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## MEMORANDUM

From: Lori J. Brown

Date: July 2, 2004

Re: Administration of Consolidated Return Loss Disallowance Regulations

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On July 1, 2004, Theresa Abell and Martin Huck from the Corporate Division of the IRS Office of Chief Counsel spoke about the administration of the loss disallowance regulations under Treas. Reg. § 1.337(d)-2T at a luncheon hosted by the firm of Buchanan Ingersoll, P.C. Attached is a copy of the slides distributed by the IRS. They are essentially an updated version of the slides which were distributed at the recent Insurance Tax Seminar by Bill Alexander, Associate Chief Counsel, in the IRS Corporate Division.

The IRS attorneys indicated that a taxpayer can prove that a loss on the sale of the stock of a subsidiary is not “attributable to the recognition of built-in gain” under several methods. In this regard, because of the intense interest in this topic, the IRS is now considering additional guidance on the use of these methods, although the promulgation of new loss disallowance regulations in order to replace Treas. Reg. § 1.337(d)-2T which sunset in March, 2005, remains their top priority. The IRS also may modify the time for elections to apply the Treas. Reg. § 1.337(d)-2T regulations for stock sales before March 7, 2002.

The first method discussed is the basis disconformity approach. The IRS believes that it is the easier of the two methods to apply and generally provides the more correct answer (although a taxpayer can still attempt to utilize the modified tracing approach or another method). Under the basis disconformity approach, the amount of the gain that is treated as built-in (thus resulting in a disallowance of the loss) is the lesser of:

(1) the sum of all gains (net of directly related expenses) recognized on asset dispositions while the subsidiary is a member of the group (including assets acquired after the subsidiary stock is purchased),

(2) the excess, if any, of (a) the share's basis over (b) the share's proportionate interest in the subsidiary's net asset basis, i.e., the sum of the subsidiary's money, basis in assets other than stock of lower tier subsidiaries, net operating losses, and deductions recognized but deferred over the subsidiary's liability. (Even though slide #11 does not include net capital loss carryforwards and various credits allocable to a subsidiary upon leaving the consolidated group, the IRS indicated that those amounts probably are included in determining net asset basis for this purpose); and

(3) the excess, if any, of positive adjustments made to the share under Treas. Reg. § 1.1502-32 over negative adjustments (excluding distributions).

The determination of the amount of basis disconformity is made immediately before the stock is disposed of or deconsolidated.

In the context of a life insurance company which cannot join a life/nonlife consolidated group during the five-year waiting period, the basis disconformity approach is likely to provide an inaccurate answer because the investment adjustment regulations which attempt to maintain any conformity (or disconformity) do not apply during the waiting period. The IRS attorneys are aware of this potential problem.

The next approach is the modified tracing/nexus approach. Under this approach, a taxpayer must determine whether stock basis reflects inside built-in gain any time that the subsidiary engages in any transaction that could have imported unrealized appreciation into the subsidiary or altered any share's interest in unrealized appreciation. Specific examples include contributions, acquisition of assets with built-in gain, mergers and intra-group spins. It was made clear by the IRS attorneys that the assets on which built-in gain is "traced" is not limited to those assets held by the subsidiary at the time the subsidiary joins the consolidated group (or at the time the stock is acquired). This is because there could be later basis redeterminations in the subsidiary's stock basis whereby the same effect is achieved and the built-in gain becomes reflected in the subsidiary's stock basis prior to the disposition of the asset. This issue was very controversial with practitioners who attended the meeting.

Finally, the IRS indicated that other approaches could be utilized as long as they end up disallowing noneconomic stock losses. In certain cases, the IRS indicated it may be possible to prove there is no noneconomic stock loss as a statutory matter, i.e., when there is a single section 338 acquisition or a single section 351 acquisition with no later basis redetermination, i.e., both of these transactions generally conform inside and outside basis. However, in the context of section 351 transactions, for example, they indicated that basis disconformity could occur if a

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built-in gain asset was transferred to a subsidiary in exchange for new stock. In that case, there could be basis disconformity in the shares, thus potentially creating a potential loss disallowance, although if all shares were held within the consolidated group and sold at the same time, the losses and gains in the stock would be offset and, therefore, no loss would be disallowed. See Treas. Reg. § 1.337(d)-2T(a)(4).

Please call me with any questions.