies to such transfer.

(ii) Paragraph (b)(2) of this section shall not apply to a deconsolidation of a subsidiary member if —

(A) during the taxable year of such deconsolidation, in one or more fully taxable transactions, the members of the group dispose of all of the shares of the subsidiary member stock that they own immediately before the deconsolidation to a person or persons that are not members of the group;

(B) such deconsolidation results from a fully taxable disposition, to a person or persons that are not members of the group, of some of the shares of the subsidiary member, and, during the taxable year of such deconsolidation, the members of the group are allowed a worthless stock loss under section 165(g) with respect to all of the shares of subsidiary member stock that they own immediately after the deconsolidation; or

(C) the deconsolidation of the subsidiary member results from the deconsolidation of a higher-tier subsidiary member and, immediately after the deconsolidation of the subsidiary member, none of the stock of the subsidiary member is owned by a group member.

(4) *Special rule for lower-tier subsidiaries.* If, immediately after a transfer of subsidiary member stock or a deconsolidation of a subsidiary member, a lower-tier subsidiary member some of the stock of which is owned by the subsidiary member is a member of the group, then, for purposes of applying paragraph (b) of this section, the subsidiary member shall be treated as having transferred its stock of the lower-tier subsidiary member. This prin-

ciple shall apply to stock of subsidiary members that are owned by such lower-tier subsidiary member.

(5) *Stock basis adjustments for higher-tier stock.* The basis adjustments required under this paragraph (b) result in basis adjustments to higher-tier member stock. The adjustments are applied in the order of the tiers, from the lowest to highest. For example, if a common parent owns stock of a subsidiary member that owns stock of a lower-tier subsidiary member and the subsidiary member recognizes a loss on the disposition of a portion of its shares of the lower-tier subsidiary member stock, the common parent must adjust its basis in its subsidiary member stock under the principles of §1.1502–32 to reflect the adjustments that the subsidiary member must make to its basis in its stock of the lower-tier subsidiary member.

(6) *Ordering rules.* (i) The rules of this paragraph (b) apply after the rules of §1.1502–32 are applied.

(ii) The rules of this paragraph (b) apply before the rules of §1.337(d)–2T and paragraph (c) of this section are applied.

(iii) Paragraph (b) of this section (and any resulting basis adjustments to higher-tier member stock made pursuant to paragraph (b)(5) of this section) applies to redetermine the basis of stock of a lower-tier subsidiary member before paragraph (b) of this section applies to a higher-tier member of such lower-tier subsidiary member.

(c) *Loss suspension—(1) General rule.* Any loss recognized by a member of a consolidated group with respect to the disposition of a share of subsidiary member stock shall be suspended to the extent of the duplicated loss with respect to such share of stock if, immediately after the disposition, the subsidiary is a member of the consolidated group of which it was a member immediately prior to the disposition (or any successor group).

(2) *Special rule for lower-tier subsidiaries.* This paragraph (c)(2) applies if neither paragraph (c)(1) nor (f) of this section applies to a member's disposition of a share of stock of a subsidiary member (the departing member), a loss is recognized on the disposition of such share, and the departing member owns stock of one or more other subsidiary members (a remaining member) that is a member of such group immediately after the disposition. In that case, such loss shall be suspended to the extent

the duplicated loss with respect to the departing member stock disposed of is attributable to the remaining member or members.

(3) *Treatment of suspended loss.* For purposes of the rules of §1.1502–32, any loss suspended pursuant to paragraph (c)(1) or (c)(2) of this section is treated as a non-capital, nondeductible expense of the member that disposes of subsidiary member stock, incurred during the taxable year that includes the date of the disposition of stock to which paragraph (c)(1) or (c)(2) of this section applies. See §1.1502–32T(b)(3)(iii)(C). Consequently, the basis of a higher-tier member's stock of the member that disposes of subsidiary member stock is reduced by the suspended loss in the year it is suspended.

(4) *Reduction of suspended loss—(i) General rule.* The amount of any loss suspended pursuant to paragraphs (c)(1) and (c)(2) of this section shall be reduced, but not below zero, by the subsidiary member's (and any successor's) items of deduction and loss, and the subsidiary member's (and any successor's) allocable share of items of deduction and loss of all lower-tier subsidiary members, that are allocable to the period beginning on the date of the disposition that gave rise to the suspended loss and ending on the day before the first date on which the subsidiary member (or any successor) is not a member of the group of which it was a member immediately prior to the disposition (or any successor group), and that are taken into account in determining consolidated taxable income (or loss) of such group for any taxable year that includes any date on or after the date of the disposition and before the first date on which the subsidiary member (or any successor) is not a member of such group; provided, however, that such reduction shall not exceed the excess of the amount of such items over the amount of such items that are taken into account in determining the basis adjustments made under §1.1502–32 to stock of the subsidiary member (or any successor) owned by members of the group. The preceding sentence shall not apply to items of deduction and loss to the extent that the group can establish that all or a portion of such items was not reflected in the computation of the duplicated loss with respect to the subsidiary member on the date of the disposition of stock that gave rise to the suspended loss.

(ii) *Operating rules—(A) Year in which deduction or loss is taken into account.* For purposes of paragraph (c)(4)(i) of this section, a subsidiary member's (or any successor's) deductions and losses are treated as taken into account when and to the extent they are absorbed by the subsidiary member (or any successor) or any other member. To the extent that the subsidiary member's (or any successor'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 is treated as taken into account in the year in which it is absorbed. To the extent that a subsidiary member's (or any successor's) deduction or loss is carried back and absorbed in a prior year (whether consolidated or separate), the deduction or loss is treated as taken into account in the year in which it arises and not in the year in which it is absorbed.

(B) *Determination of items that are allocable to the post-disposition, pre-deconsolidation period.* For purposes of paragraph (c)(4)(i) of this section, the determination of whether a subsidiary member's (or any successor's) items of deduction and loss and allocable share of items of deduction and loss of all lower-tier subsidiary members are allocable to the period beginning on the date of the disposition of subsidiary stock that gave rise to the suspended loss and ending on the day before the first date on which the subsidiary member (or any successor) is not a member of the consolidated group of which it was a member immediately prior to the disposition (or any successor group) is determined pursuant to the rules of §1.1502–76(b)(2), without regard to §1.1502–76(b)(2)(ii)(D), as if the subsidiary member ceased to be a member of the group at the end of the day before the disposition and filed separate returns for the period beginning on the date of the disposition and ending on the day before the first date on which it is not a member of such group.

(5) *Allowable loss—(i) General rule.* To the extent not reduced under paragraph (c)(4) of this section, any loss suspended pursuant to paragraph (c)(1) or (c)(2) of this section shall be allowed, to the extent otherwise allowable under applicable provisions of the Internal Revenue Code and regulations thereunder, on a return filed by the group of which the subsidiary was a member on the date of the disposition of

subsidiary stock that gave rise to the suspended loss (or any successor group) for the taxable year that includes the day before the first date on which the subsidiary (or any successor) is not a member of such group or the date the group is allowed a worthless stock loss under section 165(g) (taking into account the provisions of §1.1502-80(c)) with respect to all of the subsidiary member stock owned by members.

(ii) *No tiering up of certain adjustments.* No adjustments shall be made to a member's basis of stock of a subsidiary member (or any successor) for a suspended loss that is taken into account under paragraph (c)(5)(i) of this section. See §1.1502-32T(a)(2).

(iii) *Statement of allowed loss.* Paragraph (c)(5)(i) of this section applies only if the separate statement required under this paragraph (c)(5)(iii) is filed with, or as part of, the taxpayer's return for the year in which the loss is allowable. The statement must be entitled "ALLOWED LOSS UNDER §1.1502-35T(c)(5)" and must contain the name and employer identification number of the subsidiary the stock of which gave rise to the loss.

(6) *Special rule for dispositions of certain carryover basis assets.* If—

(i) A member of a group recognizes a loss on the disposition of an asset other than stock of a subsidiary member;

(ii) Such member's basis in the asset disposed of was determined, directly or indirectly, in whole or in part, by reference to the basis of stock of a subsidiary member and, at the time of the determination of the member's basis in the asset disposed of, there was a duplicated loss with respect to such stock of the subsidiary member; and

(iii) Immediately after the disposition, the subsidiary member is a member of such group, then such loss shall be suspended pursuant to the principles of paragraphs (c)(1) and (c)(2) of this section to the extent of the duplicated loss with respect to such stock at the time of the determination of basis of the asset disposed of. Principles similar to those set forth in paragraphs (c)(3), (c)(4), and (c)(5) of this section shall apply to a loss suspended pursuant to this paragraph (c)(6).

(7) *Coordination with loss deferral, loss disallowance, and other rules—(i) In general.* Loss recognized on the disposition of subsidiary member stock or another asset is subject to redetermination, deferral, or

disallowance under other applicable provisions of the Internal Revenue Code and regulations thereunder, including sections 267(f) and 482. Paragraphs (c)(1), (c)(2), and (c)(6) of this section do not apply to a loss that is disallowed under any other provision. If loss is deferred under any other provision, paragraphs (c)(1), (c)(2), and (c)(6) of this section apply when the loss would otherwise be taken into account under such other provision. However, if an overriding event described in paragraph (c)(7)(ii) of this section occurs before the deferred loss is taken into account, paragraphs (c)(1), (c)(2), and (c)(6) of this section apply to the loss immediately before the event occurs, even though the loss may not be taken into account until a later time.

(ii) *Overriding events.* For purposes of paragraph (c)(7)(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); or

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

(8) *Application.* This paragraph (c) shall not be applied in a manner that permanently disallows a deduction for an economic loss, provided that such deduction is otherwise allowable. If the application of any provision of this paragraph (c) results in such a disallowance, proper adjustment may be made to prevent such a disallowance. Whether a provision of this paragraph (c) has resulted in such a disallowance is determined on the date on which the subsidiary (or any successor) the disposition of the stock of which gave rise to a suspended stock loss is not a member of the group or the date the group is allowed a worthless stock loss under section 165(g) (taking into account the provisions of §1.1502-80(c)) with respect to all of such subsidiary member stock owned by members. Proper adjustment in such cases shall be made by restoring the suspended stock loss immediately before the subsidiary ceases to be a member of the group or the group is allowed a worthless stock loss under section 165(g) (taking into account the provisions of §1.1502-80(c)) with respect to all of such subsidiary member stock owned by members, to the extent that its reduction pursuant to paragraph (c)(4) of

this section had the result of permanently disallowing a deduction for an economic loss.

(9) *Ordering rule.* The rules of this paragraph (c) apply after the rules of paragraph (b) of this section and §1.337(d)-2T are applied.

(d) *Definitions—(1) Disposition.* *Disposition* means any event in which gain or loss is recognized, in whole or in part.

(2) *Deconsolidation.* *Deconsolidation* means any event that causes a subsidiary member to no longer be a member of the consolidated group.

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

(4) *Duplicated loss—(i) In general.* Duplicated loss is determined immediately after a disposition and equals the excess, if any, of—

(A) The sum of—

(I) The aggregate adjusted basis of the subsidiary member's assets other than any stock that subsidiary member owns in another subsidiary member; and

(2) Any losses attributable to the subsidiary member and carried to the subsidiary member's first taxable year following the disposition; and

(3) Any deductions of the subsidiary member that have been recognized but are deferred under a provision of the Internal Revenue Code (such as deductions deferred under section 469); over

(B) The sum of—

(I) The value of the subsidiary member's stock; and

(2) Any liabilities of the subsidiary member that have been taken account for tax purposes.

(ii) *Special rules.* (A) The amounts determined under paragraph (d)(4)(i) (other than amounts described in paragraph (d)(4)(i)(B)(I)) of this section with respect to a subsidiary member include its allocable share of corresponding amounts with respect to all lower-tier subsidiary members. If 80 percent or more in value of the stock of a subsidiary member is acquired by purchase in a single transaction (or in a series of related transactions during any 12-month period), the value of the subsidiary member's stock may not exceed the purchase price of the stock divided by the percentage of the stock (by value) so purchased. For this purpose, stock is acquired by purchase if the transferee is not related to the transferor within the meaning of sections 267(b) and 707(b)(1), using the

language “10 percent” instead of “50 percent” each place that it appears, and the transferee’s basis in the stock is determined wholly by reference to the consideration paid for such stock.

(B) The amounts determined under paragraph (d)(4)(i) of this section are not applied more than once to suspend a loss under this section.

(5) *Predecessor and Successor.* A predecessor is a transferor of assets to a transferee (the successor) in a transaction—

(i) To which section 381(a) applies;

(ii) In which substantially all of the assets of the transferor are transferred to members in a complete liquidation;

(iii) In which the successor’s basis in assets is determined (directly or indirectly, in whole or in part) by reference to the transferor’s basis in such assets, but the transferee is a successor only with respect to the assets the basis of which is so determined; or

(iv) Which is an intercompany transaction, but only with respect to assets that are being accounted for by the transferor in a prior intercompany transaction.

(6) *Successor group.* A surviving group is treated as a successor group of a consolidated group (the terminating group) that ceases to exist as a result of—

(i) 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

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

(7) *Preferred stock, common stock.* Preferred stock and common stock shall have the meanings set forth in §1.1502–32(d)(2) and (3), respectively.

(8) *Higher-tier.* A subsidiary member is higher-tier with respect to a member if or to the extent investment basis adjustments under §1.1502–32 with respect to the stock of the latter member would affect investment basis adjustments with respect to the stock of the former member.

(9) *Lower-tier.* A subsidiary member is lower-tier with respect to a member if or to the extent investment basis adjustments under §1.1502–32 with respect to the stock of the former member would affect investment basis adjustments with respect to the stock of the latter member.

(e) *Examples.* For purposes of the examples in this section, all groups file consolidated returns on a calendar-year basis, the facts set forth the only corporate activity, all transactions are between unrelated persons unless otherwise specified, and tax liabilities are disregarded. The principles of paragraphs (a) through (d) of this section are illustrated by the following examples:

Example 1. Nondeconsolidating sale of preferred stock of lower-tier subsidiary member. (i) *Facts.* P owns 100 percent of the common stock of each of S1 and S2. S1 and S2 each have only one class of stock outstanding. P’s basis in the stock of S1 is \$100 and the value of such stock is \$130. P’s basis in the stock of S2 is \$120 and the value of such stock is \$90. P, S1, and S2 are all members of the P group. S1 and S2 form S3. In Year 1, in transfers to which section 351 applies, S1 contributes \$100 to S3 in exchange for all of the common stock of S3 and S2 contributes an asset with a basis of \$50 and a value of \$20 to S3 in exchange for all of the preferred stock of S3. S3 becomes a member of the P group. In Year 3, in a transaction that is not part of the plan that includes the contributions to S3, S2 sells the preferred stock of S3 for \$20. Immediately after the sale, S3 is a member of the P group.

(ii) *Application of basis redetermination rule.* Because S2’s basis in the preferred stock of S3 exceeds its value immediately prior to the sale and S3 is a member of the P group immediately after the sale, all of the P group members’ bases in the stock of S3 is redetermined pursuant to paragraph (b)(1) of this section. Of the group members’ total basis of \$150 in the S3 stock, \$20 is allocated to the preferred stock, the fair market value of the preferred stock on the date of the sale, and \$130 is allocated to the common stock. S2’s sale of the preferred stock results in the recognition of \$0 of gain/loss. Pursuant to paragraph (b)(5) of this section, the redetermination of S1’s and S2’s bases in the stock of S3 results in adjustments to P’s basis in the stock of S1 and S2. In particular, P’s basis in the stock of S1 is increased by \$30 to \$130 and its basis in the stock of S2 is decreased by \$30 to \$90.

Example 2. Deconsolidating sale of common stock.

(i) *Facts.* In Year 1, in a transfer to which section 351 applies, P contributes Asset A with a basis of \$900 and a value of \$200 to S in exchange for one share of S common stock (CS1). In Years 2 and 3, in successive but unrelated transfers to which section 351 applies, P transfers \$200 to S in exchange for one share of S common stock (CS2), Asset B with a basis of \$300 and a value of \$200 in exchange for one share of S common stock (CS3), and Asset C with a basis of \$1000 and a value of \$200 in exchange for one share of S common stock (CS4). In Year 4, S sells Asset A for \$200, recognizing \$700 of loss that is used to offset income of P recognized during Year 4. As a result of the sale of Asset A, the basis of each of P’s four shares of S common stock is reduced by \$175. Therefore, the basis of CS1 is \$725. The basis of CS2 is \$25. The basis of CS3 is \$125, and the basis of CS4 is \$825. In Year 5 in a transaction that is not part of a plan that includes the Year 1 contribution, P sells CS4 for \$200. Immediately after the sale of CS4, S is not a member of the P group.

(ii) *Application of basis redetermination rule.* Because P’s basis in each of CS1 and CS4 exceeds its value immediately prior to the deconsolidation of S, P’s basis in its shares of S common stock is redetermined pursuant to paragraph (b)(2) of this section. Pursuant to paragraph (b)(2)(ii) of this section, the reallocable basis amount is \$350 (the lesser of \$1150, the gross loss inherent in the stock of S owned by P immediately before the sale, and \$350, the aggregate amount of S’s items of deduction and loss that were previously taken into account in the computation of the adjustment to the basis of the stock of S that P did not hold at a loss immediately before the deconsolidation). Pursuant to paragraph (b)(2)(i) of this section, first, P’s basis in CS1 is reduced from \$725 to \$600 and P’s basis in CS4 is reduced from \$825 to \$600. Then, the reallocable basis amount increases P’s basis in CS2 from \$25 to \$250 and P’s basis in CS3 from \$125 to \$250. P recognizes \$400 of loss on the sale of CS4. The loss suspension rule does not apply because S is no longer a member of the P group. Thus, the loss is allowable at that time.

Example 3. Nondeconsolidating sale of common stock.

(i) *Facts.* In Year 1, P forms S with a contribution of \$80 in exchange for 80 shares of the common stock of S, which at that time represents all of the outstanding stock of S. S becomes a member of the P group. In Year 2, P contributes Asset A with a basis of \$50 and a value of \$20 in exchange for 20 shares of the common stock of S in a transfer to which section 351 applies. In Year 3, in a transaction that is not part of the plan that includes the Year 2 contribution, P sells the 20 shares of the common stock of S that it acquired in Year 2 for \$20. Immediately after the Year 3 stock sale, S is a member of the P group. At the time of the Year 3 stock sale, S has \$80 and Asset A. In Year 4, S sells Asset A, the basis and value of which have not changed since its contribution to S. On the sale of Asset A for \$20, S recognizes a \$30 loss. The P group cannot establish that all or a portion of the \$30 loss was not reflected in the calculation of the duplicated loss of S on the date of the Year 3 stock sale. The \$30 loss is used on the P group return to offset income of P. In Year 5, P sells its remaining S common stock for \$80.

(ii) *Application of basis redetermination and loss suspension rules.* Because P’s basis in the common stock sold exceeds its value immediately prior to the sale and S is a member of the P group immediately after the sale, P’s basis in all of the stock of S is redetermined pursuant to paragraph (b)(1) of this section. Of P’s total basis of \$130 in the S common stock, a proportionate amount is allocated to each of the 100 shares of S common stock. Accordingly, \$26 is allocated to the common stock of S that is sold and \$104 is allocated to the common stock of S that is retained. On P’s sale of the 20 shares of the common stock of S for \$20, P recognizes a loss of \$6. Because the sale of the 20 shares of common stock of S does not result in the deconsolidation of S, under paragraph (c)(1) of this section, that loss is suspended to the extent of the duplicated loss with respect to the shares sold. The duplicated loss with respect to the shares sold is \$6. Therefore, the entire \$6 loss is suspended.

(iii) *Effect of subsequent asset sale on stock basis.* Of the \$30 loss recognized on the sale of Asset A, \$24 is taken into account in determining the basis adjustments made under §1.1502–32 to the stock

of S owned by P. Accordingly, P's basis in its S stock is reduced by \$24 from \$104 to \$80.

(iv) *Effect of subsequent asset sale on suspended loss.* Because P cannot establish that all or a portion of the loss recognized on the sale of Asset A was not reflected in the calculation of the duplicated loss of S on the date of the Year 3 stock sale and such loss is allocable to the period beginning on the date of the Year 3 disposition of the S stock and ending on the day before the first date on which S is not a member of the P group and is taken into account in determining consolidated taxable income (or loss) of the P group for a taxable year that includes a date on or after the date of the Year 3 disposition and before the first date on which S is not a member of the P group, such asset loss reduces the suspended loss pursuant to paragraph (c)(4) of this section. The amount of such reduction, however, cannot exceed \$6, the excess of the amount of such loss, \$30, over the amount of such loss that is taken into account in determining the basis adjustment made to the stock of S owned by P, \$24. Therefore, the suspended loss is reduced to zero.

(v) *Effect of subsequent stock sale.* P recognizes \$0 gain/loss on the Year 5 sale of its remaining S common stock. No amount of suspended loss remains to be allowed under paragraph (c)(5) of this section.

Example 4. Nondeconsolidating sale of common stock of lower-tier subsidiary. (i) *Facts.* In Year 1, P forms S1 with a contribution of \$200 in exchange for all of the common stock of S1, which represents all of the outstanding stock of S1. In the same year, S1 forms S2 with a contribution of \$80 in exchange for 80 shares of the common stock of S2, which at that time represents all of the outstanding stock of S2. S1 and S2 become members of the P group. In the same year, S2 purchases Asset A for \$80. In Year 2, S1 contributes Asset B with a basis of \$50 and a value of \$20 in exchange for 20 shares of the common stock of S2 in a transfer to which section 351 applies. In Year 3, S1 sells the 20 shares of the common stock of S2 that it acquired in Year 2 for \$20. Immediately after the Year 3 stock sale, S2 is a member of the P group. At the time of the Year 3 stock sale, the bases and values of Asset A and Asset B are unchanged. In Year 4, S2 sells Asset B for \$45, recognizing a \$5 loss. The P group cannot establish that all or a portion of the \$5 loss was not reflected in the calculation of the duplicated loss of S2 on the date of the Year 3 stock sale. The \$5 loss is used on the P group return to offset income of P. In Year 5, S1 sells its remaining S2 common stock for \$100.

(ii) *Application of basis redetermination and loss suspension rules.* Because S1's basis in the S2 common stock sold exceeds its value immediately prior to the sale and S2 is a member of the P group immediately after the sale, S1's basis in all of the stock of S2 is redetermined pursuant to paragraph (b)(1) of this section. Of S1's total basis of \$130 in the S2 common stock, a proportionate amount is allocated to each of the 100 shares of S2 common stock. Accordingly, a total of \$26 is allocated to the common stock of S2 that is sold and \$104 is allocated to the common stock of S2 that is retained. On S1's sale of the 20 shares of the common stock of S2 for \$20, S1 recognizes a loss of \$6. Because the sale of the 20 shares of common stock of S2 does not result in the deconsolidation of S2, under paragraph (c)(1) of this section, that loss is suspended to the extent of the duplicated loss with respect to the shares sold. The duplicated loss with respect to the shares sold is \$6. Therefore, the

entire \$6 loss is suspended. Pursuant to paragraph (c)(3) of this section and §1.1502-32T(b)(3)(iii)(C), the suspended loss is treated as a noncapital, nondeductible expense incurred by S1 during the tax year that includes the date of the disposition of stock to which paragraph (c)(1) of this section applies. Accordingly, P's basis in its S1 stock is reduced from \$200 to \$194.

(iii) *Effect of subsequent asset sale on stock basis.* Of the \$5 loss recognized on the sale of Asset B, \$4 is taken into account in determining the basis adjustments made under §1.1502-32 to the stock of S2 owned by S1. Accordingly, S1's basis in its S2 stock is reduced by \$4 from \$104 to \$100 and P's basis in its S1 stock is reduced by \$4 from \$194 to \$190.

(iv) *Effect of subsequent asset sale on suspended loss.* Because P cannot establish that all or a portion of the loss recognized on the sale of Asset B was not reflected in the calculation of the duplicated loss of S2 on the date of the Year 3 stock sale and such loss is allocable to the period beginning on the date of the Year 3 disposition of the S2 stock and ending on the day before the first date on which S2 is not a member of the P group and is taken into account in determining consolidated taxable income (or loss) of the P group for a taxable year that includes a date on or after the date of the Year 3 disposition and before the first date on which S2 is not a member of the P group, such asset loss reduces the suspended loss pursuant to paragraph (c)(4) of this section. The amount of such reduction, however, cannot exceed \$1, the excess of the amount of such loss, \$5, over the amount of such loss that is taken into account in determining the basis adjustment made to the stock of S2 owned by members of the P group, \$4. Therefore, the suspended loss is reduced to \$5.

(v) *Effect of subsequent stock sale.* In Year 5, when S1 sells its remaining S2 stock for \$100, it recognizes \$0 gain/loss. Pursuant to paragraph (c)(5) of this section, the remaining \$5 of the suspended loss is allowed on the P group's return for Year 5 when S1 sells its remaining S2 stock.

Example 5. Deconsolidating sale of subsidiary member owning stock of another subsidiary member that remains in group. (i) *Facts.* In Year 1, P forms S1 with a contribution of Asset A with a basis of \$50 and a value of \$20 in exchange for 100 shares of common stock of S1 in a transfer to which section 351 applies. Also in Year 1, P and S1 form S2. P contributes \$80 to S2 in exchange for 80 shares of common stock of S2. S1 contributes Asset A to S2 in exchange for 20 shares of common stock of S2 in a transfer to which section 351 applies. In Year 3, in a transaction that is not part of a plan that includes the Year 1 contributions, P sells its 100 shares of S1 common stock for \$20. Immediately after the Year 3 stock sale, S2 is a member of the P group. At the time of the Year 3 stock sale, S1 owns 20 shares of common stock of S2, and S2 has \$80 and Asset A. In Year 4, S2 sells Asset A, the basis and value of which have not changed since its contribution to S2. On the sale of Asset A for \$20, S2 recognizes a \$30 loss. That \$30 loss is used on the P group return to offset income of P. In Year 5, P sells its S2 common stock for \$80.

(ii) *Application of basis redetermination and loss suspension rules.* Pursuant to paragraph (b)(4) of this section, because immediately before P's transfer of S1 stock S1 owns stock of S2 (another subsidiary member of the same group) that has a basis that exceeds its value, paragraph (b) of this section applies as if S1

had transferred its stock of S2. Because S2 is a member of the group immediately after the transfer of the S1 stock, the group member's basis in the S2 stock is redetermined pursuant to paragraph (b)(1) of this section immediately prior to the sale of the S1 stock. Of the group members' total basis of \$130 in the S2 stock, \$26 is allocated to S1's 20 shares of S2 common stock and \$104 is allocated to P's 80 shares of S2 common stock. Pursuant to paragraph (b)(5) of this section, the redetermination of S1's basis in the stock of S2 results in an adjustment to P's basis in the stock of S1. In particular, P's basis in the stock of S1 is decreased by \$24 to \$26. On P's sale of its 100 shares of S1 common stock for \$20, P recognizes a loss of \$6. Because S1 is not a member of the P group immediately after P's sale of the S1 stock, paragraph (c)(1) of this section does not apply to suspend such loss. However, because P recognizes a loss with respect to the disposition of the S1 stock and S1 owns stock of S2 (which is a member of the P group immediately after the disposition), paragraph (c)(2) of this section does apply to suspend up to \$6 of that loss, an amount equal to the amount by which the duplicated loss with respect to the stock of S1 sold is attributable to S2's adjusted basis in its assets, loss carryforwards, and deferred deductions.

(iii) *Effect of subsequent asset sale on stock basis.* Of the \$30 loss recognized on the sale of Asset A, \$24 is taken into account in determining the basis adjustments made under §1.1502-32 to the stock of S2 owned by P. Accordingly, P's basis in its S2 stock is reduced by \$24 from \$104 to \$80.

(iv) *Effect of subsequent asset sale on suspended loss.* Because P cannot establish that all or a portion of the loss recognized on the sale of Asset A was not reflected in the calculation of the duplicated loss of S2 on the date of the Year 3 stock sale and such loss is allocable to the period beginning on the date of the Year 3 deemed disposition of the S2 stock and ending on the day before the first date on which S2 is not a member of the P group and is taken into account in determining consolidated taxable income (or loss) of the P group for a taxable year that includes a date on or after the date of the Year 3 deemed disposition and before the first date on which S2 is not a member of the P group, such asset loss reduces the suspended loss pursuant to paragraph (c)(4) of this section. The amount of such reduction, however, cannot exceed \$6, the excess of the amount of such loss, \$30, over the amount of such loss that is taken into account in determining the basis adjustment made to the stock of S2 owned by P, \$24. Therefore, the suspended loss is reduced to zero.

(v) *Effect of subsequent stock sale.* P recognizes \$0 gain/loss on the Year 5 sale of its remaining S2 common stock. No amount of suspended loss remains to be allowed under paragraph (c)(5) of this section.

Example 6. Loss recognized on asset with basis determined by reference to stock basis of subsidiary member. (i) *Facts.* In Year 1, P forms S with a contribution of \$80 in exchange for 80 shares of common stock of S which at that time represents all of the outstanding stock of S. S becomes a member of the P group. In Year 2, P contributes Asset A with a basis of \$50 and a value of \$20 in exchange for 20 shares of common stock of S in a transfer to which section 351 applies. In Year 3, in a transaction that is not part of a plan that includes the Year 1 and Year 2 contributions, P contributes the 20 shares of S com-

mon stock it acquired in Year 2 to PS, a partnership, in exchange for a 20 percent capital and profits interest in a transaction described in section 721. Immediately after the contribution to PS, S is a member of the P group. In Year 4, P sells its interest in PS for \$20, recognizing a \$30 loss.

(ii) *Application of basis redetermination rule upon nonrecognition transfer.* Because P's basis in the S common stock contributed to PS exceeds its value immediately prior to the transfer and S is a member of the P group immediately after the transfer, P's basis in all of the S stock is redetermined pursuant to paragraph (b)(1) of this section. Of P's total basis of \$130 in the common stock of S, a proportionate amount is allocated to each share of S common stock. Accordingly, \$26 is allocated to the S common stock that is contributed to PS and, under section 722, P's basis in its interest in PS is \$26.

(iii) *Application of loss suspension rule on disposition of asset with basis determined by reference to stock basis of subsidiary member.* P recognizes a \$6 loss on its disposition of its interest in PS. Because P's basis in its interest in PS was determined by reference to the basis of S stock and at the time of the determination of P's basis in its interest in PS such S stock had a duplicated loss of \$6, and, immediately after the disposition, S is a member of the P group, such loss is suspended to the extent of such duplicated loss. Principles similar to those of paragraphs (c)(3), (c)(4), and (c)(5) of this section shall apply to such suspended loss.

(f) *Worthlessness and certain dispositions not followed by separate return years—(1) General rule.* Notwithstanding any other provision in the regulations under section 1502, if stock of a subsidiary member is treated as worthless under section 165 (taking into account the provisions of §1.1502–80(c)), or if a member of a group disposes of subsidiary member stock and on the following day the subsidiary is not a member of the group and does not have a separate return year, then all losses treated as attributable to the subsidiary member under the principles of §1.1502–21(b)(2)(iv), after computing the taxable income of the group, the subsidiary member, or a group of which the subsidiary member was previously a member for the taxable year that includes the determination of worthlessness or the disposition and any prior taxable year, shall be treated as expired, but not as absorbed by the group, as of the beginning of the group's taxable year that follows the taxable year that includes the determination of worthlessness or the disposition.

(2) *Election in the case of determinations of worthlessness and dispositions not followed by a separate return that occurred prior to March 14, 2003.* If stock of a subsidiary member is treated as worthless under section 165 (taking into account the provisions of §1.1502–80(c)) on or after

March 7, 2002, and prior to March 14, 2003, or if a member of a group disposes of subsidiary member stock on or after March 7, 2002, and prior to March 14, 2003, and on the following day the subsidiary is not a member of the group and does not have a separate return year, then, notwithstanding paragraph (f)(1) of this section, the common parent may make an irrevocable election to reattribute to itself all or any portion of the losses treated as attributable to such subsidiary member under the principles of §1.1502–21(b)(2)(iv). The election shall be in the form of a statement filed with or as part of the group's return for the taxable year in which the worthlessness is established or the disposition occurs. The statement shall be entitled "Election under Section 1.1502–35T(f)(2)" and must state that the common parent is making an irrevocable election under this paragraph (f)(2) to reattribute to itself the losses of the subsidiary member the stock of which is worthless or disposed of. In addition, it must identify the subsidiary to which the election relates and the portion of losses subject to the election. If the election provided in this paragraph is made, the common parent shall be treated as succeeding to the reattributed losses as if the losses were succeeded to in a transaction described in section 381(a). For purposes of applying the provisions of §1.1502–32, the reattributed losses shall be treated as absorbed by the group immediately prior to the allowance of any loss or inclusion of any income or gain with respect to the determination of worthlessness or the disposition. In the case of an election to reattribute less than all of the losses otherwise treated as attributable to such subsidiary member under the principles of §1.1502–21(b)(2)(iv), paragraph (f)(1) of this section shall apply to that portion of the losses for which an election under this paragraph (f)(2) is not made.

(g) *Anti-avoidance rules—(1) Transfer of share without a loss in avoidance.* If a share of subsidiary member stock has a basis that does not exceed its value and the share is transferred with a view to avoiding application of the rules of paragraph (b) of this section prior to the transfer of a share of subsidiary member stock that has a basis that does exceed its value or a deconsolidation of a subsidiary member, the rules of paragraph (b) of this section shall ap-

ply immediately prior to the transfer of stock that has a basis that does not exceed its value.

(2) *Transfers of loss property in avoidance.* If a member of a consolidated group contributes an asset with a basis that exceeds its value to a partnership in a transaction described in section 721 or a corporation that is not a member of such group in a transfer described in section 351, such partnership or corporation contributes such asset to a subsidiary member in a transfer described in section 351, and such contributions are undertaken with a view to avoiding the rules of paragraph (b) or (c) of this section, adjustments must be made to carry out the purposes of this section.

(3) *Anti-loss reimportation—(i) Application.* This paragraph (g)(3) applies if—

(A) A member of a group recognizes and is allowed a loss on the disposition of a share of stock of a subsidiary member with respect to which there is a duplicated loss; and

(B) Within the 10-year period beginning on the date the subsidiary member (or any successor) ceases to be a member of such group—

(1) The subsidiary member (or any successor) again becomes a member of such group (or any successor group) when the subsidiary member (or any successor) owns any asset that has a basis in excess of value at such time and that was owned by the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) and that had a basis in excess of value on such date;

(2) The subsidiary member (or any successor) again becomes a member of such group (or any successor group) when the subsidiary member (or any successor) owns any asset that has a basis in excess of value at such time and that has a basis that reflects, directly or indirectly, in whole or in part, the basis of any asset that was owned by the subsidiary member on the date of a disposition of stock of such subsidiary member (or any successor) and that had a basis in excess of value on such date;

(3) In a transaction described in section 381 or section 351, any member of such group (or any successor group) acquires any asset of the subsidiary member (or any successor) that was owned by the subsidiary member (or any successor) on the date of a disposition of stock of such

subsidiary member (or any successor) and that had a basis in excess of its value on such date, or any asset that has a basis that reflects, directly or indirectly, in whole or in part, the basis of any asset that was owned by the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) and that had a basis in excess of its value on such date, and, immediately after the acquisition of such asset, such asset has a basis in excess of its value;

(4) The subsidiary member (or any successor) again becomes a member of such group (or any successor group) when the subsidiary member (or any successor) has a liability (within the meaning of section 358(h)(3)) that it had on the date of a disposition of stock of such subsidiary member (or any successor) and such liability will give rise to a deduction;

(5) In a transaction described in section 381 or section 351, any member of such group (or any successor group) assumes a liability (within the meaning of section 358(h)(3)) that was a liability of the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor);

(6) The subsidiary member (or any successor) again becomes a member of such group (or any successor group) when the subsidiary member (or any successor) has any losses or deferred deductions that were losses or deferred deductions of the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor);

(7) The subsidiary member (or any successor) again becomes a member of such group (or any successor group) when the subsidiary member (or any successor) has any losses or deferred deductions that are attributable to any asset that was owned by the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) and that had a basis in excess of value on such date;

(8) The subsidiary member (or any successor) again becomes a member of such group (or any successor group) when the subsidiary member (or any successor) has any losses or deferred deductions that are attributable to any asset that had a basis that reflected, directly or indirectly, in whole or in part, the basis of any asset that was owned by the subsidiary member (or any

successor) on the date of a disposition of stock of such subsidiary member (or any successor) and that had a basis in excess of value on such date;

(9) The subsidiary member (or any successor) again becomes a member of such group (or any successor group) when the subsidiary member (or any successor) has any losses or deferred deductions that are attributable to a liability (within the meaning of section 358(h)(3)) that it had on the date of a disposition of stock of such subsidiary member (or any successor);

(10) Any member of such group (or any successor group) succeeds to any losses or deferred deductions of the subsidiary member (or any successor) that were losses or deferred deductions of the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor), that are attributable to any asset that was owned by the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) and that had a basis in excess of value on such date, that are attributable to any asset that had a basis that reflected, directly or indirectly, in whole or in part, the basis of any asset that was owned by the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) and that had a basis in excess of value on such date, or that are attributable to a liability (within the meaning of section 358(h)(3)) of the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor); or

(11) Any losses or deferred deductions of the subsidiary member (or any successor) that were losses or deferred deductions of the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor), that are attributable to any asset that was owned by the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) and that had a basis in excess of value on such date, that are attributable to any asset that had a basis that reflected, directly or indirectly, in whole or in part, the basis of any asset that was owned by the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) and that had a basis in ex-

cess of value on such date, or that are attributable to a liability (within the meaning of section 358(h)(3)) of the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) are carried back to a pre-disposition taxable year of the subsidiary member.

(ii) *Operating rules.* (A) For purposes of paragraph (g)(3)(i)(B) of this section, assets shall include stock and securities and the subsidiary member (or any successor) shall be treated as having its allocable share of losses and deferred deductions of all lower-tier subsidiary members and as owning its allocable share of each asset of all lower-tier subsidiary members.

(B) For purposes of paragraphs (g)(3)(i)(B)(6), (7), (8), and (9) of this section, unless the group can establish otherwise, if the subsidiary member (or any successor) again becomes a member of such group (or any successor group) at a time when the subsidiary member (or any successor) has any losses or deferred deductions, such losses and deferred deductions shall be treated as losses or deferred deductions that were losses or deferred deductions of the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor), losses or deferred deductions that are attributable to assets that were owned by the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) and that had bases in excess of value on such date, losses or deferred deductions that are attributable to assets that had bases that reflected, directly or indirectly, in whole or in part, the bases of assets that were owned by the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) and that had bases in excess of value on such date, or losses or deferred deductions attributable to a liability (within the meaning of section 358(h)(3)) of the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor).

(C) For purposes of paragraph (g)(3)(i)(B)(10) of this section, unless the group can establish otherwise, if a member of such group (or any successor group) succeeds to any losses or deferred deductions of the subsidiary member (or any suc-

cessor), such losses and deferred deductions shall be treated as losses or deferred deductions that were losses or deferred deductions of the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor), losses or deferred deductions that are attributable to assets that were owned by the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) and that had bases in excess of value on such date, losses or deferred deductions that are attributable to assets that had bases that reflected, directly or indirectly, in whole or in part, the bases of assets that were owned by the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) and that had a basis in excess of value on such date, or losses or deferred deductions attributable to a liability (within the meaning of section 358(h)(3)) of the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor).

(D) For purposes of paragraph (g)(3)(i)(B)(II) of this section, unless the group can establish otherwise, if any losses or deferred deductions of the subsidiary member (or any successor) are carried back to a pre-disposition taxable year of the subsidiary member, such losses and deferred deductions shall be treated as losses or deferred deductions that were losses or deferred deductions of the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor), losses or deferred deductions that are attributable to assets that were owned by the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) and that had a basis in excess of value on such date, losses or deferred deductions that are attributable to assets that had bases that reflected, directly or indirectly, in whole or in part, the bases of assets that were owned by the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) and that had a basis in excess of value on such date, or losses or deferred deductions that are attributable to a liability (within the meaning of section 358(h)(3)) of the subsidiary member (or any successor) on the date of

a disposition of stock of such subsidiary member (or any successor).

(iii) *Loss disallowance.* If this paragraph (g)(3) applies, then, to the extent that the aggregate amount of loss recognized by members of the group (and any successor group) on dispositions of the subsidiary member stock was attributable to a duplicated loss of such subsidiary member that was allowed, such group (or any successor group) will be denied the use of—

(A) Any loss recognized that is attributable to, directly or indirectly, an asset that was owned by the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) and that had a basis in excess of value on such date, to the extent of the lesser of the loss inherent in such asset on the date of a disposition of the stock of the subsidiary member (or any successor) and the loss inherent in such asset on the date of the event described in paragraph (g)(3)(i)(B) of this section that gives rise to the application of this paragraph (g)(3);

(B) Any loss recognized that is attributable to, directly or indirectly, an asset that has a basis that reflects, directly or indirectly, in whole or in part, the basis of any asset that was owned by the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) and that had a basis in excess of its value on such date, to the extent of the lesser of the loss inherent in the asset that was owned by the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) the basis of which is reflected, directly or indirectly, in whole or in part, in the basis of such asset on the date of the disposition and the loss inherent in such asset on the date of the event described in paragraph (g)(3)(i)(B) of this section that gives rise to the application of this paragraph (g)(3);

(C) Any loss or deduction that is attributable to a liability described in paragraph (g)(3)(i)(B)(4) or (5) of this section; and

(D) Any loss or deduction described in paragraph (g)(3)(i)(B)(6), (7), (8), (9), (10), or (11) of this section, provided that a loss or deferred deduction described in paragraph (g)(3)(i)(B)(11) of this section shall be allowed to be carried forward to a post-disposition taxable year of the subsidiary member.

(iv) *Treatment of disallowed loss.* For purposes of §1.1502–32(b)(3)(iii), any loss or deduction the use of which is disallowed pursuant to paragraph (g)(3)(iii) of this section (other than a loss or deduction described in paragraph (g)(3)(i)(B)(11) of this section), and with respect to which no waiver described in §1.1502–32(b)(4) is filed, is treated as a noncapital, nondeductible expense incurred during the taxable year that such loss would otherwise be absorbed.

(4) *Avoidance of recognition of gain.* (i) If a transaction is structured with a view to, and has the effect of, deferring or avoiding the recognition of gain on a disposition of stock by invoking the application of paragraph (b)(1) of this section to redetermine the basis of stock of a subsidiary member, and the stock loss that gives rise to the application of paragraph (b)(1) of this section is not significant, paragraphs (b) and (c) of this section shall not apply.

(ii) If a transaction is structured with a view to, and has the effect of, deferring or avoiding the recognition of gain on a disposition of stock by invoking the application of paragraph (b)(2) of this section to redetermine the basis of stock of a subsidiary member, and the duplicated loss of the subsidiary member that is reflected in stock of the subsidiary member owned by members of the group immediately before the deconsolidation is not significant, paragraphs (b) and (c) of this section shall not apply.

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

Example 1. Transfers of property in avoidance of basis redetermination rule. (i) *Facts.* In Year 1, P forms S with a contribution of \$100 in exchange for 100 shares of common stock of S which at that time represents all of the outstanding stock of S. S becomes a member of the P group. In Year 2, P contributes 20 shares of common stock of S to PS, a partnership, in exchange for a 20 percent capital and profits interest in a transaction described in section 721. In Year 3, P contributes Asset A with a basis of \$50 and a value of \$20 to PS in exchange for an additional capital and profits interest in PS in a transaction described in section 721. Also in Year 3, PS contributes Asset A to S and P contributes an additional \$80 to S in transfers to which section 351 applies. In Year 4, S sells Asset A for \$20, recognizing a loss of \$30. The P group uses that loss to offset income of P. Also in Year 4, P sells its entire interest in PS for \$40, recognizing a loss of \$30.

(ii) *Analysis.* Pursuant to paragraph (g)(2) of this section, if P's contributions of S stock and Asset A to PS were undertaken with a view to avoiding the application of the basis redetermination or the loss sus-

pension rule, adjustments must be made such that the group does not obtain more than one tax benefit from the \$30 loss inherent in Asset A.

Example 2. Transfers effecting a reimportation of loss. (i) *Facts.* In Year 1, P forms S with a contribution of Asset A with a value of \$100 and a basis of \$120, Asset B with a value of \$50 and a basis of \$70, Asset C with a value of \$90 and a basis of \$100 in exchange for all of the common stock of S and S becomes a member of the P group. In Year 2, in a transaction that is not part of a plan that includes the contribution, P sells the stock of S for \$240, recognizing a loss of \$50. At such time, the bases and values of Assets A, B, and C have not changed since their contribution to S. In Year 3, S sells Asset A, recognizing a \$20 loss. In Year 3, S merges into M in a reorganization described in section 368(a)(1)(A). In Year 8, P purchases all of the stock of M for \$300. At that time, M has a \$10 net operating loss. In addition, M owns Asset D, which was acquired in an exchange described in section 1031 in connection with the surrender of Asset B. Asset C has a value of \$80 and a basis of \$100. Asset D has a value of \$60 and a basis of \$70. In Year 9, P has operating income of \$100 and M recognizes \$20 of loss on the sale of Asset C. In Year 10, P has operating income of \$50 and M recognizes \$50 of loss on the sale of Asset D.

(ii) *Analysis.* P's \$50 loss on the sale of S stock is entirely attributable to duplicated loss. Therefore, pursuant to paragraph (g)(3) of this section, assuming the P group cannot establish otherwise, M's \$10 net operating loss is treated as attributable to assets that were owned by S on the date of the disposition and that had bases in excess of value on such date. Without regard to any other limitations on the group's use of M's net operating loss, the P group cannot use M's \$10 net operating loss pursuant to paragraph (g)(3)(iii)(D) of this section. Pursuant to paragraph (g)(3)(iv) of this section and §1.1502-32T(b)(3)(iii)(D), such loss is treated as a noncapital, nondeductible expense of M incurred during the taxable year that includes the day after the reorganization. In addition, the P group is denied the use of \$10 of the loss recognized on the sale of Asset C. Finally, the P group is denied the use of \$10 of the loss recognized on the sale of Asset D. Pursuant to paragraph (g)(3)(iv) of

this section and §1.1502-32T(b)(3)(iii)(D), each such disallowed loss is treated as a noncapital, nondeductible expense of M incurred during the taxable year that includes the date of the disposition of the asset with respect to which such loss was recognized.

Example 3. Transfers to avoid recognition of gain. (i) *Facts.* P owns all of the stock of S1 and S2. The S2 stock has a basis of \$400 and a value of \$500. S1 owns 50% of the stock of the S3 common stock with a basis of \$150. S2 owns the remaining 50% of the S3 common stock with a basis of \$100 and a value of \$200 and one share of S3 preferred stock with a basis of \$10 and a value of \$9. P intends to sell all of its S2 stock to an unrelated buyer. P, therefore, engages in the following steps to dispose of S2 without recognizing a substantial portion of the built-in gain in S2. First, P causes a recapitalization of S3 in which S2's S3 common stock is exchanged for new S3 preferred shares. P then sells all of its S2 stock. Immediately after the sale of the S2 stock, S3 is a member of the P group.

(ii) *Analysis.* Pursuant to paragraph (b)(4) of this section, because S2 owns stock of S3 (another subsidiary member of the same group) and, immediately after the sale of the S2 stock, S3 is a member of the group, then for purposes of applying paragraph (b) of this section, S2 is deemed to have transferred its S3 stock. Because S3 is a member of the group immediately after the transfer of the S2 stock and the S3 stock deemed transferred has a basis in excess of value, the group member's basis in the S3 stock is redetermined pursuant to paragraph (b)(1) of this section immediately prior to the sale of the S2 stock. Pursuant to paragraph (b)(1) of this section, the total basis of S3 stock held by members of the P group is allocated first to the S3 preferred shares, up to their value of \$209, and then to the remaining shares of S3 common held by S1. S2's aggregate basis in the S3 preferred stock is increased from \$110 to \$209. This increase tiers up and increases P's basis in the S2 stock from \$400 to \$499. Accordingly, P will recognize only \$1 of gain on the sale of its S2 stock. However, because the recapitalization of S3 was structured with a view to, and has the effect of, avoiding the recognition of gain on a disposition of stock by invoking the application of paragraph (b) of this section, para-

graph (g)(4)(i) of this section applies. Accordingly, paragraph (b) of this section does not apply upon P's disposition of the S2 stock and P recognizes \$100 of gain on the disposition of the S2 stock.

(h) *Application of other anti-abuse rules.* The rules of this section do not preclude the application of anti-abuse rules under other provisions of the Internal Revenue Code and regulations thereunder.

(i) [Reserved].

(j) *Effective date.* This section, except for paragraph (g)(3) of this section, applies with respect to stock transfers, deconsolidations of subsidiary members, determinations of worthlessness, and stock dispositions on or after March 7, 2002, and no later than March 11, 2006, but only if such events occur during a taxable year the original return for which is due (without regard to extensions) after March 14, 2003. Paragraph (g)(3) of this section applies to events described in paragraph (g)(3)(iii) of this section occurring on or after October 18, 2002, and no later than March 11, 2006, but only if such events occur during a taxable year the original return for which is due (without regard to extensions) after March 14, 2003.

Par. 8. The authority citation for part 602 continues to read as follows:

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

Par. 9. In §602.101, paragraph (b) is amended by adding an entry to the table in numerical order to read as follows:

§602.101 OMB Control numbers.

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(b) * * *

CFR part or section where identified and described

Current OMB control No.

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1.1502-35T..... 1545-1828

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David A. Mader,
Assistant Deputy Commissioner
of Internal Revenue.

Approved March 7, 2003.

Pamela F. Olson,
Assistant Secretary of the Treasury.