

**CONSOLIDATED ATTRIBUTE REDUCTION
REGULATIONS[®]**

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Consolidated Attribute Reduction Regulations*

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In early 2005, the Treasury Department issued final regulations that employ a hybrid single member, group-wide entity approach to reduce consolidated group members' tax attributes when a member excludes cancellation of debt income ("COD") under the bankruptcy or insolvency exceptions to COD (together with the prior temporary regulations, the "Consolidated 108 Regulations").¹ This outline briefly summarizes the general section 108 cancellation of debt rules and the application of these rules to the consolidated attribute reduction regulations. The regulations generally do not apply to transactions on or before August 29, 2003, although the IRS is maintaining its pre-regulation litigating position of group-wide consolidated attribute reduction

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¹ Final regulations: T.D. 9192, 70 F.R. 14395 (Mar. 21, 2005); temporary regulations and amendments: T.D. 9089, 68 F.R. 52542 and 68 F.R. 52487-03 (Sept. 4, 2003); T.D. 9098, REG-153319-03 (Dec. 10, 2003); T.D. 9117, 69 F.R. 12069 (March 12, 2004). The final regulations generally apply to COD realized after March 21, 2005, and optionally to COD realized after August 29, 2003. Alternatively, the temporary regulations generally will apply to COD realized during such earlier period. It bears noting that the temporary regulations issued in August 2003 did not contain the month long notice and comment period generally required by the Administrative Procedure Act for legislative regulations such as these, due to the need for "immediate guidance" and the fact that consolidated groups "may be taking inconsistent positions that are inconsistent with the policies underlying section 108 and the [single consolidated NOL] principle enunciated by the Supreme Court in *United Dominion Indus., Inc. v. United States*, 532 U.S. 822 (2001)."

All section references are to the Internal Revenue Code of 1986, as amended ("I.R.C."), and to the Treasury Regulations promulgated thereunder.

with respect to those transactions.² Marvel Entertainment is currently challenging the IRS's reduction of NOLs on a consolidated group basis for excluded COD income incurred prior to the effective date of the 2003 regulations.³

I. SECTION 108 CANCELLATION OF DEBT RULES

A. General Rule. Generally, COD is included in a taxpayer's gross income.⁴ However, a taxpayer does not recognize COD if it is in bankruptcy or to the extent it is insolvent.⁵ COD is recognized only to the extent it exceeds a debtor's insolvency,⁶ although a debtor in a Title 11 proceeding generally will not recognize any COD.⁷

B. Exclusion of COD. A taxpayer that excludes COD from gross income because of its insolvency or bankruptcy must reduce its tax attributes after the determination of its tax for the year of cancellation or, in the case of tax basis, as of the beginning of its next

² See, e.g., CCA 200714017 (April 6, 2007). For a critique of the IRS's analysis, see Lawrence M. Axelrod, *What's "Reasonable" Before the Consolidated COD Regulations?*, 115 Tax Notes 745 (May 21, 2007).

³ See *Marvel Entertainment, LLC v. Commissioner*, T.C. Docket No. 12113-13 (filed May 29, 2013).

⁴ I.R.C. § 61(a)(12).

⁵ I.R.C. § 108(a)(1)(B); cf. Treas. Reg. § 1.1502-13(g)(3)(ii)(B) (COD resulting from the actual or deemed satisfaction of an intercompany obligation is not excluded from income under section 108(a), thus effectively promoting the matching principle).

⁶ I.R.C. § 108(a)(3); see also F.S.A. 200135002 (Apr. 10, 2001) (holding that the tax consequences of disposing of property in connection with the discharge of debt may depend on whether the debt is recourse or nonrecourse, and that under section 108(a), when assets are contributed to a taxpayer "simultaneously" with a debt discharge, the contributed assets are taken into account immediately after the discharge to determine how much basis the taxpayer must reduce).

⁷ I.R.C. § 108(a)(1)(A).

taxable year.⁸ A taxpayer may elect to reduce the basis of its depreciable property prior to the reduction of other tax attributes (a “depreciable property election”).⁹ Subject to the depreciable property election, a taxpayer must reduce its tax attributes in the following order:

- net operating losses (“NOLs”) created in the taxable year of discharge, and then NOL carryovers in the order in which they arose;¹⁰
- general business credits, in the order they would be used against taxable income;¹¹
- alternative minimum tax credits;¹²
- capital loss carryovers, first from the year of discharge and then in the order created;¹³
- basis of both depreciable and nondepreciable assets (in the order provided in regulations), but in general such aggregate basis is not required to be reduced below the aggregate amount of the debtor’s liabilities outstanding immediately after the discharge;¹⁴

⁸ For a discussion of the timing of attribute reduction, *see, e.g.*, 1997 F.S.A. LEXIS 356 (Feb. 28, 1997) (for purposes of determining in which year tax attributes ought to be reduced by the taxpayer under section 108(b), the date of discharge in a bankruptcy proceeding is the effective date of the court’s order if the amount of the discharge can be determined at that time).

⁹ I.R.C. § 108(b)(5). To the extent such an election is made, the basis of property must be reduced dollar for dollar, but not below zero.

¹⁰ I.R.C. § 108(b)(2)(A), (b)(3)(A), (b)(4)(B).

¹¹ I.R.C. § 108(b)(2)(B), (b)(3)(B), (b)(4)(C).

¹² I.R.C. § 108(b)(2)(C), (b)(3)(B).

¹³ I.R.C. § 108(b)(2)(D), (b)(3)(A), (b)(4)(B).

¹⁴ I.R.C. §§ 108(b)(2)(E), 108(b)(3)(A), 1017(b)(2); Treas. Reg. § 1.1017-1(b)(3).

- carryovers of passive activity loss deductions and credits that have been suspended under the passive activity loss rules;¹⁵ and
- foreign tax credit carryovers to or from the taxable year of discharge.¹⁶

All credits are reduced \$1 for every \$3 of excluded COD.¹⁷

C. Prior Law Regarding Consolidated Group Attribute Reduction. Whether consolidated groups could isolate attribution reduction to the attributes of solely the debtor member that incurred the excluded COD had been a hotly debated issue for some time before the Consolidated 108 Regulations were issued. At one time, the IRS took the position that a debtor member's COD would reduce only those attributes attributable to that member,¹⁸ but eventually reversed its position and argued that a debtor member's COD would reduce the group's consolidated NOL ("CNOL"), even if no portion of the CNOL was attributable to the debtor member.¹⁹ The IRS viewed the Supreme Court's holding in *United Dominion*²⁰ as support for its view that separate-entity attribute reduction did not apply,²¹

¹⁵ I.R.C. § 108(b)(2)(F), (b)(3)(B).

¹⁶ I.R.C. § 108(b)(2)(G), (b)(3)(B), (b)(4)(C).

¹⁷ I.R.C. § 108(b)(3)(B).

¹⁸ *See, e.g.*, PLR 9121017 (Feb. 21, 1991).

¹⁹ *See, e.g.*, FSA 199912007 (Dec. 14, 1998) (a consolidated group that excludes COD under section 108(a) must reduce the group's CNOL as a tax attribute, even if no portion of the CNOL is attributable to the member realizing the excluded COD); *Peoplefeeders, Inc. v. Comm'r*, T.C. Memo 1999-36 (IRS similarly asserted this position in litigation, but case was decided on other grounds).

²⁰ *Supra* note 1.

²¹ CCA 200149008 (Aug. 10, 2001) (when analyzing reduction of attributes under section 108(b), "[i]t is the Service's position that, in the case of NOLs, the reduction of attributes of the members of a consolidated group is not done on a member-by-member basis, as

and still maintains that position.²² Bills introduced during 2003 in both the House and the Senate also mandated attribute reduction on a consolidated group basis,²³ but were not pursued following the issuance of the Consolidated 108 Regulations.

II. CONSOLIDATED 108 REGULATIONS

- A. Determination of Insolvency. The Consolidated 108 Regulations determine the insolvency of a debtor that realizes COD on a separate entity basis, taking into account only the assets and liabilities of the member whose debt is cancelled.²⁴ Applying this rule to the question of whether an insolvent or bankrupt single member LLC (an “SMLLC”) could exclude COD, an IRS official stated that an SMLLC would only be treated as bankrupt or insolvent if its member is also bankrupt or insolvent.²⁵ The IRS’s position notwithstanding, compelling arguments can be made that an SMLLC’s bankruptcy is sufficient to qualify for exclusion.
- B. Depreciable Property Election. A consolidated group may elect to first reduce the basis of the depreciable

apparently proposed by the debtors. In the case of a consolidated group, there is only one NOL, the consolidated NOL (“CNOL”); *see also* CCA 200305019 (Jan. 10, 2002) (citing *United Dominion* to support the proposition that a group’s corporate equity reduction transaction-tainted (“CERT-tainted”) loss under section 172(g)(1) should be applied *pro rata* among the portions of the CNOL apportioned to members for carryback to separate return years, notwithstanding the fact that the CERT-tainted loss was traceable to acquisition borrowing by one profitable group member).

²² *See supra* note 2.

²³ S. 1331, 108th Cong. (1st Sess. 2003); and H.R. 2706, 108th Cong. (1st Sess. 2003). Both bills were referred to Committee prior to the issuance of the Consolidated 108 Regulations.

²⁴ Treas. Reg. § 1.1502-28(a)(1).

²⁵ Lee A. Sheppard, *ABA Mulls Consolidated Attribute Reduction*, 2003 TNT 189-10 (Sept. 30, 2003) (statement of Derek Cain, Deputy Associate Chief Counsel (Corporate), Internal Revenue Service).

property of the debtor member that realizes excluded COD (but not below zero), i.e., on a separate entity basis, before applying the normal ordering rules for attribute reduction.²⁶ By contrast, within the context of the normal ordering rules, the basis of a debtor member's depreciable and nondepreciable assets generally cannot be reduced below the aggregate amount of liabilities immediately after the debt cancellation.²⁷ This limitation is applied by reference to the aggregate basis of property held by the member (reduced by any depreciable basis as to which a depreciable property election was made), rather than the aggregate basis of property held by all the group members, and by reference to the debtor member's liabilities, rather than the aggregate liabilities of all group members.²⁸

C. Hybrid Approach to Consolidated Attribute Reduction: Ordering Rules. The Consolidated 108 Regulations provide a three-part rule for the reduction of tax attributes. Separate member attributes are reduced first, followed by the “push down” of any reduction in the stock basis of a subsidiary member to the tax attributes of the subsidiary member (under the so-called “look-through” rule, discussed in Section II.E. below). Finally, consolidated attributes of all members are reduced.

The Consolidated 108 Regulations reduce all attributes of the debtor member before reducing any attributes of other group members.²⁹ Notably, this approach differs from the pure consolidated approach adopted by the IRS prior to the regulations, based in part on the

²⁶ Treas. Reg. § 1.1502-28(b)(2)(i). Stock basis may be treated as depreciable property to the extent the subsidiary consents to a corresponding reduction in the basis of its depreciable property. I.R.C. § 1017(b)(3)(D).

²⁷ I.R.C. §§ 108(b)(2)(D), 108(b)(3)(A), 1017(b)(2); Treas. Reg. § 1.1017-1(b)(3).

²⁸ Treas. Reg. §§ 1.1502-28(b)(3)(ii); 1.1017-1(c)(3).

²⁹ Treas. Reg. § 1.1502-28(a)(2)(i).

Supreme Court's single asset CNOL approach in *United Dominion*. Had the regulations adopted a pure consolidated approach, the entire CNOL would be reduced to zero before any other attributes of the debtor or any other member are reduced. Instead, the regulations preserve the location of tax items within a consolidated group to the greatest extent possible by reducing all tax attributes of, or attributed to, the debtor member first.

Attributes of the debtor member include the debtor member's allocable portion of consolidated attributes and the debtor's own separate company attributes, *e.g.*, any loss carryforwards of the debtor member arising in separate return limitation years ("SRLYs"), and the basis of the debtor member's property (including stock basis in subsidiaries).³⁰ Under the look-through rule discussed below, any reduction in the stock basis of a subsidiary requires a corresponding reduction in the tax attributes of the subsidiary member.

If the excluded COD exceeds the attributes of the debtor member, then consolidated attributes attributable to other group members are reduced.³¹ "Consolidated attributes" are not specifically defined in the regulations, but apparently include consolidated losses and credits of any type.³² In addition, they expressly include SRLY subgroup losses attributable to a subgroup of which the debtor is a member, and SRLY losses to which the section 382/SRLY "overlap" rule applies.³³ Consolidated attributes do not include tax basis.³⁴

³⁰ Treas. Reg. §§ 1.1502-28(a)(2)(ii), 1.1502-21(b)(2)(iv).

³¹ Treas. Reg. §§ 1.1502-28(a)(4), 1.1502-21(b)(2)(iv).

³² Treas. Reg. § 1.1502-28(a).

³³ Treas. Reg. § 1.1502-28(a)(2)(ii) and (a)(4).

³⁴ Treas. Reg. § 1.1502-28.

The regulations' approach limits the chance that a debtor member's tax attributes will survive.³⁵ The preamble to the temporary regulations explains that this reduces the ability to "shift" the cost of the attribute reduction to other members, such that if and when the debtor member leaves the group, the debtor member will bear the cost of increased future tax liability, rather than the other members of the group. In effect, the regulations attempt to balance the principles of section 108 with the single entity principles of the consolidated return regulations.

- D. Limited Asset Basis Reduction Rules. The regulations provide that a debtor member's excluded COD may only reduce asset basis of a debtor member (and, under the "look-through" rule or by reason of the depreciable property election, its direct and indirect subsidiaries). Asset basis of other consolidated group members may not be reduced. The general treatment of tax basis as a separate company attribute seems to us to be the correct result given the fact that the basis of assets held by such other members is not directly available to offset income of the debtor member, and in fact may never give rise to a tax attribute that could be directly available to offset a group member's income in a consolidated return year.³⁶
- E. "Look-Through" Basis Reduction Rule. A mandatory look-through rule applies to preserve the "single taxpayer" fiction of consolidated groups when a debtor member reduces its basis in subsidiary stock.³⁷ This rule operates in a top-down fashion, such that the reduction of the stock basis of a subsidiary member cascades down from a top-tier debtor member through the attributes of its direct and indirect subsidiary debtors. More specifically, the look-through rule treats a subsidiary member as a "debtor" with an amount of excluded COD equal to the reduction in its stock basis,

³⁵ T.D. 9089, 68 F.R. 52487-03 (Sept. 4, 2003).

³⁶ Treas. Reg. § 1.1502-28(a)(4); T.D. 9089 (Aug. 29, 2003).

³⁷ The basis of subsidiary stock cannot, however, be reduced below zero. Treas. Reg. § 1.1502-28(a)(2).

and thus requires the subsidiary member to reduce its tax attributes, *i.e.*, both the consolidated attributes attributable to that subsidiary as well as that subsidiary's own attributes.³⁸

The regulations provide that the look through rule applies if the subsidiary whose stock basis is reduced is *either* (i) a member of the debtor's consolidated group on the last day of the debtor's taxable year of discharge or (ii) the first day of the debtor's next taxable year.³⁹

All of the subsidiary's separate attributes are available for reduction, including its SRLY attributes and tax basis,⁴⁰ although the basis of its assets generally cannot be reduced below the aggregate amount of liabilities outstanding immediately after the debt discharge (absent an election to reduce depreciable asset basis first).⁴¹ If the amount of excluded COD deemed realized by a subsidiary under this provision exceeds its tax attributes, such COD will not reduce attributes of any other non-debtor member under the regulations, since there already was a reduction in the stock basis of that subsidiary reflecting such excess.⁴² In effect, the "push down" of the stock basis reduction is intended to achieve somewhat the same effect as the consolidated return "investment adjustment" rules do with respect to stock but in reverse.

In general, further to section 1017(d), the regulations treat the reduction of tax basis as a result of excluded

³⁸ Treas. Reg. § 1.1502-28(a)(3)(ii). This rule does not apply to reduction of basis in the equity of pass-through entities.

³⁹ Treas. Reg. § 1.1502-28(a)(3)(ii).

⁴⁰ In contrast, section 1017(b)(3)(D) is elective. Stock basis may be treated as depreciable property to the extent the subsidiary consents to reduce the basis of (only) its depreciable assets in the context of a section 108(b) election. I.R.C. § 1017(b)(3)(D).

⁴¹ I.R.C. §§ 108(b)(2)(E), 108(b)(3)(A), 1017(b)(2); Treas. Reg. § 1.1017-1(b)(3).

⁴² Treas. Reg. § 1.1502-28(a)(3)(ii), (a)(4).

COD as a section 1245 recapture item subject to recognition notwithstanding any other provision in the Code.⁴³

Although certain transactions resulting in a carried-over basis are excluded from recapture, a section 332 liquidation of a subsidiary whose stock basis was reduced and reflects a built-in gain could trigger recapture since the subsidiary's stock basis does not itself carry over in the liquidation.⁴⁴ Under the first set of proposed and temporary regulations,⁴⁵ the section 1245 "taint" attached to the stock, even if the subsidiary had reduced various losses or credits or reduced its own asset basis, thereby subjecting its assets to a section 1245 taint as well (which could similarly include stock basis in other members). Thus, the original look-through rule inappropriately multiplied and spread the section 1245 "taint" throughout the consolidated group. Thereafter, the regulations corrected this problem by limiting the section 1245 "taint" with respect to subsidiary stock to any stock basis reduction for which there is no corresponding reduction in the tax attributes of the subsidiary (such as the subsidiary's allocable CNOL or tax basis) under the look-through rule or the depreciable property election.⁴⁶ The potential for section 1245 recapture with respect to any "tainted" stock basis remains a trap for the unwary.

F. Attribute Reduction for Multiple Debtor Members.

When multiple group members realize excluded COD, the regulations apply from the top down, beginning with the excluded COD of the highest-tier debtor member. Such debtor member reduces its own direct

⁴³ See Treas. Reg. § 1.1502-28(b)(3).

⁴⁴ I.R.C. § 1245(b)(3).

⁴⁵ Such temporary regulations generally apply to COD realized after August 29, 2003 and on or before March 21, 2005, although the final regulations may be electively applied retroactively. T.D. 9192, 70 F.R. 14395 (Mar. 21, 2005); T.D. 9117, 69 F.R. 12069 (March 12, 2004).

⁴⁶ Treas. Reg. § 1.1502-28(b)(4).

and allocated tax attributes first, followed by the push down of any reduction in stock basis to lower-tier members under the look-through rule.⁴⁷ The use of this top-down approach may cause any direct or indirect subsidiary to reduce or eliminate its tax attributes prior to applying the rules to its own actual excluded COD. This same separate-company/look-through process is repeated in full at each successively lower-tier level with respect to such lower-tier subsidiaries' actual excluded COD. If, after these reductions, the actual excluded COD of multiple members exceeds the remaining consolidated tax attributes of the group, each such member's excluded COD will reduce remaining consolidated tax attributes *pro rata* to zero, based on relative COD amounts.⁴⁸

If more than one higher-tier member which holds stock in another subsidiary member reduces its basis in such stock, the excluded COD will be applied on a *pro rata* basis to reduce the attributes of the lower-tier member.⁴⁹ If a subsidiary is a member of one higher-tier debtor member's group on the last day of that debtor's taxable year (the first group) and is a member of another group the next day (the second group), *and* both the higher-tier member in the first group and the higher-tier member in the second group reduced their basis in the subsidiary's stock held by them effectively at the same time due to excluded COD, the look-through rule will be applied chronologically, *i.e.*, the attributes of the subsidiary will first be reduced with respect to the COD of the first group and then with respect to the COD of the second group.⁵⁰

⁴⁷ Treas. Reg. § 1.1502-28(b). A member (the first member) is a higher-tier member of another member (the second member) if the first member is the common parent of a consolidated group, or if investment adjustments with respect to the stock of the second member would affect investment adjustments with respect to the stock of the first member. Treas. Reg. § 1.1502-28(b)(1)(ii).

⁴⁸ Treas. Reg. § 1.1502-28(b)(1)(iii).

⁴⁹ Treas. Reg. § 1.1502-28(b)(1)(iv).

⁵⁰ Treas. Reg. § 1.1502-28(b)(1)(v).

G. Investment Adjustment Rules. The consolidated return “investment adjustment” rules treat a debtor member’s excluded COD as tax-exempt income, increasing the stock basis of the debtor member, but only to the extent consolidated tax attributes attributable to any group member are reduced (including attributes of the common parent, or a subsidiary in another chain, are reduced).⁵¹ This rule applies only to a debtor member’s own excluded COD, and not to the excluded COD a member is treated as incurring under the look-through rule described above.⁵² This is due to the fact, as explained above, that the look-through rule is effectively a form of investment adjustment “in reverse.” By contrast, when a member’s tax attribute is reduced as a result of consolidated attribute reduction other than by reason of the look-through rule, the stock basis in that member is also reduced.⁵³

H. Excess Loss Account Rules. In coordination with the Consolidated 108 Regulations, the consolidated return regulations require excess loss account (“ELA”) recapture in connection with excluded COD of a subsidiary member as to which there is an ELA if and to the extent such excluded COD does not reduce tax attributes of the group.⁵⁴ This appropriately recognizes that requiring a greater portion of the ELA to be

⁵¹ Treas. Reg. § 1.1502-32(b)(3)(ii)(C)(1). This treatment applies with respect to determinations of stock basis in consolidated return years for which the original tax return is due (without extensions) after August 29, 2003, but may be applied retroactively if the taxpayer so desires. Treas. Reg. § 1.1502-32(h)(7); Temp. Treas. Reg. § 1.1502-32T(h)(7) (2004). Under prior law, a debtor member’s stock basis was increased for excluded COD only to the extent that a member’s own NOL or tax basis was reduced. *See* Treas. Reg. § 1.1502-32(b)(3)(ii)(C), (iii) (2003) (amended 2005).

⁵² Treas. Reg. § 1.1502-32(b)(3)(ii)(C)(1).

⁵³ Treas. Reg. § 1.1502-32(b)(3)(iii).

⁵⁴ Treas. Reg. § 1.1502-19. If the parent has multiple ELAs with respect to different shares of subsidiary stock, its ELAs would be recaptured in a manner that equalizes the ELAs. Treas. Reg. § 1.1502-19(b)(1)(ii).

recaptured would unduly penalize a consolidated group that has already reduced attributes as a result of COD exclusion.

This ELA rule applies when a parent is treated as disposing of the stock of a worthless subsidiary after August 29, 2003. In addition, the consolidated group may choose to determine or redetermine the amount of the parent's tax liability using such ELA rule if the parent was treated as disposing of the stock of a worthless subsidiary in a consolidated return year beginning on or after January 1, 1995.⁵⁵

Notably, the timing of attribute reduction (after the computation of tax for the year COD is realized) and the timing of ELA recapture (the year of the recapture event) are seemingly incompatible, since the amount of ELA recapture cannot be determined until after attributes are reduced. This gave rise to some speculation that maybe the ELA recapture income should not be included in the COD year. The final regulations (and prior thereto, the March 2004 temporary regulations) confirm, however, that ELA income must be taken into account in the year the COD is realized.⁵⁶ In the preamble to the temporary regulations, Treasury acknowledged that this inclusion could give rise to a circular calculation, resulting in a potential melt down of a group's NOLs.⁵⁷ To address this concern, the IRS adopted section 1.1502-11 regulations limiting the iterative process in the case of a single ELA/stock disposition but reserved on the issue of multiple dispositions.⁵⁸

I. Apportionment of a CNOL Within a Consolidated Group. The amount of any CNOL absorbed by the

⁵⁵ Treas. Reg. § 1.1502-19(h)(1), (2)(i), (ii).

⁵⁶ Treas. Reg. § 1.1502-28(b)(6)(ii); Temp. Reg. § 1.1502-28T(b)(6)(ii).

⁵⁷ T.D. 9117, 69 F.R. 12069 (March 12, 2004).

⁵⁸ Treas. Reg. § 1.1502-11(b). *See* section II.M., below, for a discussion of the section 1.1502-11 calculation.

group in any year is apportioned among members based on the percentage of the CNOL attributable to each member as of the beginning of the year.⁵⁹ The percentage of CNOL attributable to a member is equal to the product of (x) the CNOL and (y) the separate NOL of the member for the year the loss was created, divided by the sum of all members' separate NOLs for that year.⁶⁰

The percentage of CNOL attributable to each member must be recalculated on the first day of the taxable year following a year in which (i) a portion of the CNOL attributable to a member for a taxable year is carried back to a separate return year, (ii) a member's excluded COD reduced any portion of the CNOL attributable to such member under the regulations, or (iii) a member that generated an NOL in a given taxable year leaves the consolidated group in that taxable year. A member's recomputed percentage of the CNOL equals the member's attributable share of the remaining CNOL as of the first day of the following taxable year divided by the sum of the unabsorbed CNOL attributable to all members on such date.⁶¹

J. Deconsolidation from a Consolidated Group During the Year. The portion of a CNOL attributable to a departing subsidiary will be determined after any consolidated attribute reduction resulting from any

⁵⁹ Treas. Reg. § 1.1502-21(b)(1).

⁶⁰ Treas. Reg. § 1.1502-21(b)(2)(iv)(A), (B). For this purpose, a member's separate NOL is determined by computing the CNOL by reference to only the member's items of income, gain, deduction, and loss, including the member's losses and deductions actually absorbed by the group in the taxable year (whether or not absorbed by that member). Treas. Reg. § 1.1502-21(b)(2)(iv)(B)(1).

⁶¹ Treas. Reg. § 1.1502-21(b)(2)(iv)(B)(2). The 2005 regulations regarding apportionment of NOLs within a consolidated group apply only to taxable years for which the original tax return is due (without extensions) after August 29, 2003. Treas. Reg. § 1.1502-21(h)(6); Temp. Treas. Reg. § 1.1502-21T(h)(6) (2004).

member's excluded COD.⁶² By contrast, the look-through rule will not apply to the stock basis of a departing subsidiary that is not a group member *as of the last day* of the debtor member's taxable year. Accordingly, it may be possible to avoid the application of the look-through rule, but not CNOL reduction, through a mid-year deconsolidation. Under the temporary regulations, it appeared possible that the look-through rule did not apply to any subsidiary that was not a member of the group *at year end*. For example, under the temporary regulations, if the group had terminated before year-end, so that every subsidiary was a non-member with respect to the old group, it is possible that the look-through rule did not apply.

This disparate treatment for the CNOL and tax basis is consistent with the fact that a debtor only reduces its tax basis in assets that it holds as of the first day of its next taxable year.⁶³ Moreover, a consolidated group is entitled to use the CNOL attributable to a departing group member to shelter the group's income for the entire taxable year.⁶⁴

K. Intragroup Reorganizations and Group Structure Changes. In the case of a tax-free reorganization of a debtor member into another member of the group, the regulations provide that the successor member will be treated as the member that realized the excluded COD.⁶⁵ In addition, if a member that realizes excluded COD acquires the assets of the common parent in a tax-

⁶² Treas. Reg. § 1.1502-28(b)(8). This appeared to be the result under the temporary regulations but was not explicitly stated. The next day rule of Treasury Regulation section 1.1502-76(b)(1)(ii)(B) will not apply to treat a departing member as realizing excluded COD at the beginning of the day following the day on which the member leaves the group.

⁶³ I.R.C. §§ 108(b)(2)(E)(ii), 1017(a); Treas. Reg. § 1.1502-28(b)(3)(i).

⁶⁴ Treas. Reg. §§ 1.1502-79A(a)(1)(ii), 1.1502-21(b)(2)(ii)(A).

⁶⁵ Treas. Reg. § 1.1502-28(b)(9)(i), (b)(10) (generally applies to COD realized after March 21, 2005, and may be electively applied retroactively to COD realized after August 29, 2003).

free reorganization and succeeds such common parent, the member's attributes remaining after the determination of the group's tax will be available for reduction.⁶⁶

- L. No Special Anti-Abuse Rules. Initially, the IRS and Treasury had indicated that they were considering adopting rules to address the effect of both transitory transactions and other transactions designed to avoid the application of the attribute reduction rules, but subsequently determined that no special anti-abuse rules were necessary at this time.⁶⁷ However, the preamble to the final regulations cautions that, even in the absence of a specific anti-abuse rule, certain transactions may be challenged under existing law.⁶⁸ Informally, the IRS has acknowledged the fact that year-end attribute reduction by its terms permits a fair amount of tax planning.
- M. Elimination of Circular Stock Basis on Disposition of Member Stock. A taxable disposition of a subsidiary's stock (including one attributable to ELA recapture) in the same year in which a member has excluded COD creates a potential circular basis problem in that the departing subsidiary's tax attributes remain available for reduction by excluded COD incurred throughout the group's tax year and any reduction in tax attributes is supposed to result in a negative investment adjustment in the tax basis of the subsidiary, which would, in turn, adjust the group's gain or loss from the disposition of

⁶⁶ Treas. Reg. § 1.1502-28(b)(9)(ii).

⁶⁷ See preambles to temporary and final regulations. T.D. 9089, 68 F.R. 52487-03 (Sept. 4, 2003), and T.D. 9192, 70 F.R. 14395 (Mar. 21, 2005).

⁶⁸ T.D. 9192, 70 F.R. 14395 (Mar. 21, 2005); *see also* Kenneth A. Gary, *IRS Officials Address Attribute Reduction, Antiabuse Rules*, 2003 TNT 193-4 (Oct. 6, 2003) (statement of Derek Cain, then-Deputy Associate Chief Counsel (Corporate), Internal Revenue Service, that "a fair amount of tax planning [is] a baseline," and that the Service is primarily concerned about transitory activities, such as "drop[ping] an asset and immediately pull[ing] it back out").

the subsidiary's stock and the potential absorption of the group's tax attributes. This is made even more complicated by the fact that attribute reduction for excluded COD is supposed to take place after the determination of tax for the year,⁶⁹ while stock basis adjustments with respect to a departing member are supposed to be made immediately before the member departs.⁷⁰

Treasury Regulation section 1.1502-11, amended in connection with the Consolidated 108 Regulations,⁷¹ provides a nine-step methodology to address the circular basis problem (at least in single member disposition situations):

1. Compute limitation on deductions and losses to offset income or gain under Treasury Regulation section 1.1502-11(b)(2) and (3).
2. Tentatively adjust stock basis under the investment adjustment rules, but not to reflect the realization of excluded COD and the reduction of attributes in respect thereof.
3. Tentatively compute stock gain or loss from disposition of subsidiary member stock.
4. Tentatively compute tax imposed on the consolidated group without regard to whether all or a portion of an ELA in a share of subsidiary stock is required to be taken into account pursuant to

⁶⁹ I.R.C. § 108(b)(4).

⁷⁰ Treas. Reg. § 1.1502-32(b).

⁷¹ Prior to adoption of the final Consolidated 108 Regulations, the methodology applied to calculate reduction of tax attributes attempted to limit actual reduction of tax attributes to the amount of tax attributes available for reduction following a tentative computation of taxable income or loss. This methodology did not account for, among other things, the use of credits in the computation of the consolidated group's tax liability for the year of discharge. T.D. 9192, 70 F.R. 14395 (Mar. 21, 2005).

Treasury Regulation section 1.1502-19(b)(1) and (c)(1)(iii)(B).

5. Tentatively reduce attributes remaining after the tentative computation of the tax imposed.
6. Apply the investment adjustment rules to reflect the amount of the subsidiary's income and gain included, and unlimited deductions and losses that are absorbed, in the tentative computation under step 4, and the attribute reduction under step 5.
7. Compute actual gain or loss on the disposition of subsidiary stock using the basis computed under step 6.
8. Compute actual tax imposed on the group for the year of the disposition by applying the limitation computed under step 1, and include the gain or loss from disposition of subsidiary stock computed under step 7. Attributes that were tentatively used in the computation of tax imposed in step 4 and attributes that were tentatively reduced in step 5 cannot offset any ELA taken into account as a result of the application of Treasury Regulation section 1.1502-19(b)(1) and (c)(1)(iii)(B).
9. Apply the rules of sections 108 and 1017 and Treasury Regulation section 1.1502-28 to reduce the attributes remaining after the actual computation of tax imposed in step 8.⁷²

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⁷² Treas. Reg. § 1.1502-11(c)(2). The regulations contain four helpful examples of the nine-step calculation. Treas. Reg. § 1.1502-11(c)(5), Exs. 1-4.