Worthless Stock Losses from Liquidations and Related Issues in Consolidation

By Matthew K. White, Michael J. Wilder, and Andrew Blair-Stanek

The recent economic downturn has left many otherwise profitable affiliated groups of corporations with one or more failing subsidiaries. From a federal income tax perspective, insolvent subsidiaries often present a significant planning opportunity. If feasible from a business standpoint, the liquidation of an insolvent subsidiary could result in the recognition of an immediate stock loss. In many states, a deemed liquidation for tax purposes can be accomplished easily, through the conversion of the corporate entity into a limited liability company (LLC). In the simplest case, a parent corporation (P) that owns all of the outstanding stock and debt of an insolvent subsidiary (S) converts S into an LLC that is treated thereafter as a disregarded entity.[1] P will frequently be able to obtain immediate losses — and sometimes ordinary deductions — from the resulting deemed liquidation, without the bother of dissolving S, selling the entity or its assets to a third party, or otherwise altering S's ongoing business operations.[2]

It sounds simple and, indeed, the actual transaction could not be more straightforward. Unfortunately, the tax analysis can be surprisingly complex and uncertain, and where P and S file a consolidated return, the interaction of the consolidated return rules with generally applicable tax principles creates additional opportunities and pitfalls. But with proper fortitude, planning, and a peculiar sense of humor, you may find some enjoyment and profit in the liquidation of an insolvent subsidiary. This article reviews the key concepts and issues that are implicated by these situations.

Generally Applicable Tax Principles

Assume that parent P forms subsidiary S in Year 1 by transferring $300 to S in exchange for all of S's common stock and transferring $900 to S in exchange for an instrument that is denominated as a recourse loan. Assume that S loses a combined $1,000 in Years 1 and 2, generating $1,000 of unused net operating losses carryovers (NOLs), and that, at the end of Year 3, S's remaining assets are worth $200. At this point, P decides to liquidate S, either actually or constructively (through an LLC conversion). The S common stock is cancelled (or is deemed cancelled) in exchange for no consideration, and P receives (or is deemed to receive) the $200 of S's assets in exchange for the cancellation of the $900 S loan.

The threshold matter for determining the tax treatment of the liquidation is the proper classification of the $900 loan. If the loan documents contain arm's-length terms and S has been paying the stated interest rate, the loan likely will be respected as debt. In many circumstance, however, related parties make cash advances without observing the formalities or considering whether the advance is intended to be a more in the nature of a loan or an equity contribution. In such cases, it may be unclear whether the advance should be characterized as debt or equity.[3]

If the intercompany loan is recharacterized as equity, it must be further classified as either preferred or common stock. In general, if the loan states a "sum-certain" principal amount, then classification as preferred stock is more likely (on the theory that the principal amount would have a preference over the common stock under local law).[4] In other cases, the cash advance might not be documented or might be documented so informally that it might have no preference over the common stock. If so, the advance could be treated as common stock.[5]

Before considering the overlay of the consolidated return rules, this article reviews the consequences that flow from these three potential characterizations of the loan in the separate return context.

A. If the Loan Is Debt

1. *Treatment of S Stock*

Where P owns an amount of stock in S meeting the requirements of section 1504(a)(2) (i.e., 80 percent of the vote and value of the S stock), section 332(a) provides that P will recognize no gain or loss on the receipt of S's property in a complete liquidation of S. Because P owns all of the stock of S in our example, P's realized loss from the liquidation might arguably be disallowed under section 332. The regulations under section 332, however, require that P "receives at least partial payment for the stock of which it owns in the liquidating corporation."[6] Thus, because P receives the $200 of S's assets in partial repayment of the loan, but receives nothing for its S stock, section 332 cannot apply.[7]

Instead, P generally will be entitled to a loss or deduction for its worthless S stock under section 165. This section allows a deduction for "any loss sustained during the taxable year and not compensated by insurance or otherwise."[8] Section 165 permits a deduction only if the loss on stock is evidenced by a closed and completed transaction, fixed by identifiable events, and actually sustained.[9]

Thus, at least two initial requirements must be satisfied to ensure that P is entitled to a deduction under section 165 with respect to the S stock: (i) the S stock must have first become worthless in Year 3, rather than a prior year; and (ii) P's loss must be fixed by an identifiable event. In practice, establishing the exact year in which S becomes worthless can be a challenging, fact-intensive endeavor.[10] Assuming that S did not become worthless until Year 3, the other requirement — that P's loss must be fixed by an identifiable event — would be satisfied by the actual or deemed dissolution of S in connection with the complete liquidation.[11]

The next question is whether P's $300 loss on the S stock is capital or ordinary. Under the general rule in section 165(g)(1), if a security is a capital asset, as would typically be the case for the S stock in P's hands, P's worthless stock deduction will be treated as a capital loss.[12]

Section 163(g)(3), however, provides an important exception to the general rule and permits ordinary loss treatment for worthless securities of an "affiliated corporation," defined by a two-prong test.

First, to be an affiliated corporation, P must hold 80 percent of the S stock by vote and value.[13] In our example, P owns 100 percent of the S stock.[14] Second, the subsidiary must meet a gross receipts test. Under this test, more than 90 percent of the aggregate gross receipts of the subsidiary for all taxable years must have been from non-passive sources.[15] The list of passive sources includes royalties, rents, dividends, interest, annuities, and gains from the sales or exchanges of stock and securities.[16] In calculating gross receipts, the passive income from the sales or exchanges of stock and securities is measured by only the gain, and not the entire consideration received.[17]

The legislative history of section 165(g)(3) provides that P should be permitted an ordinary loss in cases where S's operations would have generated predominately ordinary deductions if P had conducted them directly through a division.[18] The gross receipts test is a proxy for P's deemed operation of the S business. The gross receipts test can impose significant substantiation burdens on subsidiaries with long histories, since it aggregates *all* taxable years in which the subsidiary has existed. In addition, the IRS has issued several private letter rulings holding that S's gross receipts history includes the history of any predecessor corporations that merged or liquidated into S in tax-free transactions.[19] Therefore, a taxpayer may need to substantiate the gross receipts history of all predecessor corporations of S.

On the other hand, the ability to selectively merge or liquidate target corporations into S and obtain the gross receipts history of the target presents a planning opportunity. For instance, if S is a holding company with passive income that would not satisfy the 90-percent gross receipts test, P may be able to arrange to merge or liquidate an active subsidiary elsewhere in the P group into S before S liquidates in order to qualify for a later worthless stock deduction.[20]

Another planning opportunity arises from the ability to engage in intercompany transactions within a consolidated group to generate active receipts for S. In several private letter rulings, the IRS has held that intercompany payments received by S, including payments such as dividends that would normally be considered passive under the rules applicable to nonconsolidated taxpayers (separate entity rules), can be recharacterized as active gross receipts under principles that specifically apply to transactions between consolidated group members.[21] The letter rulings analyze payments from other group members by looking to the gross receipts history of the payor member, and treating S as receiving active or passive receipts essentially in proportion to the payor's active and passive gross receipts.[22] Apparently, if S has too many passive receipts, the IRS will permit a consolidated group to make dividend payments selectively from active subsidiaries before S liquidates in order to satisfy the 90-percent test. The IRS will not, however, permit look-through relief for dividend payments from subsidiaries that are not included in the P consolidated group.[23]

There are a number of areas of uncertainty that arise under the gross receipts test. For example, it is unclear how capital contributions to S, or cash loans to S that are later forgiven in whole or in part, should be taken into account under the gross receipts test.[24] It is also unclear how to apply the test in situations where a subsidiary has no gross receipts.[25]

The upshot is that if the S loan is respected as debt and S can satisfy the 90-percent gross receipts test (either based on its historic activities or through the previously described planning technique), P will generally be able to obtain an ordinary stock loss from the liquidation of S.

2. Treatment of S Loan

In the foregoing example, P's $700 loss realized on the receipt of $200 in partial satisfaction of its $900 loan will be taken into account under either section 166 or section 1271.[26] Section 166(a)(1) allows an ordinary deduction for debt that becomes wholly worthless within a taxable year, whereas section 166(a)(2) allows an ordinary deduction for *partial* worthlessness.[27] The partial-worthlessness deduction is allowed only if certain evidentiary requirements are satisfied, including the requirement that the debt be "charged off" on P's books during the taxable year.[28] Because the S debt will be completely extinguished for $200 in the liquidation, it appears that the requirements for an ordinary deduction under section 166(a)(2) are satisfied.

But section 1271, which governs the retirement of debt instruments, might also apply to the extinguishment of the S debt. Section 1271(a)(1) provides that "[a]mounts received by the holder on retirement of any debt instrument shall be considered as amounts received in exchange therefor." Accordingly, if section 1271(a) applies, and the S loan is a capital asset, P will be treated as exchanging the asset for $200 of cash and will have a $700 capital loss.

Which provision governs: section 166(a)(2) or 1271(a)(1)? Surprisingly, the answer is unclear. Each provision has a long history, and a full analysis of their potential overlap is beyond the scope of this article.[29] For discussion purposes, assume that, if P has not charged off the S debt earlier in the year, then section 1271(a) is the more likely answer.[30] If P charges off $700 of the S loan on its books earlier in the year, however, S might be able to claim an ordinary deduction for the S debt, despite the "retirement" of the debt later in the year pursuant to the liquidation. The greater the temporal and transactional separateness between the charge-off and the actual extinguishment, the higher the likelihood that P will be entitled to an ordinary deduction under section 166(a)(2), rather than a capital loss under section 1271.

In summary, when P and S do not file a consolidated return, the rule should be "the sooner, the better" for charging off intercompany loans.[31] Using foresight will make it easier to avoid section 1271(a) treatment upon the retirement of the S debt in the liquidation. Finally, where the S debt has not been charged off prior to the liquidation, P may nonetheless be entitled to an ordinary deduction if it can be established that the S loan is not a capital asset.[32]

3. Treatment of S

If the S loan is treated as debt, the liquidating distribution will be a fully taxable transaction at the S level. But whether the taxable transaction is treated as a "complete liquidation" under section 336(b) or instead as a section 1001 exchange by S could materially affect S's tax consequences. Although it is clear that the dissolution of an insolvent subsidiary is not a "complete liquidation" at the P level under section 331 or 332,[33] commentators have suggested that, based on the policies and legislative history under-

lying the statute, the dissolution could be deemed a complete liquidation at the S level for purposes of section 336(b).[34]

To illustrate the stakes, assume that at the time of liquidation S has only one asset with a basis (as well as value) of $200 and no NOLs. If section 1001 applies, S will be treated as transferring its asset to P in repayment of a $200 portion of the S loan; the remaining portion of the loan note will be treated as upaid, resulting in $700 of cancellation of indebtedness income (CODI). In this scenario, S will have no gain or loss from repaying $200 of the loan with a $200 basis asset, and S will have $700 of CODI.

S should be happy with this result because, under section 108, the $700 of CODI will be excluded from S's income. The toll charge that section 108 generally imposes on a debtor with excluded CODI is the reduction of the debtor's tax attributes. If S were to remain in existence following the cancellation of the S loan, S would be required to reduce its tax attributes by as much as $700 under section 108. But S will not remain in existence, and its tax attributes, if any, will be eliminated in the taxable liquidation regardless of section 108.[35] In short, neither the $700 of CODI nor the attribute reduction required under section 108 will create adverse tax consequences for S.

If section 336(b) applies instead of section 1001, S will be subject to a different taxing regime. Instead of being treated as repaying debt to S with the $200 asset, S would be treated as selling its $200 asset to S in exchange for P's assumption of S's $900 liability to P. In essence, section 336(b) treats P as a third-party buyer that assumes the entire $900 debt to purchase S's asset, rather than as a direct creditor of S who is accepting partial payment for the loan. The difference between a direct debt repayment of the S loan and a deemed assumption by P of the S loan can be dramatic. In the former case, S has (harmless) excluded CODI, but in the latter case S has taxable gain of $700.

Fortunately, two recent private letter rulings suggest that the IRS believes section 1001 applies to an insolvent liquidation.[36] Therefore, S should not have to suffer the adverse effects of section 336(b).

B. If the Loan Is Preferred Stock

If the S loan is recharacterized as preferred stock, will the tax consequences to P be favorably or adversely affected? Once again, most of the answers are fuzzy.

In the foregoing example, S has no liabilities other than the S loan. Therefore, if the S loan is preferred stock, S will have positive equity value (though S's common stock should still be considered worthless for purposes of section 165, because the preferred stock will be entitled to receive all $200 of S's assets in the liquidation). In a more realistic scenario, establishing the worthlessness of the S common stock will require a determination that the fair market value of S's assets is less than the liquidation preference on the S loan. For this purpose, the IRS believes that the fair market value of all of S's assets, including tangible and intangible assets (such as goodwill and going concern value) and other assets that may not appear on S's balance sheet, must be taken into account.[37]

Assuming that S's total assets are worth $200 and that P will receive those assets with respect to the $900 preferred equity in the liquidation, the transaction might be a complete liquidation for purposes of 331 and 336. The transaction would not, however, be a complete liquidation for purposes of section 332. Courts and the IRS have interpreted section 332 as requiring that at least partial payment for each class of S stock owned by P.[38] Therefore, section 332 will not apply to prevent P from claiming a $300 worthless stock deduction. If the transaction constitutes a section 331 liquidation, P would also be entitled to a $700 capital loss on the preferred equity.[39]

The uncertainty arises because of the very real possibility that the liquidation could be characterized as an upstream reorganization under section 368(a)(1)(C).[40] Under this analysis, P would be the acquiring corporation and would be deemed to transfer voting stock to S in exchange for S's assets. S would then be deemed to retransfer the voting stock to P in exchange for all of S's outstanding stock.[41]

The position that the liquidation could be both an occasion for P to claim a worthless stock deduction and a tax-free reorganization was arguably strengthened by the promulgation of proposed regulations in 2005 (the "no net value" regulations).[42] These regulations contain an example specifically addressing a situation in which P receives a distribution on S's preferred stock but not common stock. The example concludes: "[P] is entitled to a worthless security deduction for its [S] common stock. The transaction may qualify as a reorganization under section 368(a)(1)(C). If the transaction does not qualify as a reorganization, [P] will recognize gain or loss on its [S] preferred stock under section 331."[43]

Based on this example, qualification as an upstream C reorganization may be good news for P. Although P's $700 loss on the preferred equity would be disallowed,[44] P would inherit all of S's inside attributes, including the $1,000 of NOLs, under section 381. In addition, P would obtain an immediate $300 worthless stock deduction (either capital or ordinary) with respect to the S common stock. The overall potential tax losses for P — $1,300 — exceed P's economic loss of $1,000. To put it another way, P's $300 stock loss duplicates $300 of S's inside losses, all of which will be inherited by P.

Are these results too good to be true? Certainly, they can be viewed as inconsistent with the congressional intent behind section 382(g)(4)(D), which was designed to address similar duplicative benefits to P that arise from claiming a worthless stock loss and then later utilizing inside attributes of S's that were reflected in amount of the stock loss. Nevertheless, the publication of the no net value regulations suggests that the IRS and Treasury are willing to tolerate some duplication in the interests of administrability.

This loss-duplication opportunity, however, may not be etched in stone. First, the government is apparently reviewing these transactions and might not be completely comfortable with the duplicated losses. That the no net value regulations were proposed five years ago but do not appear on a list of priority guidance items for 2010[45] suggests that the government continues to wrestle with the difficult technical and policy issues raised by intercompany reorganizations. Second, the IRS might be able to challenge the loss-duplication result under current law.

For example, the IRS could argue that P's loss on the common stock is precluded by section 356(c), which provides that no loss is recognized on an exchange to which section 354 applies. Under this theory, P's cancellation of the S common stock and S preferred stock and deemed receipt of P preferred stock would be treated as one overall exchange described in section 354,[46] so that P's common

stock loss would be disallowed under section 356(c). The counterargument is that S's common stock should not be lumped in with the section 354 exchange of the S preferred stock because, consistent with section 165 and the no net value regulations, P's receipt of nothing for the S common is not an "exchange" at all.[47]

Alternatively, the IRS might argue that the liquidation does not qualify as a "C" reorganization. To qualify as a reorganization, a transaction must meet certain non-statutory requirements, including the requirement that a reorganization have a valid business purpose. The IRS could conceivably question the business purpose for the reorganization. Although unlikely, the IRS could also assert that these upstream liquidations are taxable under current law (the no net value regulations merely state that such transactions "may" qualify as "C" reorganizations and that section 331 applies if the transaction is not a reorganization). Possible arguments would be that the solely for voting stock requirement is not satisfied,[48] or that, in this context, the policies underlying the worthless stock deduction are inconsistent with the purposes and assumptions of the reorganization provisions.[49]

In any event, if a taxpayer is planning to report a liquidation into preferred equity as an upstream reorganization coupled with a worthless stock deduction, it can strengthen its position by developing the factual support for a business purpose. In addition, the taxpayer should consider having P actually issue voting stock to S in the transaction (to achieve greater certainty regarding qualification as a "C" reorganization) or, if possible, dissolving S pursuant to a state law merger of S into P in order to qualify the transaction as a tax-free merger under the less stringent requirements of section 368(a)(1)(A).

Finally, a taxpayer may wonder why so many basic questions arising from this simple transaction are in such a state of flux. A partial explanation is that upstream liquidations could not qualify as "C" reorganizations until very recently,[50] and old case law addressing these transactions did not anticipate the advent of the "check-the-box" regulations and deemed liquidations.

C. If the Loan Is Common Stock

Although the S loan should rarely be recharacterized as common stock, the possibility can arise occasionally. If the arrangements between P and S are sufficiently informal, there may be a state law question whether P's claim against the S assets represented by the loan really has a priority over P's common stock. In such cases, P could be viewed as owning a single class of S common stock. In the foregoing example, S would be treated as distributing its $200 of assets to P in exchange solely for S common stock. This exchange would qualify as a tax-free liquidation under section 332, and P would not recognize any loss in the transaction (although P would inherit S's $1,000 of NOLs).

Consolidated Return Issues

A number of special rules apply that affect the analysis above if S joins P in filing consolidated U.S. federal income tax returns. Because the consolidated return rules add considerable complexity, the tax adviser should always start the analysis with the "separate entity" rules. After completing the separate entity analysis, the adviser should turn to the consolidated return rules.

The following discussion presents an overview of the most significant consolidated return rules applicable to the liquidation of a worthless subsidiary. Although the overview, of necessity, quickly devolves into a dense, technical analysis, the goal is merely to provide a general awareness of the key consolidated return concepts and the potential barriers to claiming losses.[51]

The most important consolidated return provisions affecting worthless subsidiary liquidations are the rules relating to basis adjustments in subsidiary stock (the "basis adjustment rules") and the rules that expressly defer or disallow certain losses on subsidiary stock (the "unified loss rules"). Other important provisions include rules relating to transactions between members of a consolidated group (the "intercompany transaction rules") and a subset of those rules that address the treatment of obligations between group members (the "intercompany debt rules"). These rules are designed to carry out a policy that reflects the hybrid nature of the consolidated return regime: For certain purposes, a consolidated group is a "single entity" consisting of multiple corporations that are treated as divisions, and accordingly, the group's tax results should correspond approximately to the results that would be obtained by a single corporation engaging in intradivisional transactions. For other purposes, however, the group is a coalition of separate taxable entities, and hence, it is appropriate to respect certain aspects of transactions between group members and the ownership of subsidiary stock, as well as to recognize the consequences of both taxable and tax-free liquidations.

A. A Recap of Separate Return Treatment

Assume for the remainder of this article that the S loan is respected as debt. Thus, under separate return treatment, P would be entitled to a $300 worthless stock loss upon the liquidation of S, in the amount of P's basis in the S stock. P's stock loss will be capital unless the S stock is held as other than a capital asset or the requirements of section 165(g)(3) are satisfied. P should also be entitled to either a bad debt deduction under section 166 or a loss under section 1271 of $700 (the difference between the P's $900 basis in the loan and the $200 that P receives in partial satisfaction of the loan). P's deduction generally would be ordinary if section 166 applies and capital if section 1271(a) applies.

In addition, S is likely to realize $700 of CODI that would be excluded under section 108(a).[52] Because the liquidation is not a transaction to which section 381 applies, S's unused $1,000 of NOLs will disappear.

In summary, P will obtain $1,000 in losses from the liquidation, S should have no taxable income from the liquidation, and S's remaining attributes will be eliminated.

B. Consolidated Return Analysis — Overview

If P and S file a consolidated return, the overall analysis is best described as a six-stage process:

First, conduct a separate entity analysis to determine the characterization of the liquidation under generally applicable law. (The liquidation should be fully taxable to P and S provided that the S loan is debt).[53]

Second, consider the effects of the basis adjustment during Years 1 through 3 on P's basis in S to determine the amount of P's built-in

stock loss immediately before the liquidation.

Third, apply the intercompany transaction rules and the intercompany debt rules to the items arising directly from the liquidation. Under these rules, which might change the items of gain or loss normally recognized by P and S under separate entity principles, all of S's items appear to be accelerated (rather than deferred or eliminated).

Fourth, apply the basis adjustment rules *again* to account for the S's accelerated items, since these items will further increase or decrease P's stock basis in S immediately before the liquidation.

Fifth, apply the unified loss rules to P's potential stock losses in the liquidation. Under these rules, some or all of P's losses might be disallowed.

And sixth, determine the effect of the preceding steps on the attributes of the consolidated group. In general, S's inside attributes will disappear in the liquidation.[55]

The next section discusses the applicable rules in greater detail, but they may be tough to absorb in one sitting. To aid comprehension, an example illustrating how all of the rules work together is included at the end of this article.

C. Basis Adjustments

Under the basis adjustment rules of Treas. Reg. § 1.1502-32, P's basis in S is adjusted each year. P's basis in S is increased each year by the amount of S's income and gain and decreased by the amount of S's deductions and loss. The purpose of adjusting P's basis in S under these rules is to ensure that S's income and deductions, which are reported on the group's consolidated return, are not duplicated on the group's return when the stock of S is later sold at a gain or loss.

Although net income or gain of S in a given year will increase P's basis in S, a net deduction or loss for S in a given year does not reduce P's basis in S unless and until it is absorbed by S or another member of the P consolidated group.[56] Moreover, P's basis in S is always decreased by the amount of distributions from S. Accordingly, in determining P's potential losses from a liquidation of S, a group must take into account not only P's initial basis in S ($300 in our example), but also any changes to the basis of S stock occurring under the basis adjustment rules as a result S's income, gain, deduction, loss, or distributions during the period in which P and S file a consolidated return.

D. Intercompany Transaction and Intercompany Debt Rules

In addition to the basis adjustments made to the S stock during the period before the liquidation, P must also adjust S's basis by items of gain and loss recognized by S that result directly from the liquidation; these adjustments are made immediately prior to the liquidation. The two most significant provisions at this stage in the process are the intercompany transaction rules and the intercompany debt rules.

1. Intercompany Transaction Rules

In general, the intercompany transaction rules provide that items of income, gain, loss, or deduction arising from transactions between P and S should be taken into account separately by P and S, but that adjustments must be made to ensure that these intercompany items match in amount and character (the "matching rule"). Adjustment must also be made to ensure that P and S take their items into account at the same time. In most cases, gains or losses from taxable exchanges between P and S are deferred until the exchanged property is disposed of outside the group. Items from debt instruments, however, are taken into account as they are realized.

Perhaps the most noteworthy aspect of an insolvent liquidation is that, although the transaction can be purely internal and involve no third parties, for technical reasons the intercompany transaction rules might not apply at all. An intercompany transaction is defined as a transaction between corporations that are members of the same consolidated group "immediately after the transaction."[57] Because S does not exist immediately after the liquidation, the liquidation might not constitute an intercompany transaction.

On the other hand, there is a broad "successor" rule that usually treats P as a continuation of S for purposes of the intercompany transaction rules. When the successor rule applies, S will essentially be considered a member of the consolidated group immediately after the transaction, and P will inherit any deferred items of S and continue to defer them. The successor rule applies to, among other things, section 381 transactions and transactions in which P receives substantially all of S's assets in "complete liquidation."

Because the IRS has recently taken the position that the dissolution of insolvent S is not a "complete liquidation" within the meaning of section 336(b), but is rather a section 1001 exchange, P should not be treated as a successor to S. Accordingly, the items of P and S from the liquidation should be exempt from the intercompany transaction rules, including the generally applicable deferral rules. Another interesting consequence of section 1001 treatment is that section 267, which is an overlapping provision that defers or disallows losses from sales between related parties, should also be rendered inapplicable, because the rules under section 267(f) follow the principles of the intercompany transaction rules.[58] Therefore, the conclusion that the dissolution of S is not a complete liquidation (and that losses are not deferred under the intercompany transaction rules) should also exempt nonconsolidated corporations from deferral or disallowance of losses under section 267 in the case of an insolvent liquidation.

2. Intercompany Debt Rules

The intercompany transaction rules include a separate subset of rules addressing intercompany debt.[59] Generally, these rules apply to certain intercompany transactions involving the assignment or extinguishment of an intercompany obligation or a "comparable transaction" ("triggering transactions").[60] A comparable transaction is one in which the creditor or debtor realizes income or deduction from a transaction that does not meet the definition of an intercompany transaction (such as a creditor's mark-to-market gain or loss or a partial bad debt deduction on an intercompany obligation). If a triggering transaction occurs, the intercompany debt is treated as satisfied and reissued for its fair market value in deemed transactions that occur immediately before the actual transaction giving rise to the realized amount.[61]

Under the intercompany debt rules, section 108(a) is expressly turned off.[62] Therefore, a debtor member realizing CODI will be required to include all of the realized income. Under the previously described matching rule, however, the creditor member will virtually always be entitled

to an ordinary loss equal in amount to the debtor's CODI.[63]

These rules work reasonably well in accomplishing single-entity treatment for intercompany transactions involving debt. Regrettably, the drafters of the rules did not consider the possibility that an insolvent liquidation might not be an "intercompany transaction" (as described above), and thus that the special adjustments to the normal debt rules might not apply to an insolvent liquidation. But in view of the purposes of the intercompany debt rules and their application to "comparable transactions," the rules should ultimately apply in this case because the dissolution of S should be a "comparable transaction."

Applying the intercompany debt rules to the prior example, the S loan should be treated as satisfied and reissued for its fair market value of $200 immediately before the liquidation. Curiously, while the liquidation is not an intercompany transaction, the deemed satisfaction (which is triggered under the comparable transaction rule) is likely itself an intercompany transaction (because S should still be treated as a group member immediately after the deemed satisfaction). Accordingly, the items of P and S from the deemed satisfaction should be taken into account under the matching rule and the other provisions of the intercompany debt rules.[64]

As a result, S will have $700 of CODI from the deemed satisfaction of the S loan for its fair market value of $200, and P will have an offsetting loss of $700 on the S debt. Under the matching rule and other special debt rules, S's CODI will be includible, and P's offsetting deduction will be ordinary (to match the character of S's ordinary income).[64]

P will then be treated as reissuing a new $200 loan to S. At this point, S is still insolvent because S's $200 of assets do not exceed its $200 of liabilities. Finally, in the actual liquidation, S will be treated as paying off the reissued debt for exactly $200, resulting in no further gain or loss to S or P from the debt. P still will not be treated as receiving any consideration for the S common stock, and thus will be eligible for a worthless stock deduction.

E. Reapplication of Basis Rules

Because the deemed satisfaction and reissuance of the S loan will cause S to recognize $700 of CODI, the basis adjustment rules must be applied again. Under these rules, P's basis in S will be increased by $700, potentially resulting in a larger worthless stock deduction for P. If S has any gain or loss on its assets from the distribution, those items of gain or loss will also be accelerated immediately before the liquidation, again affecting P's basis in S and the amount of P's potential stock loss.[65]

F. Application of Unified Loss Rules

The unified loss rules, which are set forth in Treas. Reg. § 1.1502-36, work in tandem with the basis adjustment rules to ensure that a consolidated group can neither obtain more than one tax benefit from a single economic loss nor create a noneconomic loss.[66] The unified loss rules apply whenever P "transfers" a share of S stock that has a built-in loss (with certain exceptions).[67] When they apply, the unified loss rules have their own three-step regime for eliminating duplicative or noneconomic loss.

The first step, in cases where P disposes of less than all of the S stock, is for P to reallocate previous basis adjustments among its existing S shares in a manner that generally limits P's ability to cherry-pick shares with the largest loss.[68] In the example, all of the S shares will be dissolved, so the basis redetermination rule will not apply.

The second step is to apply the basis reduction rule. Under this rule, before P can claim a loss (from a taxable disposition), P's basis in the loss shares of must be reduced (but not below the shares' fair market value) by the lesser of (i) the amount of net positive investment adjustments that were previously made to those share under the basis adjustment rules or (ii) the shares' disconformity amount.[69] The disconformity amount is, generally speaking, the amount by which P's basis in a share of S stock exceeds the inside attributes of S attributable to that share (such as NOLs, tax credits, asset basis, etc.).[70] After reducing basis in the S stock by the lesser of the two amounts described above, P is entitled to claim any remaining loss on the shares that results from the transaction.

The third step of the regime, which ensures that the group (or a third party that acquires S) can not benefit from both a stock loss and a comparable loss from the inside attributes of S, requires that S's inside attributes be reduced, generally by the amount of stock loss claimed by P.[71] Assuming the parent recognizes loss with respect to its the subsidiary common stock and the transaction does not qualify as a reorganization, the parent's loss will trigger attribute reduction and possibly attribute elimination.[72]

G. Example – Pulling It All Together

The following example illustrates how the aforementioned rules work together. In this example, the facts are the same as in the foregoing example with the following additional facts included to clarify certain issues: S has previously purchased a capital asset (Asset A) for a nominal amount that has appreciated in value. In addition, S has generated $1,200 of NOLs in Years 1 and 2 and the group has absorbed $200 of those losses. S has no income or loss during Year 3. At the end of Year 3, when Asset A has a basis of $0 and a value of $200, S liquidates into P.

In this case, here is how the six-step process applies.

First, determine the separate entity consequences of the liquidation. In this case, P would have a $300 worthless stock deduction and a $700 loss on the S loan. S would likely have $700 of excluded CODI. S would also have $200 of gain from distributing Asset A (assuming that none of S's remaining NOLs can be used to offset the gain on Asset A, perhaps because the P group has an overall consolidated net operating loss in Year 3 from other activities).

Second, consider the effects of the basis adjustment rules during Years 1 through 3. P's initial basis of $300 will be reduced by $200 (the amount of S's losses absorbed by the P group). P's basis, however, will not be adjusted for the $1,000 of NOLs that remain unused by the group. Accordingly, P will have a $100 basis in S immediately as of the date of the liquidation.[73]

Third, apply the intercompany transaction and intercompany debt rules to the items triggered by the liquidation. Under the intercompany debt rules, immediately before the liquidation, S will be deemed to satisfy the S loan for a deemed cash payment of $200, and then P will be deemed to reissue a new note to P in exchange for the $200. As a result, S will have includible CODI of $700 and P will have an ordinary loss of $700 with respect to the S loan. In ad-

dition, because the dissolution of S is not an intercompany transaction that would result in deferral of S's items from the liquidation, S will have $200 of immediate gain from the distribution of Asset A.

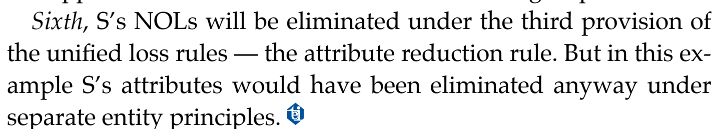
Fourth, apply the basis adjustment rules again to account for the items accelerated in step 3 above. Under these rules, S's $700 of CODI and $200 of gain will result in a $900 positive basis adjustment in the S stock before the liquidation is given effect. Thus, P's basis in S will be $1,000 at the moment in time immediately before the liquidation.

Fifth, apply the unified loss rules to determine the amount of P's allowable loss on the S stock. The first provision in the unified loss rules — basis redetermination — does not apply because P is disposing of all of the S stock in the liquidation. The second provision in the unified loss rules — the basis reduction rule — does apply. Under this rule, P's basis in S must be reduced by the lesser of the stock's net positive investment adjustments and the disconformity amount.

The net positive adjustments to the S stock are $700 (negative $200 for the previously absorbed S losses and positive $900 for the accelerated items arising in the liquidation). The disconformity amount is $0 (P's $1,000 basis in the S stock minus S's inside attributes, specifically $1,000 of unabsorbed losses). Because the disconformity amount is $0, P does not have to reduce its basis in the S stock. P is entitled to a $1,000 worthless stock deduction, which will be capital or ordinary, depending on whether S satisfies the 90-percent gross receipts test.

This example illustrates the precision of the unified loss rules. Because P has lost $1,000 as an economic matter, but was unable to use the NOLs, the disconformity amount limitation on the disallowance of loss ensures that P is able to fully recover its loss through a worthless stock deduction. Interestingly, P's stock loss will be $700 larger than the loss P would recognize under separate entity principles, which is a pleasant result, particularly in the case of an ordinary stock loss. Finally, the P group may plan into an ordinary deduction under section 165(g)(3) by arranging to give S active gross receipts under the special look-through rules that the IRS applies to transactions within a consolidated group.[74]

Sixth, S's NOLs will be eliminated under the third provision of the unified loss rules — the attribute reduction rule. But in this example S's attributes would have been eliminated anyway under separate entity principles.



Matthew K. White *is a partner in the Washington, D.C., office of McDermott Will & Emery LLP. Mr. White focuses his practice on the U.S. federal tax aspects of corporate mergers, acquisitions, and restructuring transactions, and is the leader of the Tax Department's Corporate and Consolidated affinity group. He received his B.A. degree from Vanderbilt University, his J.D. degree from Tulane University, and his L.L.M. in Taxation degree from Georgetown University Law Center. He may be contacted at mkwhite@mwe.com.*

Michael J. Wilder *is a partner in the Washington, D.C., office of McDermott Will & Emery LLP. Mr. Wilder's practice focuses on tax issues arising from mergers, acquisitions, and restructurings involving U.S. and foreign entities. He received his B.A. degree from Yale University and his J.D. degree from Michigan Law School. He was formerly an attorney at the Office of Associate Chief Counsel (Corporate) at the Internal Revenue Service. He may be contacted at mwilder@mwe.com.*

Andrew Blair-Stanek *is an associate in the Washington, D.C., office of McDermott Will & Emery LLP. He received his A.B. degree from Princeton University and his J.D. degree from Yale Law School. He may be contacted at ablairstanek@mwe.com.*

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1. *See, e.g.*, PLR 200952032 (Sept. 24, 2009) (ruling that the conversion of a corporate subsidiary to a single-member LLC followed by the re-conversion of the subsidiary to a corporation is treated as an upstream reorganization followed by an drop of assets under section 368(a)(2)(C)); PLR 200944011 (July 24, 2009) (ruling that the conversion of a corporate subsidiary to a single-member LLC is treated as a liquidation under section 332); PLR 200944026 (June 29, 2009) (same); Treas. Reg. § 301.7701-3(b)(1)(ii). All "section" references are to the Internal Revenue Code of 1986, as amended, and all "Treas. Reg. §" and "Prop. Reg. §" references are to the final and proposed Treasury regulations, respectively.
2. *See* Rev. Rul. 2003-125, 2003-2 C.B. 1243, Situation 2 (permitting P to claim a worthless stock deduction under section 165(g)(3) upon a "check-the-box" election for a worthless foreign subsidiary even though the subsidiary's business operations continued and were deemed to be conducted by P); Rev. Rul. 70-489, 1970-2 C.B. 53.
3. In classifying an instrument as debt or equity, courts consider multiple factors, some of which include capitalization ratios, the instrument's terms, payment histories, intent of the parties, and whether the creditor is also a shareholder of the debtor, which is the case here. Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 4.03 (hereinafter "Bittker & Eustice"); William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 Tax L. Rev. 369, 407-08 (1971); *see, e.g., Bauer v. Commissioner,* 748 F.2d 1365, 1368 (9th Cir. 1984). While the parent's being both creditor and shareholder of the debtor weighs toward classification as equity, it is just one among numerous factors, and the courts' application of these factors is unpredictable. Plumb, 26 Tax L. Rev. at 408-10.
4. CCA 200706011 (Feb. 9, 2007).
5. LAFA 20040301F (Dec. 16, 2003); Bittker & Eustice ¶ 4.02[4]; *cf*. Rev. Rul. 75-222, 1975-1 C.B. 105.
6. Treas. Reg. § 1.332-2(b).
7. If section 332 treatment is desired (so that P can inherit S's attributes, such as ordinary losses, under section 381), consideration should be given to capitalizing the S loan well in advance of the liquidation. Capitalizing the S loan in anticipation of the liquidation is unlikely to be respected. *See* Rev. Rul. 68-602, 1968-2 C.B. 135; CCA 200818005 (Jan. 29. 2008); *cf*. Rev. Rul. 78-330, 1978-2 C.B. 147.
8. I.R.C. § 165(a); Treas. Reg. § 1.165-1.
9. Treas. Reg. § 1.165-1(b).
10. A number of courts have denied worthless stock deductions to taxpayers on the grounds that the stock first became worthless in a prior year. *See, e.g., Bilthouse v. United States*, 553 F.3d 513 (7th Cir. 2009); *Young v. Commissioner*, 123 F.2d 597 (2d Cir. 1941). For this reason, it is said that worthless stock deductions should be claimed "early and often." That is to say, the deduction could be claimed protectively with respect to the S stock in an earlier year as well as in the year of liquidation, in case a court or the Internal Revenue Service were to determine that S was worthless before the year of liquidation. Protective claims for

years before the liquidation, however, do raise additional issues. For example, the application of section 382(g)(4)(D) must be considered (which would severely limit S's ability to use its inside attributes if P retains the 50 percent or more of the S stock at the end of the year).

11. Rev. Rul. 70-489, 1970-2 C.B. 53; Rev. Rul. 2003-125, 2003-2 C.B. 1243.
12. I.R.C. § 163(g)(1); Treas. Reg. § 1.165-5(c).
13. I.R.C. §§ 163(g)(3)(A) and 1504(a)(2).
14. If P and S file a consolidated return, regulations aggregate all members of P's consolidated group for purposes of satisfying the 80-percent requirement. *See* Treas. Reg. § 1.1502-34. Taxpayers who do not meet the 80-percent ownership requirement cannot acquire additional S stock from a third party to meet the requirement, because stock acquired solely for the purpose of converting a capital loss into an ordinary loss is disregarded. Treas. Reg. § 1.165-5(d)(2)(iii).
15. I.R.C. § 163(g)(3)(B).
16. *Id.*
17. *Id.*; Treas. Reg. § 1.165-5(d)(2)(iii).
18. S. Rep. No. 77-1631, 77th Cong., 2d Sess. (1942); 90 Cong. Rec. 121 (1944) (statement of Sen. Davis); *see also* S. Rep. No. 91-1530, 91st Cong., 2d Sess. (1970).
19. *See* PLR 200710004 (Dec. 5, 2006); PLR 201011003 (Nov. 30, 2009); PLR 201006003 (Oct. 28, 2009).
20. *See, e.g.*, PLR 201011003.
21. *See* Part D.1 of the discussion of "Consolidated Return Issues" (page 128).
22. *See* PLR 200710004; PLR 200932018 (Aug. 7, 2009); PLR 201011003. In PLR 200710004, the IRS determined the character of S's gross receipts based on the proportion of the other member's active earnings and profits to its passive earnings and profits, whereas in PLRs 200932018 and 201011003, the IRS looked instead to the actual active and passive gross receipts of the other members.
23. *Compare* PLR 200710004 (affiliates filing consolidated returns; dividend look-through allowed) *with* TAM 200727016 (Jan. 11, 2007), n.3 (affiliates filing separate returns; no dividend look-through).
24. The position most consistent with the policies described in the legislative history of section 165(g)(3) would be, in most situations, to disregard the cash proceeds obtained from capital contributions and income arising from the discharge of indebtedness, treating such proceeds and income as neither passive nor active gross receipts.
25. *Compare* TAM 200914021 (Dec. 8, 2008) (operating company satisfied test notwithstanding the absence of gross receipts) *with* TAM 8939001 (June 9, 1989) (holding company with no gross receipts violates test).
26. If the S loan is a security (within the meaning of section 165(g)(2)(C)), then P will not be entitled to a partial worthlessness deduction under section 166(a)(2) and would instead recognize a capital loss under section 165(g)(1) unless the gross receipts test is satisfied. The S loan will constitute a security for this purpose if it has interest coupons or is in "registered form." *See, e.g., Funk. v. Commissioner*, 35 T.C. 42 (1960), acq. 1961-2 C.B. 4. The example in this article assumes that the S loan is not a security.
27. The deduction allowed is determined by reference to the taxpayer's adjusted basis. I.R.C. § 166(b); Treas. Reg. § 1.166-1(d)(1); cf. I.R.C. § 1011.
28. Treas. Reg. § 1.166-3(a)(2); *Spring City Foundry Co.v. Commissioner,* 292 U.S. 182 (1934) (holding that a taxpayer must prove that debt is not worthless in earlier year).
29. For excellent discussions of the issue, *see* David C. Garlock, F*ederal Income Taxation of Debt Instruments* ¶ 1603.03 (5th ed. 2005); and Daniel J. Coburn, *Losses on the Retirement of Debt Instruments Under §1271(a)(1): Are Bad Debt Deductions Now Extinct?*, 44 Tax Mgmt. Memo. 379 (Sept. 22, 2003).
30. *See, e.g., McClain v. Commissioner,* 311 U.S. 527 (1941) (addressing overlap of processor statutes with similar language); Treas. Reg. § 1.1502-13(g)(7), Ex. 2(ii) (assuming the S's loss from the retirement of a B note is taken into account under section 1271); *but see* Rev. Rul. 2003-125, 2003-2 C.B. 1243 ("[the subsidiary] creditors, including P, may be entitled to a deduction for a partially or wholly worthless debt under section 166"); Rev. Rul. 70-498, 1970-2 C.B. 53 ("[P] is entitled to a bad debt deduction to the extent provided in section 166 of the Code in the taxable year in which the balance of the debt became worthless..."); Rev. Rul. 59-296, 1959-2 C.B. 87 ("[P] is entitled to a bad debt deduction to the extent provided in section 166 of the Code"); CCA 200706011 (Feb. 9, 2007); TAM 9253003 (Sept. 22, 1992).
31. If P and S file a consolidated return then P's loss on the S loan will invariably be ordinary, and S will have a corresponding amount of CODI, regardless of whether P claims a partial worthless debt deduction or recognizes a loss under section 1271.
32. *See* I.R.C. § 1221(a)(4)*; Burbank Liquidation Corp. v. Commissioner*, 39 T.C. 999 (1963); *Federal Nat'l Mortgage Assoc. v. Commissioner*, 100 T.C. 541 (1993); Rev. Rul. 80-56, 1980-1 C.B. 154; Rev. Rul. 80-57, 1980-1 C.B. 157; Capital Asset Exclusion for Accounts and Notes Receivable, 73 Fed. Reg. 21,861 (Apr. 23, 2008) (withdrawing proposed regulations rejecting the position in B*urbank Liquidating* and *Fannie Mae,* and stating that the IRS "will not challenge return reporting positions of taxpayers under section 1221(a)(4) that apply existing law, including *Burbank Liquidating Corp.*, *FNMA*, and *Bielfeldt*. *See also* Rev. Rul. 80-56 and 80-57").
33. *See* Rev. Rul. 2003-125, 2003-2 C.B. 1243 ("If a shareholder receives no payment for its stock in a liquidation of the corporation, neither § 331 nor § 332 applies to the liquidation.").
34. *See* 3 Andrew J. Dubroff, *et al.*, *Federal Income Taxation of Corporations Filing Consolidated Returns* § 74.05[2][a][i], at 74-204 (2d ed. 2008).
35. In other words, the section 1001 exchange does not qualify as a section 381 transaction, and so P will not inherit any of S's attributes under section 381.
36. PLR 200932018 (Apr. 14, 2009) (expressly applying section 1001 to an insolvent liquidation); PLR 201014033 (Apr. 12, 2010) (rulings (4) and (6) predicated on application of section 1001 rather than section 331 to an insolvent liquidation). Informal discussions with IRS personnel suggest that this ruling position continues to have force.
37. *See* Rev. Rul. 2003-125, 2003-2 C.B. 1243.
38. *See Spaulding Bakeries, Inc. v. Commissioner,*, 27 T.C. 684 (1957); *H.K. Porter Co. v. Commissioner*, 87 T.C. 689 (1986). *See also* Prop. Reg. § 1.332-2(b) (distribution required with respect to each class of stock).
39. Of course, sections 166 and 1271, which apply to debt instruments, are inapplicable if the S loan is preferred stock.
40. The liquidation might also qualify as an upstream reorganization under section 368(a)(1)(A) if effected pursuant to a state merger statute.
41. The notion that circular transfers of P stock to and from an insolvent subsidiary — particularly deemed circular transfers — would be respected, or even required, and that such transfers could turn a taxable liquidation into a tax-free reorganization, may seem counterintuitive. Circular transfers of P stock, however, are a well-established concept in the reorganization area. *See, e.g.,* Treas. Reg. § 1.368-2(d)(4), Ex. 1; Rev. Rul. 78-47, 1978-1 C.B. 113; Rev. Rul. 69-617, 1969-2 C.B. 57.
42. Transactions Involving the Transfer of No Net Value, 70 Fed. Reg.

11,903 (Mar. 10, 2005).

43. Prop. Reg. § 1.332-2(b), Ex. 1.
44. The deemed exchange of P common stock for the S preferred stock would be treated as a tax-free under section 354, and P's loss would be disallowed.
45. *See* Department of the Treasury, F*irst Periodic Update of the 2009-2010 Priority Guidance Plan* (Mar. 16, 2010), *available* at http://www.irs.gov/pub/irs-utl/2009_-_2010_priority_guidance_plan.pdf.
46. *See, e.g.,* Rev. Rul. 74-515, 1974-2 C.B. 118. In this ruling, the IRS addressed a reorganization where the target had both common and preferred stock. The target's common stock was exchanged for the acquiring company's shares, while the target's preferred stock was exchanged for cash. Some target shareholders held both common and preferred stock, and received cash in an amount less than their basis in the preferred stock. The IRS ruled that section 356(c) barred these shareholders from recognizing this loss. The ruling thus treats the overall exchange by those shareholders as subject to 354 and 356, rather than bifurcating the transactions into separate exchanges of common stock for common stock (tax-free under section 354) and cash for preferred stock (which would give rise to a loss as a section 302 redemption).
47. *See* 70 Fed. Reg. at 11,907 ("The IRS and Treasury have adopted the [requirement that payment on each class of stock be received in a section 332 liquidation] because they believe it is appropriate for a taxpayer to recognize loss when it fails to receive a distribution on a class of stock in liquidation of its subsidiary. The recipient corporation would recognize such a loss if the distribution qualified as a reorganization."). *See also* The Allocation of Consideration and Allocation and Recovery of Basis in Transactions Involving Corporate Stock or Securities, 74 Fed. Reg. 3509 (Jan. 21, 2009) (proposing to overturn the result in Rev. Rul. 74-515 and permit loss recognition to target shareholder receiving solely cash for one class of target stock and stock for another class of target stock).
48. For example, P could have an outstanding class of nonvoting stock, and it could be argued that the stock deemed to be issued by P in exchange for S's assets would consist in part of the P nonvoting stock, resulting in a violation of the "solely for voting stock" requirement.
49. *See, e.g., T*reas. Reg. § 1.368-2(d)(1) (providing that the assumption of liabilities in a "C" reorganization may so alter the character of a transaction as to place the transactions outside the purposes and assumptions of the reorganization provisions). The no net value regulations would remove this statement and replace it with a more generally applicable rule addressing mergers of an insolvent corporations. The IRS could argue in the alternative that, if the liquidation is a reorganization, P's worthless stock deduction should be disallowed to the extent that such deduction is duplicated by the attributes of S that P inherits under section 381. *See, e.g., Ilfeld Co. v. Hernandez*, 292 U.S. 62 (1934); *Marwais Steel Co. v. Commissioner*, 354 F.2d 907 (9th Cir. 1965).
50. Final regulations issued in 2000 overturned the result in *Bausch & Lomb Optical Co. v. Commissioner,* 267 F.2d 75 (2d Cir. 1959), which had held that an upstream merger did not satisfy the "solely for voting stock" requirement for a "C" reorganization. *See* Treas. Reg. § 1.368-2(d)(4).
51. The tax treatment of a worthless subsidiary liquidation may be affected by numerous additional consolidated return rules, as well as additional aspects of the rules discussed herein, that are beyond the scope of this article.
52. This example assumes that section 336(b) does not apply for the reasons stated in Part I.
53. If the loan is not debt, and the transaction is a reorganization or a section 331 liquidation, then the consolidated return analysis will differ somewhat from the steps set forth below.
54. Other rules, such as the elimination of circular basis adjustments pursuant to Treas. Reg. §§ 1.l502-11(b) and (c), may come into play depending on a taxpayer's particular circumstances.
55. If the liquidation is a reorganization or a section 331 liquidation, then S's attributes would not necessarily disappear in the transaction, but might be reduced or eliminated under the unified loss rules.
56. Treas. Reg. § 1.1502-32(d)(3)(i).
57. Treas. Reg. § 1.1502-13(b)(1)(i).
58. Treas. Reg. § 1.267(f)-1(a)(2).
59. *See* Treas. Reg. § 1.1502-13(g).
60. Treas. Reg. § 1.1502-13(g)(3)(i)(A)(1).
61. *Id*.
62. Treas. Reg. § 1.1502-13(g)(4)(i)(C).
63. *See, e.g.,* Treas. Reg. § 1.1502-13(g)(7), Ex. 2(ii).
64. *See* Treas. Reg. § 1.1502-13(c)(4).
65. *But see* Treas. Reg. §§ 1.1502-11(b) and (c) (relating to disallowance on circular basis adjustments in connection with a disposition of S stock).
66. A loss is considered noneconomic if it arises from a basis increase resulting from S's sale of appreciated property. In such a case, permitting P to obtain a loss from the sale of S stock when the loss results from S's gain on the sale of assets would effectively permit the corporate-level gain on the assets, which would be offset by the stock loss, to escape taxation. *See* Treas. Reg. § 1.1502-36(a)(2).
67. The definition of "transfer" is very specific and unique to the unified loss rules. A transfer of a loss share occurs on the earliest of: The date that P ceases to own the share as a result of a transaction in which, but for Treas. Reg. § 1.1502-36, P would recognize income, gain, loss, or deduction with respect to the share; the date P and S cease to be members of the same group; the date that a nonmember acquires the share from P; and the last day of the taxable year during which the share becomes worthless. *See* Treas. Reg. § 1.1502-36(f)(10). For our purposes, an insolvent liquidation is a transfer of the S shares.
68. Treas. Reg. § 1.1502-36(b) (basis redetermination rule).
69. Treas. Reg. § 1.1502-36(c) (basis reduction rule).
70. The determination of the amount of S's inside attributes (for purposes of determining the disconformity amount) can become exceedingly complex if S has lower-tier subsidiaries. *See* Treas. Reg. § 1.1502-36(c)(6).
71. Treas. Reg. § 1.1502-36(d) (attribute reduction rule).
72. Treas. Reg. § 1.1502-36(d)(1) and (d)(7)(ii).
73. This example ignores the basis effects of any tax-sharing payments made or deemed made by P or S. *See* Treas. Reg. § 1.1552-1(b)(2).
74. Although the results in the example are taxpayer-favorable, in other situations the unified loss rules can have the effect of disallowing economic losses of the P group. Furthermore, the application of the unified loss rules to multi-party scenarios (*e.g.,* where S has one or more lower-tier subsidiaries that are also insolvent, and where S or its subsidiaries recognize CODI during Year 3 from third-party debt — which CODI is not excluded under section 108(a) and must be taken into account under the consolidated attribute reduction rules of Treas. Reg. § 1.1502-28) can give rise to mind-boggling and frequently unadministrable complexities. So it is not all good or always good. Sometimes, however, it is quite satisfactory.