

(l) No deduction under section 170 with respect to charitable contributions shall be taken into account;

(m) No deduction under section 922 (relating to the deduction for Western Hemisphere trade corporations) shall be taken into account;

(n) No deductions under section 243(a)(1), 244(a), 245, or 247 (relating to deductions with respect to dividends received and dividends paid) shall be taken into account;

(o) Basis shall be determined under §§ 1.1502-31 and 1.1502-32, and earnings and profits shall be determined under § 1.1502-33; and

(p) The limitation on deductions provided in section 613A shall be taken into account for each member's oil and gas properties as provided in § 1.1502-44.

(q) A thrift institution's deduction under section 593(b)(2) (relating to the addition to the reserve for bad debts of a thrift institution under the percentage of taxable income method) shall be determined under § 1.1502-42.

(r) See §§ 1.337(d)-2, 1.1502-35, and 1.1502-36 for rules relating to basis adjustments and allowance of stock loss on dispositions or transfers of subsidiary stock.

(Secs. 1502 and 7805 of the Internal Revenue Code of 1954 (68A Stat. 637; 917; 26 U.S.C. 1502, 7805))

[T.D. 6894, 31 FR 11794, Sept. 8, 1966]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 1.1502-12, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at [www.fdsys.gov](http://www.fdsys.gov).

### § 1.1502-13 Intercompany transactions.

(a) *In general*—(1) *Purpose*. This section provides rules for taking into account items of income, gain, deduction, and loss of members from intercompany transactions. The purpose of this section is to provide rules to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability).

(2) *Separate entity and single entity treatment*. Under this section, the selling member (S) and the buying member (B) are treated as separate entities for some purposes but as divisions of a sin-

gle corporation for other purposes. The *amount* and *location* of S's intercompany items and B's corresponding items are determined on a separate entity basis (separate entity treatment). For example, S determines its gain or loss from a sale of property to B on a separate entity basis, and B has a cost basis in the property. The *timing*, and the *character*, *source*, and other *attributes* of the intercompany items and corresponding items, although initially determined on a separate entity basis, are redetermined under this section to produce the effect of transactions between divisions of a single corporation (single entity treatment). For example, if S sells land to B at a gain and B sells the land to a nonmember, S does not take its gain into account until B's sale to the nonmember.

(3) *Timing rules as a method of accounting*—(i) *In general*. The timing rules of this section are a method of accounting for intercompany transactions, to be applied by each member in addition to the member's other methods of accounting. See § 1.1502-17 and, with regard to consolidated return years beginning on or after November 7, 2001, § 1.446-1(c)(2)(iii). To the extent the timing rules of this section are inconsistent with a member's otherwise applicable methods of accounting, the timing rules of this section control. For example, if S sells property to B in exchange for B's note, the timing rules of this section apply instead of the installment sale rules of section 453. S's or B's application of the timing rules of this section to an intercompany transaction clearly reflects income only if the effect of that transaction as a whole (including, for example, related costs and expenses) on consolidated taxable income is clearly reflected.

(ii) *Automatic consent for joining and departing members*—(A) *Consent granted*. Section 446(e) consent is granted under this section to the extent a change in method of accounting is necessary solely by reason of the timing rules of this section—

(1) For each member, with respect to its intercompany transactions, in the first consolidated return year which follows a separate return year and in which the member engages in an intercompany transaction; and

(2) For each former member, with respect to its transactions with members that would otherwise be intercompany transactions if the former member were still a member, in the first separate return year in which the former member engages in such a transaction.

(B) *Cut-off basis.* Any change in method of accounting described in paragraph (a)(3)(ii)(A) of this section is to be effected on a cut-off basis for transactions entered into on or after the first day of the year for which consent is granted under paragraph (a)(3)(ii)(A) of this section.

(4) *Application of other rules of law.* See § 1.1502-80(a) regarding the general applicability of other rules of law and a limitation on duplicative adjustments. The rules of this section apply in addition to other applicable law (including nonstatutory authorities). For example, this section applies in addition to sections 267(f) (additional rules for certain losses), 269 (acquisitions to evade or avoid income tax), and 482 (allocations among commonly controlled taxpayers). Thus, an item taken into account under this section can be deferred, disallowed, or eliminated under other applicable law, for example, section 1091 (losses from wash sales).

(5) *References.* References in other sections to this section include, as appropriate, references to prior law. For effective dates and prior law see paragraph (1) of this section.

(6) *Overview—(i) In general.* The principal rules of this section that implement single entity treatment are the matching rule and the acceleration rule of paragraphs (c) and (d) of this section. Under the matching rule, S and B are generally treated as divisions of a single corporation for purposes of taking into account their items from intercompany transactions. The acceleration rule provides additional rules for taking the items into account if the effect of treating S and B as divisions cannot be achieved (for example, if S or B becomes a nonmember). Paragraph (b) of this section provides definitions. Paragraph (e) of this section provides simplifying rules for certain transactions. Paragraphs (f) and (g) of this section provide additional rules for stock and obligations of members. Paragraphs (h) and (j) of this section

provide anti-avoidance rules and miscellaneous operating rules.

(ii) *Table of examples.* Set forth below is a table of the examples contained in this section.

*Matching rule.* (§ 1.1502-13(c)(7)(ii))

- Example 1. Intercompany sale of land.
- Example 2. Dealer activities.
- Example 3. Intercompany section 351 transfer.
- Example 4. Depreciable property.
- Example 5. Intercompany sale followed by installment sale.
- Example 6. Intercompany sale of installment obligation.
- Example 7. Performance of services.
- Example 8. Rental of property.
- Example 9. Intercompany sale of a partnership interest.
- Example 10. Net operating losses subject to section 382 or the SRLY rules.
- Example 11. Section 475.
- Example 12. Section 1092.
- Example 13. [Reserved]
- Example 14. Source of income under section 863.
- Example 15. Section 1248.
- Example 16. Intercompany stock distribution followed by section 332 liquidation.
- Example 17. Intercompany stock sale followed by section 355 distribution.

*Acceleration rule.* (§ 1.1502-13(d)(3))

- Example 1. Becoming a nonmember—timing.
- Example 2. Becoming a nonmember—attributes.
- Example 3. Selling member's disposition of installment note.
- Example 4. Cancellation of debt and attribute reduction under section 108(b).
- Example 5. Section 481.

*Simplifying rules—inventory.* (§ 1.1502-13(e)(1)(v))

- Example 1. Increment averaging method.
- Example 2. Increment valuation method.
- Example 3. Other reasonable inventory methods.

*Stock of members.* (§ 1.1502-13(f)(7))

- Example 1. Dividend exclusion and property distribution.
- Example 2. Excess loss accounts.
- Example 3. Intercompany reorganizations.
- Example 4. All cash intercompany reorganization under section 368(a)(1)(D).
- Example 5. Stock redemptions and distributions.
- Example 6. Intercompany stock sale followed by section 332 liquidation.
- Example 7. Intercompany stock sale followed by section 355 distribution.

## Internal Revenue Service, Treasury

## § 1.1502-13

### *Obligations of members.* (§1.1502-13(g)(7)(ii))

Example 1. Interest on intercompany obligation.

Example 2. Intercompany obligation becomes nonintercompany obligation.

Example 3. Loss or bad debt deduction with respect to intercompany obligation.

Example 4. Intercompany nonrecognition transactions.

Example 5. Assumption of intercompany obligation.

Example 6. Extinguishment of intercompany obligation.

Example 7. Exchange of intercompany obligations.

Example 8. Tax benefit rule.

Example 9. Issuance at off-market rate of interest.

Example 10. Nonintercompany obligation becomes intercompany obligation.

Example 11. Notional principal contracts.

### *Anti-avoidance rules.* (§1.1502-13(h)(2))

Example 1. Sale of a partnership interest.

Example 2. Transitory status as an intercompany obligation.

Example 3. Corporate mixing bowl.

Example 4. Partnership mixing bowl.

Example 5. Sale and leaseback.

### *Miscellaneous operating rules.* (§1.1502-13(j)(9))

Example 1. Intercompany sale followed by section 351 transfer to member.

Example 2. Intercompany sale of member stock followed by recapitalization.

Example 3. Back-to-back intercompany transactions—matching.

Example 4. Back-to-back intercompany transactions—acceleration.

Example 5. Successor group.

Example 6. Liquidation—80% distributee.

Example 7. Liquidation—no 80% distributee.

(b) *Definitions.* For purposes of this section—

(1) *Intercompany transactions*—(i) *In general.* An intercompany transaction is a transaction between corporations that are members of the same consolidated group immediately after the transaction. S is the member transferring property or providing services, and B is the member receiving the property or services. Intercompany transactions include—

(A) S's sale of property (or other transfer, such as an exchange or contribution) to B, whether or not gain or loss is recognized;

(B) S's performance of services for B, and B's payment or accrual of its expenditure for S's performance;

(C) S's licensing of technology, rental of property, or loan of money to B, and B's payment or accrual of its expenditure; and

(D) S's distribution to B with respect to S stock.

(ii) *Time of transaction.* If a transaction occurs in part while S and B are members and in part while they are not members, the transaction is treated as occurring when performance by either S or B takes place, or when payment for performance would be taken into account under the rules of this section if it were an intercompany transaction, whichever is earliest. Appropriate adjustments must be made in such cases by, for example, dividing the transaction into two separate transactions reflecting the extent to which S or B has performed.

(iii) *Separate transactions.* Except as otherwise provided in this section, each transaction is analyzed separately. For example, if S simultaneously sells two properties to B, one at a gain and the other at a loss, each property is treated as sold in a separate transaction. Thus, the gain and loss cannot be offset or netted against each other for purposes of this section. Similarly, each payment or accrual of interest on a loan is a separate transaction. In addition, an accrual of premium is treated as a separate transaction, or as an offset to interest that is not a separate transaction, to the extent required under separate entity treatment. If two members exchange property, each member is S with respect to the property it transfers and B with respect to the property it receives. If two members enter into a notional principal contract, each payment under the contract is a separate transaction and the member making the payment is B with respect to that payment and the member receiving the payment is S. See paragraph (j)(4) of this section for rules aggregating certain transactions.

(2) *Intercompany items*—(i) *In general.* S's income, gain, deduction, and loss from an intercompany transaction are its intercompany items. For example, S's gain from the sale of property to B is intercompany gain. An item is an intercompany item whether it is directly or indirectly from an intercompany transaction.

(ii) *Related costs or expenses.* S's costs or expenses related to an intercompany transaction are included in determining its intercompany items. For example, if S sells inventory to B, S's direct and indirect costs properly includible under section 263A are included in determining its intercompany income. Similarly, related costs or expenses that are not capitalized under S's separate entity method of accounting are included in determining its intercompany items. For example, deductions for employee wages, in addition to other related costs, are included in determining S's intercompany items from performing services for B, and depreciation deductions are included in determining S's intercompany items from renting property to B.

(iii) *Amounts not yet recognized or incurred.* S's intercompany items include amounts from an intercompany transaction that are not yet taken into account under its separate entity method of accounting. For example, if S is a cash method taxpayer, S's intercompany income might be taken into account under this section even if the cash is not yet received. Similarly, an amount reflected in basis (or an amount equivalent to basis) under S's separate entity method of accounting that is a substitute for income, gain, deduction or loss from an intercompany transaction is an intercompany item.

(3) *Corresponding items*—(i) *In general.* B's income, gain, deduction, and loss from an intercompany transaction, or from property acquired in an intercompany transaction, are its corresponding items. For example, if B pays rent to S, B's deduction for the rent is a corresponding deduction. If B buys property from S and sells it to a nonmember, B's gain or loss from the sale to the nonmember is a corresponding gain or loss; alternatively, if B recovers the cost of the property through depreciation, B's depreciation deductions are corresponding deductions. An item is a corresponding item whether it is directly or indirectly from an intercompany transaction (or from property acquired in an intercompany transaction).

(ii) *Disallowed or eliminated amounts.* B's corresponding items include

amounts that are permanently disallowed or permanently eliminated, whether directly or indirectly. Thus, corresponding items include amounts disallowed under section 265 (expenses relating to tax-exempt income), and amounts not recognized under section 311(a) (nonrecognition of loss on distributions), section 332 (nonrecognition on liquidating distributions), or section 355(c) (certain distributions of stock of a subsidiary). On the other hand, an amount is not permanently disallowed or permanently eliminated (and therefore is not a corresponding item) to the extent it is not recognized in a transaction in which B receives a successor asset within the meaning of paragraph (j)(1) of this section. For example, B's corresponding items do not include amounts not recognized from a transaction with a nonmember to which section 1031 applies or from another transaction in which B receives exchanged basis property.

(4) *Recomputed corresponding items.* The recomputed corresponding item is the corresponding item that B would take into account if S and B were divisions of a single corporation and the intercompany transaction were between those divisions. For example, if S sells property with a \$70 basis to B for \$100, and B later sells the property to a nonmember for \$90, B's corresponding item is its \$10 loss, and the recomputed corresponding item is \$20 of gain (determined by comparing the \$90 sales price with the \$70 basis the property would have if S and B were divisions of a single corporation). Although neither S nor B actually takes the recomputed corresponding item into account, it is computed as if B did take it into account (based on reasonable and consistently applied assumptions, including any provision of the Internal Revenue Code or regulations that would affect its timing or attributes).

(5) *Treatment as a separate entity.* Treatment as a separate entity means treatment without application of the rules of this section, but with the application of the other consolidated return regulations. For example, if S sells the stock of another member to B, S's gain or loss on a separate entity

basis is determined with the application of § 1.1502-80(b) (non-applicability of section 304), but without redetermination under paragraph (c) or (d) of this section.

(6) *Attributes*. The attributes of an intercompany item or corresponding item are all of the item's characteristics, except *amount*, *location*, and *timing*, necessary to determine the item's effect on taxable income (and tax liability). For example, attributes include character, source, treatment as excluded from gross income or as a noncapital, nondeductible amount, and treatment as built-in gain or loss under section 382(h) or 384. In contrast, the characteristics of property, such as a member's holding period, or the fact that property is included in inventory, are not attributes of an item, but these characteristics might affect the determination of the attributes of items from the property.

(c) *Matching rule*. For each consolidated return year, B's corresponding items and S's intercompany items are taken into account under the following rules:

(1) *Attributes and holding periods*—(i) *Attributes*. The separate entity attributes of S's intercompany items and B's corresponding items are redetermined to the extent necessary to produce the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation, and the intercompany transaction were a transaction between divisions. Thus, the activities of both S and B might affect the attributes of both intercompany items and corresponding items. For example, if S holds property for sale to unrelated customers in the ordinary course of its trade or business, S sells the property to B at a gain and B sells the property to an unrelated person at a further gain, S's intercompany gain and B's corresponding gain might be ordinary because of S's activities with respect to the property. Similar principles apply if S performs services, rents property, or engages in any other intercompany transaction.

(ii) *Holding periods*. The holding period of property transferred in an intercompany transaction is the aggregate of the holding periods of S and B. How-

ever, if the basis of the property is determined by reference to the basis of other property, the property's holding period is determined by reference to the holding period of the other property. For example, if S distributes stock to B in a transaction to which section 355 applies, B's holding period in the distributed stock is determined by reference to B's holding period in the stock of S.

(2) *Timing*—(i) *B's items*. B takes its corresponding items into account under its accounting method, but the redetermination of the attributes of a corresponding item might affect its timing. For example, if B's sale of property acquired from S is treated as a dealer disposition because of S's activities, section 453(b) prevents any corresponding income of B from being taken into account under the installment method.

(ii) *S's items*. S takes its intercompany item into account to reflect the difference for the year between B's corresponding item taken into account and the recomputed corresponding item.

(3) *Divisions of a single corporation*. As divisions of a single corporation, S and B are treated as engaging in their actual transaction and owning any actual property involved in the transaction (rather than treating the transaction as not occurring). For example, S's sale of land held for investment to B for cash is not disregarded, but is treated as an exchange of land for cash between divisions (and B therefore succeeds to S's basis in the property). Similarly, S's issuance of its own stock to B in exchange for property is not disregarded, B is treated as owning the stock it receives in the exchange, and section 1032 does not apply to B on its subsequent sale of the S stock. Although treated as divisions, S and B nevertheless are treated as:

(i) Operating separate trades or businesses. See, e.g., § 1.446-1(d) (accounting methods for a taxpayer engaged in more than one business).

(ii) Having any special status that they have under the Internal Revenue Code or regulations. For example, a bank defined in section 581, a domestic building and loan association defined in section 7701(a)(19), and an insurance

company to which section 801 or 831 applies are treated as divisions having separate special status. On the other hand, the fact that a member holds property for sale to customers in the ordinary course of its trade or business is not a special status.

(4) *Conflict or allocation of attributes.* This paragraph (c)(4) provides special rules for redetermining and allocating attributes under paragraph (c)(1)(i) of this section.

(i) *Offsetting amounts—(A) In general.* To the extent B's corresponding item offsets S's intercompany item in amount, the attributes of B's corresponding item, determined based on both S's and B's activities, control the attributes of S's offsetting intercompany item. For example, if S sells depreciable property to B at a gain and B depreciates the property, the attributes of B's depreciation deduction (ordinary deduction) control the attributes of S's offsetting intercompany gain. Accordingly, S's gain is ordinary.

(B) *B controls unreasonable.* To the extent the results under paragraph (c)(4)(i)(A) are inconsistent with treating S and B as divisions of a single corporation, the attributes of the offsetting items must be redetermined in a manner consistent with treating S and B as divisions of a single corporation. To the extent, however, that B's corresponding item on a separate entity basis is excluded from gross income, is a noncapital, nondeductible amount, or is otherwise permanently disallowed or eliminated, the attributes of B's corresponding item always control the attributes of S's offsetting intercompany item.

(ii) *Allocation.* To the extent S's intercompany item and B's corresponding item do not offset in amount, the attributes redetermined under paragraph (c)(1)(i) of this section must be allocated to S's intercompany item and B's corresponding item by using a method that is reasonable in light of all the facts and circumstances, including the purposes of this section and any other rule affected by the attributes of S's intercompany item and B's corresponding item. A method of allocation or redetermination is unreasonable if it is not used

consistently by all members of the group from year to year.

(5) *Special status.* Notwithstanding the general rule of paragraph (c)(1)(i) of this section, to the extent an item's attributes determined under this section are permitted or not permitted to a member under the Internal Revenue Code or regulations by reason of the member's special status, the attributes required under the Internal Revenue Code or regulations apply to that member's items (but not the other member). For example, if S is a bank to which section 582(c) applies, and sells debt securities at a gain to B, a nonbank, the character of S's intercompany gain is ordinary as required under section 582(c), but the character of B's corresponding item as capital or ordinary is determined under paragraph (c)(1)(i) of this section without the application of section 582(c). For other special status issues, see, for example, sections 595(b) (foreclosure on property securing loans), 818(b) (life insurance company treatment of capital gains and losses), and 1503(c) (limitation on absorption of certain losses).

(6) *Treatment of intercompany items if corresponding items are excluded or non-deductible—(i) In general.* Under paragraph (c)(1)(i) of this section, S's intercompany item might be redetermined to be excluded from gross income or treated as a noncapital, nondeductible amount. For example, S's intercompany loss from the sale of property to B is treated as a noncapital, nondeductible amount if B distributes the property to a nonmember shareholder at no further gain or loss (because, if S and B were divisions of a single corporation, the loss would not have been recognized under section 311(a)). Paragraph (c)(6)(ii) of this section, however, provides limitations on the application of this rule to intercompany income or gain. See also §§ 1.1502-32 and 1.1502-33 (adjustments to S's stock basis and earnings and profits to reflect amounts so treated).

(ii) *Limitation on treatment of intercompany items as excluded from gross income.* Notwithstanding the general rule of paragraph (c)(1)(i) of this section, S's

intercompany income or gain is redetermined to be excluded from gross income only to the extent one of the following applies:

(A) *Disallowed amounts.* B's corresponding item is a deduction or loss and, in the taxable year the item is taken into account under this section, it is permanently and explicitly disallowed under another provision of the Internal Revenue Code or regulations. For example, deductions that are disallowed under section 265 are permanently and explicitly disallowed. An amount is not permanently and explicitly disallowed, for example, to the extent that—

(1) The Internal Revenue Code or regulations provide that the amount is not recognized (for example, a loss that is realized but not recognized under section 332 or section 355(c) is not permanently and explicitly disallowed, notwithstanding that it is a corresponding item within the meaning of paragraph (b)(3)(ii) of this section (certain disallowed or eliminated amounts));

(2) A related amount might be taken into account by B with respect to successor property, such as under section 280B (demolition costs recoverable as capitalized amounts);

(3) A related amount might be taken into account by another taxpayer, such as under section 267(d) (disallowed loss under section 267(a) might result in nonrecognition of gain for a related person);

(4) A related amount might be taken into account as a deduction or loss, including as a carryforward to a later year, under any provision of the Internal Revenue Code or regulations (whether or not the carryforward expires in a later year); or

(5) The amount is reflected in the computation of any credit against (or other reduction of) Federal income tax (whether allowed for the taxable year or carried forward to a later year).

(B) *Section 311.* The corresponding item is a loss that is realized, but not recognized under section 311(a) on a distribution to a nonmember (even though the loss is not a permanently and explicitly disallowed amount within the meaning of paragraph (c)(6)(ii)(A) of this section).

(C) *Certain intercompany gains on stock—(1) In general.* Notwithstanding paragraph (c)(6)(ii)(A)(I) of this section, intercompany gain with respect to a member's stock that was created by reason of an intercompany transfer of the stock, and that would not otherwise be taken into account upon a subsequent elimination of the stock's basis but for the transfer, is redetermined to be excluded from gross income if—

(i) B or S becomes a successor (as defined in paragraph (j)(2) of this section) to the other party (either B or S), or a third member becomes a successor to both B and S;

(ii) Immediately before the intercompany gain would be taken into account, the successor member holds the member's stock with respect to which the intercompany gain was realized;

(iii) The successor member's basis in the member's stock that reflects the intercompany gain that is taken into account is eliminated without the recognition of gain or loss (and such eliminated basis is not further reflected in the basis of any successor asset);

(iv) The effects of the intercompany transaction have not previously been reflected, directly or indirectly, on the group's consolidated return; and

(v) The group has not derived, and no taxpayer will derive, any Federal income tax benefit from the intercompany transaction that gave rise to the intercompany gain or the redetermination of the intercompany gain (including any adjustment to basis in member stock under § 1.1502-32). For this purpose, the redetermination of the intercompany gain is not itself considered a Federal income tax benefit.

(2) *Effect on earnings and profits and investment adjustments.* Any amount excluded from gross income under paragraph (c)(6)(ii)(C)(I) of this section shall not be taken into account as earnings and profits of any member and shall not be treated as tax-exempt income under § 1.1502-32(b)(2)(ii).

(D) *Other amounts.* (1) The Commissioner may determine that treating S's intercompany item as excluded from gross income is consistent with the

purposes of this section and other applicable provisions of the Internal Revenue Code, regulations, and published guidance, if the following conditions are met, depending on whether the intercompany item is an item of income or an item of gain:

(2) A determination by the Commissioner may be obtained only through a letter ruling request.

(7) *Examples*—(i) *In general.* For purposes of the examples in this section, unless otherwise stated, P is the common parent of the P consolidated group, P owns all of the only class of stock of subsidiaries S and B, X is a person unrelated to any member of the P group, the taxable year of all persons is the calendar year, all persons use the accrual method of accounting, tax liabilities are disregarded, the facts set forth the only corporate activity, no member has any special status, and the transaction is not otherwise subject to recharacterization. If a member acts as both a selling member and a buying member (e.g., with respect to different aspects of a single transaction, or with respect to related transactions), the member is referred to as M, M1, or M2 (rather than as S or B).

(ii) *Matching rule.* The matching rule of this paragraph (c) is illustrated by the following examples.

*Example 1. Intercompany sale of land followed by sale to a nonmember.* (a) *Facts.* S holds land for investment with a basis of \$70. S has held the land for more than one year. On January 1 of Year 1, S sells the land to B for \$100. B also holds the land for investment. On July 1 of Year 3, B sells the land to X for \$110.

(b) *Definitions.* Under paragraph (b)(1) of this section, S's sale of the land to B is an intercompany transaction, S is the selling member, and B is the buying member. Under paragraphs (b)(2) and (3) of this section, S's \$30 gain from the sale to B is its intercompany item, and B's \$10 gain from the sale to X is its corresponding item.

(c) *Attributes.* Under the matching rule of paragraph (c) of this section, S's \$30 intercompany gain and B's \$10 corresponding gain are taken into account to produce the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation. In addition, the holding periods of S and B for the land are aggregated. Thus, the group's entire \$40 of gain is long-term capital gain. Because both S's intercompany item and B's corresponding item on a separate entity basis

are long-term capital gain, the attributes are not redetermined under paragraph (c)(1)(i) of this section.

(d) *Timing.* For each consolidated return year, S takes its intercompany item into account under the matching rule to reflect the difference for the year between B's corresponding item taken into account and the recomputed corresponding item. If S and B were divisions of a single corporation and the intercompany sale were a transfer between the divisions, B would succeed to S's \$70 basis in the land and would have a \$40 gain from the sale to X in Year 3, instead of a \$10 gain. Consequently, S takes no gain into account in Years 1 and 2, and takes the entire \$30 gain into account in Year 3, to reflect the \$30 difference in that year between the \$10 gain B takes into account and the \$40 recomputed gain (the recomputed corresponding item). Under §§ 1.1502-32 and 1.1502-33, P's basis in its S stock and the earnings and profits of S and P do not reflect S's \$30 gain until the gain is taken into account in Year 3. (Under paragraph (a)(3) of this section, the results would be the same if S sold the land to B in an installment sale to which section 453 would otherwise apply, because S must take its intercompany gain into account under this section.)

(e) *Intercompany loss followed by sale to a nonmember at a gain.* The facts are the same as in paragraph (a) of this *Example 1*, except that S's basis in the land is \$130 (rather than \$70). The attributes and timing of S's intercompany loss and B's corresponding gain are determined under the matching rule in the manner provided in paragraphs (c) and (d) of this *Example 1*. If S and B were divisions of a single corporation and the intercompany sale were a transfer between the divisions, B would succeed to S's \$130 basis in the land and would have a \$20 loss from the sale to X instead of a \$10 gain. Thus, S takes its entire \$30 loss into account in Year 3 to reflect the \$30 difference between B's \$10 gain taken into account and the \$20 recomputed loss. (The results are the same under section 267(f).) S's \$30 loss is long-term capital loss, and B's \$10 gain is long-term capital gain.

(f) *Intercompany gain followed by sale to a nonmember at a loss.* The facts are the same as in paragraph (a) of this *Example 1*, except that B sells the land to X for \$90 (rather than \$110). The attributes and timing of S's intercompany gain and B's corresponding loss are determined under the matching rule. If S and B were divisions of a single corporation and the intercompany sale were a transfer between the divisions, B would succeed to S's \$70 basis in the land and would have a \$20 gain from the sale to X instead of a \$10 loss. Thus, S takes its entire \$30 gain into account in Year 3 to reflect the \$30 difference between B's \$10 loss taken into account and the \$20 recomputed gain. S's \$30 gain is long-



term capital gain, and B's \$10 loss is long-term capital loss.

(g) *Intercompany gain followed by distribution to a nonmember at a loss.* The facts are the same as in paragraph (a) of this *Example 1*, except that B distributes the land to X, a minority shareholder of B, and at the time of the distribution the land has a fair market value of \$90. The attributes and timing of S's intercompany gain and B's corresponding loss are determined under the matching rule. Under section 311(a), B does not recognize its \$10 loss on the distribution to X. If S and B were divisions of a single corporation and the intercompany sale were a transfer between divisions, B would succeed to S's \$70 basis in the land and would have a \$20 gain from the distribution to X instead of an unrecognized \$10 loss. Under paragraph (b)(3)(ii) of this section, B's loss that is not recognized under section 311(a) is a corresponding item. Thus, S takes its \$30 gain into account under the matching rule in Year 3 to reflect the difference between B's \$10 corresponding unrecognized loss and the \$20 recomputed gain. B's \$10 corresponding loss offsets \$10 of S's intercompany gain and, under paragraph (c)(4)(i) of this section, the attributes of B's corresponding item control the attributes of S's intercompany item. Paragraph (c)(6) of this section does not prevent the redetermination of S's intercompany item as excluded from gross income. (See paragraph (c)(6)(ii)(B) of this section). Thus, \$10 of S's \$30 gain is redetermined to be excluded from gross income.

(h) *Intercompany sale followed by section 1031 exchange with nonmember.* The facts are the same as in paragraph (a) of this *Example 1*, except that, instead of selling the land to X, B exchanges the land for land owned by X in a transaction to which section 1031 applies. There is no difference in Year 3 between B's \$0 corresponding item taken into account and the \$0 recomputed corresponding item. Thus, none of S's intercompany gain is taken into account under the matching rule as a result of the section 1031 exchange. Instead, B's gain is preserved in the land received from X and, under the successor asset rule of paragraph (j)(1) of this section, S's intercompany gain is taken into account by reference to the replacement property. (If B takes gain into account as a result of boot received in the exchange, S's intercompany gain is taken into account under the matching rule to the extent the boot causes a difference between B's gain taken into account and the recomputed gain.)

(i) *Intercompany sale followed by section 351 transfer to nonmember.* The facts are the same as in paragraph (a) of this *Example 1*, except that, instead of selling the land to X, B transfers the land to X in a transaction to which section 351(a) applies and X remains a nonmember. There is no difference in Year 3 between B's \$0 corresponding item taken

into account and the \$0 recomputed corresponding item. Thus, none of S's intercompany gain is taken into account under the matching rule as a result of the section 351(a) transfer. However, S's entire gain is taken into account in Year 3 under the acceleration rule of paragraph (d) of this section (because X, a nonmember, reflects B's \$100 cost basis in the land under section 362).

*Example 2. Dealer activities.* (a) *Facts.* S holds land for investment with a basis of \$70. On January 1 of Year 1, S sells the land to B for \$100. B develops the land as residential real estate, and sells developed lots to customers during Year 3 for an aggregate amount of \$110.

(b) *Attributes.* S and B are treated under the matching rule as divisions of a single corporation for purposes of determining the attributes of S's intercompany item and B's corresponding item. Thus, although S held the land for investment, whether the gain is treated as from the sale of property described in section 1221(1) is based on the activities of both S and B. If, based on both S's and B's activities, the land is described in section 1221(1), both S's gain and B's gain are ordinary income.

*Example 3. Intercompany section 351 transfer.* (a) *Facts.* S holds land with a \$70 basis and a \$100 fair market value for sale to customers in the ordinary course of business. On January 1 of Year 1, S transfers the land to B in exchange for all of the stock of B in a transaction to which section 351 applies. S has no gain or loss under section 351(a), and its basis in the B stock is \$70 under section 358. Under section 362, B's basis in the land is \$70. B holds the land for investment. On July 1 of Year 3, B sells the land to X for \$100. Assume that if S and B were divisions of a single corporation, B's gain from the sale would be ordinary income because of S's activities.

(b) *Timing and attributes.* Under paragraph (b)(1) of this section, S's transfer to B is an intercompany transaction. Under paragraph (c)(3) of this section, S is treated as transferring the land in exchange for B's stock even though, as divisions, S could not own stock of B. S has no intercompany item, but B's \$30 gain from its sale of the land to X is a corresponding item because the land was acquired in an intercompany transaction. B's \$30 gain is ordinary income that is taken into account under B's method of accounting.

(c) *Intercompany section 351 transfer with boot.* The facts are the same as in paragraph (a) of this *Example 3*, except that S receives \$10 cash in addition to the B stock in the transfer. S recognizes \$10 of gain under section 351(b), and its basis in the B stock is \$70 under section 358. Under section 362, B's basis in the land is \$80. S takes its \$10 intercompany gain into account in Year 3 to reflect the \$10 difference between B's \$20 corresponding gain taken into account and the

\$30 recomputed gain. Both S's \$10 gain and B's \$20 gain are ordinary income.

(d) *Partial disposition.* The facts are the same as in paragraph (c) of this *Example 3*, except B sells only a one-half, undivided interest in the land to X for \$50. The timing and attributes are determined in the manner provided in paragraph (b) of this *Example 3*, except that S takes only \$5 of its gain into account in Year 3 to reflect the \$5 difference between B's \$10 gain taken into account and the \$15 recomputed gain.

*Example 4. Depreciable property.* (a) *Facts.* On January 1 of Year 1, S buys 10-year recovery property for \$100 and depreciates it under the straight-line method. On January 1 of Year 3, S sells the property to B for \$130. Under section 168(i)(7), B is treated as S for purposes of section 168 to the extent B's \$130 basis does not exceed S's adjusted basis at the time of the sale. B's additional basis is treated as new 10-year recovery property for which B elects the straight-line method of recovery. (To simplify the example, the half-year convention is disregarded.)

(b) *Depreciation through Year 3; intercompany gain.* S claims \$10 of depreciation for each of Years 1 and 2 and has an \$80 basis at the time of the sale to B. Thus, S has a \$50 intercompany gain from its sale to B. For Year 3, B has \$10 of depreciation with respect to \$80 of its basis (the portion of its \$130 basis not exceeding S's adjusted basis). In addition, B has \$5 of depreciation with respect to the \$50 of its additional basis that exceeds S's adjusted basis.

(c) *Timing.* S's \$50 gain is taken into account to reflect the difference for each consolidated return year between B's depreciation taken into account with respect to the property and the recomputed depreciation. For Year 3, B takes \$15 of depreciation into account. If the intercompany transaction were a transfer between divisions of a single corporation, B would succeed to S's adjusted basis in the property and take into account only \$10 of depreciation for Year 3. Thus, S takes \$5 of gain into account in Year 3. In each subsequent year that B takes into account \$15 of depreciation with respect to the property, S takes into account \$5 of gain.

(d) *Attributes.* Under paragraph (c)(1)(i) of this section, the attributes of S's gain and B's depreciation must be redetermined to the extent necessary to produce the same effect on consolidated taxable income as if the intercompany transaction were between divisions of a single corporation (the group must have a net depreciation deduction of \$10). In each year, \$5 of B's corresponding depreciation deduction offsets S's \$5 intercompany gain taken into account and, under paragraph (c)(4)(i) of this section, the attributes of B's corresponding item control the attributes of S's intercompany item. Accordingly, S's intercompany gain that is

taken into account as a result of B's depreciation deduction is ordinary income.

(e) *Sale of property to a nonmember.* The facts are the same as in paragraph (a) of this *Example 4*, except that B sells the property to X on January 1 of Year 5 for \$110. As set forth in paragraphs (c) and (d) of this *Example 4*, B has \$15 of depreciation with respect to the property in each of Years 3 and 4, causing S to take \$5 of intercompany gain into account in each year as ordinary income. The \$40 balance of S's intercompany gain is taken into account in Year 5 as a result of B's sale to X, to reflect the \$40 difference between B's \$10 gain taken into account and the \$50 of recomputed gain (\$110 of sale proceeds minus the \$60 basis B would have if the intercompany sale were a transfer between divisions of a single corporation). Treating S and B as divisions of a single corporation, \$40 of the gain is section 1245 gain and \$10 is section 1231 gain. On a separate entity basis, S would have more than \$10 treated as section 1231 gain, and B would have no amount treated as section 1231 gain. Under paragraph (c)(4)(ii) of this section, all \$10 of the section 1231 gain is allocated to S. S's remaining \$30 of gain, and all of B's \$10 gain, is treated as section 1245 gain.

*Example 5. Intercompany sale followed by installment sale.* (a) *Facts.* S holds land for investment with a basis of \$70x. On January 1 of Year 1, S sells the land to B for \$100x. B also holds the land for investment. On July 1 of Year 3, B sells the land to X in exchange for X's \$110x note. The note bears a market rate of interest in excess of the applicable Federal rate, and provides for principal payments of \$55x in Year 4 and \$55x in Year 5. The interest charge under section 453A(c) applies to X's note.

(b) *Timing and attributes.* S takes its \$30x gain into account to reflect the difference in each consolidated return year between B's gain taken into account for the year and the recomputed gain. Under section 453, B takes into account \$5x of gain in Year 4 and \$5x of gain in Year 5. Thus, S takes into account \$15x of gain in Year 4 and \$15x of gain in Year 5 to reflect the \$15x difference in each of those years between B's \$5x gain taken into account and the \$20x recomputed gain. Both S's \$30x gain and B's \$10x gain are subject to the section 453A(c) interest charge beginning in Year 3.

(c) *Election out under section 453(d).* If, under the facts in paragraph (a) of this *Example 5*, the P group wishes to elect not to apply section 453 with respect to S's gain, an election under section 453(d) must be made for Year 3 with respect to B's gain. This election will cause B's \$10x gain to be taken into account in Year 3. Under the matching rule, this will result in S's \$30x gain being taken into account in Year 3. (An election by the P group solely with respect to S's gain has no effect because the gain from S's sale to B is

taken into account under the matching rule, and therefore must reflect the difference between B's gain taken into account and the recomputed gain.)

(d) *Sale to a nonmember at a loss, but overall gain.* The facts are the same as in paragraph (a) of this *Example 5*, except that B sells the land to X in exchange for X's \$90x note (rather than \$110x note). If S and B were divisions of a single corporation, B would succeed to S's basis in the land, and the sale to X would be eligible for installment reporting under section 453, because it resulted in an overall gain. However, because only gains may be reported on the installment method, B's \$10x corresponding loss is taken into account in Year 3. Under paragraph (b)(4) of this section the recomputed corresponding item is \$20x gain that would be taken into account under the installment method, \$0 in Year 3 and \$10x in each of Years 4 and 5. Thus, in Year 3 S takes \$10x of gain into account to reflect the difference between B's \$10x loss taken into account and the \$0 recomputed gain for Year 3. Under paragraph (c)(4)(i) of this section, B's \$10x corresponding loss offsets \$10x of S's intercompany gain, and B's attributes control. S takes \$10x of gain into account in each of Years 4 and 5 to reflect the difference in those years between B's \$0 gain taken into account and the \$10x recomputed gain that would be taken into account under the installment method. Only the \$20x of S's gain taken into account in Years 4 and 5 is subject to the interest charge under section 453A(c) beginning in Year 3. (If P elects under section 453(d) for Year 3 not to apply section 453 with respect to the gain, all of S's \$30x gain will be taken into account in Year 3 to reflect the difference between B's \$10x loss taken into account and the \$20x recomputed gain.)

(e) *Intercompany loss, installment gain.* The facts are the same as in paragraph (a) of this *Example 5*, except that S has a \$130x (rather than \$70x) basis in the land. Under paragraph (c)(1)(i) of this section, the separate entity attributes of S's and B's items from the intercompany transaction must be redetermined to produce the same effect on consolidated taxable income (and tax liability) as if the transaction had been a transfer between divisions. If S and B were divisions of a single corporation, B would succeed to S's basis in the land and the group would have \$20x loss from the sale to X, installment reporting would be unavailable, and the interest charge under section 453A(c) would not apply. Accordingly, B's gain from the transaction is not eligible for installment treatment under section 453. B takes its \$10x gain into account in Year 3, and S takes its \$30x of loss into account in Year 3 to reflect the difference between B's \$10x gain and the \$20x recomputed loss.

(f) *Recapture income.* The facts are the same as in paragraph (a) of this *Example 5*, except

that S bought depreciable property (rather than land) for \$100x, claimed depreciation deductions, and reduced the property's basis to \$70x before Year 1. (To simplify the example, B's depreciation is disregarded.) If the intercompany sale of property had been a transfer between divisions of a single corporation, \$30x of the \$40x gain from the sale to X would be section 1245 gain (which is ineligible for installment reporting) and \$10x would be section 1231 gain (which is eligible for installment reporting). On a separate entity basis, S would have \$30x of section 1245 gain and B would have \$10x of section 1231 gain. Accordingly, the attributes are not redetermined under paragraph (c)(1)(i) of this section. All of B's \$10x gain is eligible for installment reporting and is taken into account \$5x each in Years 4 and 5 (and is subject to the interest charge under section 453A(c)). S's \$30x gain is taken into account in Year 3 to reflect the difference between B's \$0 gain taken into account and the \$30x of recomputed gain. (If S had bought the depreciable property for \$110x and its recomputed basis under section 1245 had been \$110x (rather than \$100x), B's \$10x gain and S's \$30x gain would both be recapture income ineligible for installment reporting.)

*Example 6. Intercompany sale of installment obligation.* (a) *Facts.* S holds land for investment with a basis of \$70x. On January 1 of Year 1, S sells the land to X in exchange for X's \$100x note, and S reports its gain on the installment method under section 453. X's note bears interest at a market rate of interest in excess of the applicable Federal rate, and provides for principal payments of \$50x in Year 5 and \$50x in Year 6. Section 453A applies to X's note. On July 1 of Year 3, S sells X's note to B for \$100x, resulting in \$30x gain from S's prior sale of the land to X under section 453B(a).

(b) *Timing and attributes.* S's sale of X's note to B is an intercompany transaction, and S's \$30x gain is intercompany gain. S takes \$15x of the gain into account in each of Years 5 and 6 to reflect the \$15x difference in each year between B's \$0 gain taken into account and the \$15x recomputed gain. S's gain continues to be treated as its gain from the sale to X, and the deferred tax liability remains subject to the interest charge under section 453A(c).

(c) *Worthlessness.* The facts are the same as in paragraph (a) of this *Example 6*, except that X's note becomes worthless on December 1 of Year 3 and B has a \$100x short-term capital loss under section 165(g) on a separate entity basis. Under paragraph (c)(1)(ii) of this section, B's holding period for X's note is aggregated with S's holding period. Thus, B's loss is a long-term capital loss. S takes its \$30x gain into account in Year 3 to reflect the \$30x difference between B's \$100x

loss taken into account and the \$70x recomputed loss. Under paragraph (c)(1)(i) of this section, S's gain is long-term capital gain.

(d) *Pledge.* The facts are the same as in paragraph (a) of this *Example 6*, except that, on December 1 of Year 3, B borrows \$100x from an unrelated bank and secures the indebtedness with X's note. X's note remains subject to section 453A(d) following the sale to B. Under section 453A(d), B's \$100x of proceeds from the secured indebtedness is treated as an amount received on December 1 of Year 3 by B on X's note. Thus, S takes its entire \$30x gain into account in Year 3.

*Example 7. Performance of services.* (a) *Facts.* S is a driller of water wells. B operates a ranch in a remote location, and B's taxable income from the ranch is not subject to section 447. B's ranch requires water to maintain its cattle. During Year 1, S drills an artesian well on B's ranch in exchange for \$100 from B, and S incurs \$80 of expenses (e.g., for employees and equipment). B capitalizes its \$100 cost for the well under section 263, and takes into account \$10 of cost recovery deductions in each of Years 2 through 11. Under its separate entity method of accounting, S would take its income and expenses into account in Year 1. If S and B were divisions of a single corporation, the costs incurred in drilling the well would be capitalized.

(b) *Definitions.* Under paragraph (b)(1) of this section, the service transaction is an intercompany transaction, S is the selling member, and B is the buying member. Under paragraph (b)(2)(ii) of this section, S's \$100 of income and \$80 of related expenses are both included in determining its intercompany income of \$20.

(c) *Timing and attributes.* S's \$20 of intercompany income is taken into account under the matching rule to reflect the \$20 difference between B's corresponding items taken into account (based on its \$100 cost basis in the well) and the recomputed corresponding items (based on the \$80 basis that B would have if S and B were divisions of a single corporation and B's basis were determined by reference to S's \$80 of expenses). In Year 1, S takes into account \$80 of its income and the \$80 of expenses. In each of Years 2 through 11, S takes \$2 of its \$20 intercompany income into account to reflect the annual \$2 difference between B's \$10 of cost recovery deductions taken into account and the \$8 of recomputed cost recovery deductions. S's \$100 income and \$80 expenses, and B's cost recovery deductions, are ordinary items (because S's and B's items would be ordinary on a separate entity basis, the attributes are not redetermined under paragraph (c)(1)(i) of this section). If S's offsetting \$80 of income and expense would not be taken into account in the same year under its separate entity method of accounting, they nevertheless must be taken into account under this section in a manner that

clearly reflects consolidated taxable income. See paragraph (a)(3)(i) of this section.

(d) *Sale of capitalized services.* The facts are the same as in paragraph (a) of this *Example 7*, except that B sells the ranch before Year 11 and recognizes gain attributable to the well. To the extent of S's income taken into account as a result of B's cost recovery deductions, as well as S's offsetting \$80 of income and expense, the timing and attributes are determined in the manner provided in paragraph (c) of this *Example 7*. The attributes of the remainder of S's \$20 of income and B's gain from the sale are redetermined to produce the same effect on consolidated taxable income as if S and B were divisions of a single corporation. Accordingly, S's remaining intercompany income is treated as recapture income or section 1231 gain, even though it is from S's performance of services.

*Example 8. Rental of property.* B operates a ranch that requires grazing land for its cattle. S owns undeveloped land adjoining B's ranch. On January 1 of Year 1, S leases grazing rights to B for Year 1. B's \$100 rent expense is deductible for Year 1 under its separate entity accounting method. Under paragraph (b)(1) of this section, the rental transaction is an intercompany transaction, S is the selling member, and B is the buying member. S takes its \$100 of income into account in Year 1 to reflect the \$100 difference between B's rental deduction taken into account and the \$0 recomputed rental deduction. S's income and B's deduction are ordinary items (because S's intercompany item and B's corresponding item would both be ordinary on a separate entity basis, the attributes are not redetermined under paragraph (c)(1)(i) of this section).

*Example 9. Intercompany sale of a partnership interest.* (a) *Facts.* S owns a 20% interest in the capital and profits of a general partnership. The partnership holds land for investment with a basis equal to its value, and operates depreciable assets which have value in excess of basis. S's basis in its partnership interest equals its share of the adjusted basis of the partnership's land and depreciable assets. The partnership has an election under section 754 in effect. On January 1 of Year 1, S sells its partnership interest to B at a gain. During Years 1 through 10, the partnership depreciates the operating assets, and B's depreciation deductions from the partnership reflect the increase in the basis of the depreciable assets under section 743(b).

(b) *Timing and attributes.* S's gain is taken into account during Years 1 through 10 to reflect the difference in each year between B's depreciation deductions from the partnership taken into account and the recomputed depreciation deductions from the partnership. Under paragraphs (c)(1)(i) and (c)(4)(i) of this section, S's gain taken into account is ordinary income. (The acceleration rule

does not apply to S's gain as a result of the section 743(b) adjustment, because the adjustment is solely with respect to B and therefore no nonmember reflects any part of the intercompany transaction.)

(c) *Partnership sale of assets.* The facts are the same as in paragraph (a) of this *Example 9*, and the partnership sells some of its depreciable assets to X at a gain on December 31 of Year 4. In addition to the intercompany gain taken into account as a result of the partnership's depreciation, S takes intercompany gain into account in Year 4 to reflect the difference between B's partnership items taken into account from the sale (which reflect the basis increase under section 743(b)) and the recomputed partnership items. The attributes of S's additional gain are redetermined to produce the same effect on consolidated taxable income as if S and B were divisions of a single corporation (recapture income or section 1231 gain).

(d) *B's sale of partnership interest.* The facts are the same as in paragraph (a) of this *Example 9*, and on December 31 of Year 4, B sells its partnership interest to X at no gain or loss. In addition to the intercompany gain taken into account as a result of the partnership's depreciation, the remaining balance of S's intercompany gain is taken into account in Year 4 to reflect the difference between B's \$0 gain taken into account from the sale of the partnership interest and the recomputed gain. The character of S's remaining intercompany item and B's corresponding item are determined on a separate entity basis under section 751, and then redetermined to the extent necessary to produce the same effect as treating the intercompany transaction as occurring between divisions of a single corporation.

(e) *No section 754 election.* The facts are the same as in paragraph (d) of this *Example 9*, except that the partnership does not have a section 754 election in effect, and B recognizes a capital loss from its sale of the partnership interest to X on December 31 of Year 4. Because there is no difference between B's depreciation deductions from the partnership taken into account and the recomputed depreciation deductions, S does not take any of its gain into account during Years 1 through 4 as a result of B's partnership's items. Instead, S's entire intercompany gain is taken into account in Year 4 to reflect the difference between B's loss taken into account from the sale to X and the recomputed gain or loss.

*Example 10. Net operating losses subject to section 382 or the SRLY rules.* (a) *Facts.* On January 1 of Year 1, P buys all of S's stock. S has net operating loss carryovers from prior years. P's acquisition results in an ownership change under section 382 with respect to S's loss carryovers, and S has a net unrealized built-in gain (within the meaning of section 382(h)(3)). S owns nondepreciable

property with a \$70 basis and \$100 value. On July 1 of Year 3, S sells the property to B for \$100, and its \$30 gain is recognized built-in gain (within the meaning of section 382(h)(2)) on a separate entity basis. On December 1 of Year 5, B sells the property to X for \$90.

(b) *Timing and attributes.* S's \$30 gain is taken into account in Year 5 to reflect the \$30 difference between B's \$10 loss taken into account and the recomputed \$20 gain. S and B are treated as divisions of a single corporation for purposes of applying section 382 in connection with the intercompany transaction. Under a single entity analysis, the single corporation has losses subject to limitation under section 382, and this limitation may be increased under section 382(h) if the single corporation has recognized built-in gain with respect to those losses. B's \$10 corresponding loss offsets \$10 of S's intercompany gain, and thus, under paragraph (c)(4)(i) of this section, \$10 of S's intercompany gain is redetermined not to be recognized built-in gain. S's remaining \$20 intercompany gain continues to be treated as recognized built-in gain.

(c) *B's recognized built-in gain.* The facts are the same as in paragraph (a) of this *Example 10*, except that the property declines in value after S becomes a member of the P group, S sells the property to B for its \$70 basis, and B sells the property to X for \$90 during Year 5. Treating S and B as divisions of a single corporation, S's sale to B does not cause the property to cease to be built-in gain property. Thus, B's \$20 gain from its sale to X is recognized built-in gain that increases the section 382 limitation applicable to S's losses.

(d) *SRLY limitation.* The facts are the same as in paragraph (a) of this *Example 10*, except that P's acquisition of S is not subject to the overlap rule of § 1.1502-21(g), and S's net operating loss carryovers are subject to the separate return limitation year (SRLY) rules. See § 1.1502-21(c). The application of the SRLY rules depends on S's status as a separate corporation having losses from separate return limitation years. Under paragraph (c)(5), the attribute of S's intercompany item as it relates to S's SRLY limitation is not redetermined, because the SRLY limitation depends on S's special status. Accordingly, S's \$30 intercompany gain is included in determining its SRLY limitation for Year 5.

*Example 11. Section 475.* (a) *Facts.* S, a dealer in securities within the meaning of section 475(c), owns a security with a basis of \$70. The security is held for sale to customers and is not identified under section 475(b) as within an exception to marking to market. On July 1 of Year 1, S sells the security to B for \$100. B is not a dealer and holds the security for investment. On December 31 of Year 1, the fair market value of the security is \$100. On July 1 of Year 2, B sells the security to X for \$110.

(b) *Attributes.* Under section 475, a dealer in securities can treat a security as within an exception to marking to market under section 475(b) only if it timely identifies the security as so described. Under the matching rule, attributes must be redetermined by treating S and B as divisions of a single corporation. As a result of S's activities, the single corporation is treated as a dealer with respect to securities, and B must continue to mark to market the security acquired from S. Thus, B's corresponding items and the recomputed corresponding items are determined by continuing to treat the security as not within an exception to marking to market. Under section 475(d)(3), it is possible for the character of S's intercompany items to differ from the character of B's corresponding items.

(c) *Timing and character.* S has a \$30 gain when it disposes of the security by selling it to B. This gain is intercompany gain that is taken into account in Year 1 to reflect the \$30 difference between B's \$0 gain taken into account from marking the security to market under section 475 and the recomputed \$30 gain that would be taken into account. The character of S's gain and B's gain are redetermined as if the security were transferred between divisions. Accordingly, S's gain is ordinary income under section 475(d)(3)(A)(i), but under section 475(d)(3)(B)(ii) B's \$10 gain from its sale to X is capital gain that is taken into account in Year 2.

(d) *Nondealer to dealer.* The facts are the same as in paragraph (a) of this Example 11, except that S is not a dealer and holds the security for investment with a \$70 basis. B is a dealer to which section 475 applies and, immediately after acquiring the security from S for \$100, B holds the security for sale to customers in the ordinary course of its trade or business. Because S is not a dealer and held the security for investment, the security is treated as properly identified as held for investment under section 475(b)(1) until it is sold to B. Under section 475(b)(3), the security thereafter ceases to be described in section 475(b)(1) because B holds the security for sale to customers. The mark-to-market requirement applies only to changes in the value of the security after B's acquisition. B's mark-to-market gain taken into account and the recomputed mark-to-market gain are both determined based on changes from the \$100 value of the security at the time of B's acquisition. There is no difference between B's \$0 mark-to-market gain taken into account in Year 1 and the \$0 recomputed mark-to-market gain. Therefore, none of S's gain is taken into account in Year 1 as a result of B's marking the security to market in Year 1. In Year 2, B has a \$10 gain when it disposes of the security by selling it to X, but would have had a \$40 gain if S and B were divisions of a single corporation. Thus, S takes its \$30 gain into account in Year 2

under the matching rule. Under section 475(d)(3), S's gain is capital gain even though B's subsequent gain or loss from marking to market or disposing of the security is ordinary gain or loss. If B disposes of the security at a \$10 loss in Year 2, S's gain taken into account in Year 2 is still capital because on a single entity basis section 475(d)(3) would provide for \$30 of capital gain and \$10 of ordinary loss. Because the attributes are not redetermined under paragraph (c)(1)(i) of this section, paragraph (c)(4)(i) of this section does not apply. Furthermore, if B held the security for investment, and so identified the security under section 475(b)(1), the security would continue to be excepted from marking to market.

*Example 12. Section 1092.* (a) *Facts.* On July 1 of Year 1, S enters into offsetting long and short positions with respect to actively traded personal property. The positions are not section 1256 contracts, and they are the only positions taken into account for purposes of applying section 1092. On August 1 of Year 1, S sells the long position to B at an \$11 loss, and there is \$11 of unrealized gain in the offsetting short position. On December 1 of Year 1, B sells the long position to X at no gain or loss. On December 31 of Year 1, there is still \$11 of unrealized gain in the short position. On February 1 of Year 2, S closes the short position at an \$11 gain.

(b) *Timing and attributes.* If the sale from S to B were a transfer between divisions of a single corporation, the \$11 loss on the sale to X would have been deferred under section 1092(a)(1)(A). Accordingly, there is no difference in Year 1 between B's corresponding item of \$0 and the recomputed corresponding item of \$0. S takes its \$11 loss into account in Year 2 to reflect the difference between B's corresponding item of \$0 taken into account in Year 2 and the recomputed loss of \$11 that would have been taken into account in Year 2 under section 1092(a)(1)(B) if S and B had been divisions of a single corporation. (The results are the same under section 267(f)).

*Example 13.* [Reserved]

*Example 14. Source of income under section 863.* (a) *Intercompany sale with no independent factory price.* S manufactures inventory in the United States, and recognizes \$75 of income on sales to B in Year 1. B distributes the inventory in Country Y and recognizes \$25 of income on sales to X, also in Year 1. Title passes from S to B, and from B to X, in Country Y. There is no independent factory price (as defined in regulations under section 863) for the sale from S to B. Under the matching rule, S's \$75 intercompany income and B's \$25 corresponding income are taken into account in Year 1. In determining the source of income, S and B are treated as divisions of a single corporation, and section 863 applies as if \$100 of income were recognized

from producing in the United States and selling in Country Y. Assume that applying the section 863 regulations on a single entity basis, \$50 is treated as foreign source income and \$50 as U.S. source income. Assume further that on a separate entity basis, S would have \$37.50 of foreign source income and \$37.50 of U.S. source income, and that all of B's \$25 of income would be foreign source income. Thus, on a separate entity basis, S and B would have \$62.50 of combined foreign source income and \$37.50 of U.S. source income. Accordingly, under single entity treatment, \$12.50 that would be treated as foreign source income on a separate entity basis is redetermined to be U.S. source income. Under paragraph (c)(1)(i) of this section, attributes are redetermined only to the extent of the \$12.50 necessary to achieve the same effect as a single entity determination. Under paragraph (c)(4)(ii) of this section, the redetermined attribute must be allocated between S and B using a reasonable method. For example, it may be reasonable to re-characterize only S's foreign source income as U.S. source income because only S would have any U.S. source income on a separate entity basis. However, it may also be reasonable to allocate the redetermined attribute between S and B in proportion to their separate entity amounts of foreign source income (in a 3:2 ratio, so that \$7.50 of S's foreign source income is redetermined to be U.S. source and \$5 of B's foreign source income is redetermined to be U.S. source), provided the same method is applied to all similar transactions within the group.

(b) *Intercompany sale with independent factory price.* The facts are the same as in paragraph (a) of this Example 14, except that an independent factory price exists for the sale by S to B such that \$70 of S's \$75 of income is attributable to the production function. Assume that on a single entity basis, \$70 is treated as U.S. source income (because of the existence of the independent factory price) and \$30 is treated as foreign source income. Assume that on a separate entity basis, \$70 of S's income would be treated as U.S. source, \$5 of S's income would be treated as foreign source income, and all of B's \$25 income would be treated as foreign source income. Because the results are the same on a single entity basis and a separate entity basis, the attributes are not redetermined under paragraph (c)(1)(i) of this section.

(c) *Sale of property reflecting intercompany services or intangibles.* S earns \$10 of income performing services in the United States for B. B capitalizes S's fees into the basis of property that it manufactures in the United States and sells to an unrelated person in Year 1 at a \$90 profit, with title passing in Country Y. Under the matching rule, S's \$10 income and B's \$90 income are taken into account in Year 1. In determining the source of income, S and B are treated as divisions of a

single corporation, and section 863 applies as if \$100 were earned from manufacturing in the United States and selling in Country Y. Assume that on a single entity basis \$50 is treated as foreign source income and \$50 is treated as U.S. source income. Assume that on a separate entity basis, S would have \$10 of U.S. source income, and B would have \$45 of foreign source income and \$45 of U.S. source income. Accordingly, under single entity treatment, \$5 of income that would be treated as U.S. source income on a separate entity basis is redetermined to be foreign source income. Under paragraph (c)(1)(i) of this section, attributes are redetermined only to the extent of the \$5 necessary to achieve the same effect as a single entity determination. Under paragraph (c)(4)(ii) of this section, the redetermined attribute must be allocated between S and B using a reasonable method. (If instead of performing services, S licensed an intangible to B and earned \$10 that would be treated as U.S. source income on a separate entity basis, the results would be the same.)

*Example 15, Section 1248.* (a) *Facts.* On January 1 of Year 1, S forms FT, a wholly owned foreign subsidiary, with a \$10 contribution. During Years 1 through 3, FT has earnings and profits of \$40. None of the earnings and profits is taxed as subpart F income under section 951, and FT distributes no dividends to S during this period. On January 1 of Year 4, S sells its FT stock to B for \$50. While B owns FT, FT has a deficit in earnings and profits of \$10. On July 1 of Year 6, B sells its FT stock for \$70 to X, an unrelated foreign corporation.

(b) *Timing.* S's \$40 of intercompany gain is taken into account in Year 6 to reflect the difference between B's \$20 of gain taken into account and the \$60 recomputed gain.

(c) *Attributes.* Under the matching rule, the attributes of S's intercompany gain and B's corresponding gain are redetermined to have the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation. On a single entity basis, there is \$60 of gain and the portion which is characterized as a dividend under section 1248 is determined on the basis of FT's \$30 of earnings and profits at the time of the sale of FT to X (the sum of FT's \$40 of earnings and profits while held by S and FT's \$10 deficit in earnings and profits while held by B). Therefore, \$30 of the \$60 gain is treated as a dividend under section 1248. The remaining \$30 is treated as capital gain. On a separate entity basis, all of S's \$40 gain would be treated as a dividend under section 1248 and all of B's \$20 gain would be treated as capital gain. Thus, as a result of the single entity determination, \$10 that would be treated as a dividend under

section 1248 on a separate entity basis is redetermined to be capital gain. Under paragraph (c)(4)(ii) of this section, this redetermined attribute must be allocated between S's intercompany item and B's corresponding item by using a reasonable method. On a separate entity basis, only S would have any amount treated as a dividend under section 1248 available for redetermination. Accordingly, \$10 of S's income is redetermined to be not subject to section 1248, with the result that \$30 of S's intercompany gain is treated as a dividend and the remaining \$10 is treated as capital gain. All of B's corresponding gain is treated as capital gain, as it would be on a separate entity basis.

(d) *B has loss.* The facts are the same as in paragraph (a) of this *Example 15*, except that FT has no earnings and profits or deficit in earnings and profits while B owns FT, and B sells the FT stock to X for \$40. On a single entity basis, there is \$30 of gain, and section 1248 is applied on the basis of FT's \$40 earnings and profits at the time of the sale of FT to X. Under section 1248, the amount treated as a dividend is limited to \$30 (the amount of the gain). On a separate entity basis, S's entire \$40 gain would be treated as a dividend under section 1248, and B's \$10 loss would be a capital loss. B's \$10 corresponding loss offsets \$10 of S's intercompany gain and, under paragraph (c)(4)(i) of this section, the attributes of B's corresponding item control. Accordingly, \$10 of S's gain must be redetermined to be capital gain. B's \$10 loss remains a capital loss. (If, however, S sold FT to B at a loss and B sold FT to X at a gain, it may be unreasonable for the attributes of B's corresponding gain to control S's offsetting intercompany loss. If B's attributes were to control, for example, the group could possibly claim a larger foreign tax credit than would be available if S and B were divisions of a single corporation.)

*Example 16. Intercompany stock distribution followed by section 332 liquidation.* (a) *Facts.* P owns all of the stock of S, S owns all the stock of T, a member of the P group, and T owns all of the stock of T1, also a member of the P group. On January 1 of Year 1, S distributes all of the T stock to P in a distribution to which section 301 applies. At the time of this distribution, the value of the T stock is \$100 and S has a \$40 basis in the T stock. Under section 311(b), the distribution creates \$60 of intercompany gain to S. Under section 301(d), P's basis in the T stock is \$100. S will take its \$60 intercompany gain into account under the matching rule. On January 1 of Year 4, in an independent transaction, S distributes all of its assets to P in a complete liquidation to which section 332 applies, and, under paragraph (j)(2) of this section, P succeeds to S's \$60 gain. On January 1 of Year 7, T distributes all of its T1 stock to P in a transaction to which section 355 applies. At the time of this distribution, P has a basis in

the T stock of \$100, the value of the T stock (without regard to T1) is \$75, and the value of the T1 stock is \$25. Under section 358, P allocates \$25 of its \$100 basis in the T stock to the T1 stock, and, under paragraph (j)(1) of this section, the T1 stock becomes a successor asset to the T stock. On January 1 of Year 9, in an independent transaction, T distributes all of its assets to P in a complete liquidation to which section 332 applies.

(b) *Analysis.* Under paragraphs (b)(1) and (f)(2) of this section, S's distribution in Year 1 of the T stock to P is an intercompany transaction, S is the selling member, and P is the buying member. In Year 9 when T liquidates, P has no gain or loss under section 332. Under paragraph (b)(3)(ii) of this section, P's \$0 gain or loss with respect to the T stock under section 332 is a corresponding item. P takes \$45 ( $75/100 \times \$60$ ) of its intercompany gain into account under the matching rule in Year 9 to reflect the difference between P's \$0 of unrecognized gain and P's \$45 of recomputed unrecognized gain. (If P and S were divisions of a single corporation, P would have had a \$40 basis in the T stock, and, after the Year 7 distribution of the T1 stock, would have held the T stock with a \$30 basis.) However, paragraph (c)(6) of this section does not prevent the redetermination of P's intercompany gain as excluded from gross income provided P succeeds to S's intercompany item; P and S are a single entity; P's basis in the T stock that reflects the \$45 intercompany gain taken into account is eliminated without the recognition of gain or loss (and this eliminated basis is not further reflected in the basis of any successor asset); the group has not derived and no taxpayer will derive any Federal income tax benefit from the basis in the T stock and will not derive any Federal income tax benefit from a redetermination of this portion of the gain; and the effects of the intercompany transaction have not previously been reflected, directly or indirectly, on the P group's consolidated return. (See paragraph (c)(6)(ii)(C) of this section.) Accordingly, under paragraph (c)(6)(ii)(C) of this section, the \$45 intercompany gain that P takes into account is redetermined to be excluded from gross income. P's basis in its T1 stock continues to reflect \$15 of intercompany gain.

*Example 17. Intercompany stock sale followed by section 355 distribution.* (a) *Facts.* The facts are the same as *Example 16*, except that T does not distribute the stock of T1, instead, in Year 7, T makes a distribution of \$50 to P in a transaction to which section 301 applies. Under § 1.1502-32, P's basis in its T stock is reduced by \$50 and, under paragraph (f)(2)(ii) of this section, the intercompany distribution is excluded from P's gross income. Further, in Year 9, instead of liquidating T, P distributes the T stock to its shareholders in a transaction to which section 355 applies.



(b) *Analysis.* On the distribution of the T stock in Year 9, P has \$0 of unrecognized gain under section 355(c). Under paragraph (b)(3)(ii) of this section, P's \$0 of unrecognized gain or loss with respect to the T stock under section 355(c) is a corresponding item. P takes its \$60 intercompany gain into account under the matching rule in Year 9 to reflect the difference between P's \$0 of unrecognized gain and P's \$60 of recomputed gain (\$50 unrecognized gain and \$10 recognized gain). (If P and S were divisions of a single corporation, P would have had a \$40 basis in the T stock, and, after the Year 7 distribution, would have held the T stock with a \$10 excess loss account.) See paragraph (f)(7), *Example 2* of this section. Paragraph (c)(6) of this section does not prevent the redetermination of P's intercompany gain as excluded from gross income provided P succeeds to S's intercompany item; P and S are a single entity; P's basis in the T stock that reflects the \$60 intercompany gain taken into account is eliminated without the recognition of gain or loss (and this eliminated basis is not further reflected in any successor asset); the group has not derived any Federal income tax benefit from the basis in the T stock and will not derive any Federal income tax benefit from a redetermination of this portion of the gain; and the effects of the intercompany transaction have not previously been reflected, directly or indirectly, on the P group's consolidated return. (See paragraph (c)(6)(ii)(C) of this section.) The intercompany transaction with respect to the T stock resulted in an increase in the basis of the T stock, and this increase in the basis of the T stock prevented P from holding the T stock with a \$10 excess loss account (as a result of the Year 7 distribution) at the time of the section 355 distribution. Accordingly, the group derived a Federal income tax benefit from the intercompany transaction to the extent of \$10 and, under paragraph (c)(6)(ii)(C) of this section, only \$50 of the \$60 intercompany gain that P takes into account is redetermined to be excluded from gross income.

(c) *Application of section 355(e).* If it were determined that section 355(e) applied to P's distribution of the T stock, P would recognize \$0 of gain and derive a Federal income tax benefit to the extent of the full \$60 increase in the basis of the T stock. Therefore, no portion of P's intercompany gain would be redetermined to be excluded from gross income under paragraph (c)(6)(ii)(C) of this section.

(iii) *Effective/applicability date—(A) In general.* Paragraphs (c)(6)(ii)(C), (c)(6)(ii)(D), and (c)(7)(ii), *Examples 16* and *17* of this section apply with respect to items taken into account on or after March 4, 2011.

(B) *Prior periods.* For items taken into account on or after March 7, 2008, and before March 4, 2011, see § 1.1502-13T(c)(6)(ii)(C) and (f)(7), *Examples 7* and *8* as contained in 26 CFR part 1 in effect on April 1, 2009. For items taken into account before March 7, 2008, see § 1.1502-13 as contained in 26 CFR part 1 in effect on April 1, 2007.

(d) *Acceleration rule.* S's intercompany items and B's corresponding items are taken into account under this paragraph (d) to the extent they cannot be taken into account to produce the effect of treating S and B as divisions of a single corporation. For this purpose, the following rules apply:

(1) *S's items—(i) Timing.* S takes its intercompany items into account to the extent they cannot be taken into account to produce the effect of treating S and B as divisions of a single corporation. The items are taken into account immediately before it first becomes impossible to achieve this effect. For this purpose, the effect cannot be achieved—

(A) To the extent an intercompany item or corresponding item will not be taken into account in determining the group's consolidated taxable income (or consolidated tax liability) under the matching rule (for example, if S or B becomes a nonmember, or if S's intercompany item is no longer reflected in the difference between B's basis (or an amount equivalent to basis) in property and the basis (or equivalent amount) the property would have if S and B were divisions of a single corporation); or

(B) To the extent a nonmember reflects, directly or indirectly, any aspect of the intercompany transaction (e.g., if B's cost basis in property purchased from S is reflected by a nonmember under section 362 following a section 351 transaction).

(ii) *Attributes.* The attributes of S's intercompany items taken into account under this paragraph (d)(1) are determined as follows:

(A) *Sale, exchange, or distribution.* If the item is from an intercompany sale, exchange, or distribution of property, its attributes are determined under the principles of the matching rule as if B sold the property, at the time the item is taken into account under paragraph

(d)(1)(i) of this section, for a cash payment equal to B's adjusted basis in the property (i.e., at no net gain or loss), to the following person:

(1) *Property leaves the group.* If the property is owned by a nonmember immediately after S's item is taken into account, B is treated as selling the property to that nonmember. If the nonmember is related for purposes of any provision of the Internal Revenue Code or regulations to any party to the intercompany transaction (or any related transaction) or to the common parent, the nonmember is treated as related to B for purposes of that provision. For example, if the nonmember is related to P within the meaning of section 1239(b), the deemed sale is treated as being described in section 1239(a). See paragraph (j)(6) of this section, under which property is not treated as being owned by a nonmember if it is owned by the common parent after the common parent becomes the only remaining member.

(2) *Property does not leave the group.* If the property is not owned by a nonmember immediately after S's item is taken into account, B is treated as selling the property to an affiliated corporation that is not a member of the group.

(B) *Other transactions.* If the item is from an intercompany transaction other than a sale, exchange, or distribution of property (e.g., income from S's services capitalized by B), its attributes are determined on a separate entity basis.

(2) *B's items*—(i) *Attributes.* The attributes of B's corresponding items continue to be redetermined under the principles of the matching rule, with the following adjustments:

(A) If S and B continue to join with each other in the filing of consolidated returns, the attributes of B's corresponding items (and any applicable holding periods) are determined by continuing to treat S and B as divisions of a single corporation.

(B) Once S and B no longer join with each other in the filing of consolidated returns, the attributes of B's corresponding items are determined as if the S division (but not the B division) were transferred by the single corporation to an unrelated person. Thus, S's

activities (and any applicable holding period) before the intercompany transaction continue to affect the attributes of the corresponding items (and any applicable holding period).

(ii) *Timing.* If paragraph (d)(1) of this section applies to S, B nevertheless continues to take its corresponding items into account under its accounting method. However, the redetermination of the attributes of a corresponding item under this paragraph (d)(2) might affect its timing.

(3) *Examples.* The acceleration rule of this paragraph (d) is illustrated by the following examples.

*Example 1. Becoming a nonmember—timing.*

(a) *Facts.* S owns land with a basis of \$70. On January 1 of Year 1, S sells the land to B for \$100. On July 1 of Year 3, P sells 60% of S's stock to X for \$60 and, as a result, S becomes a nonmember.

(b) *Matching rule.* Under the matching rule, none of S's \$30 gain is taken into account in Years 1 through 3 because there is no difference between B's \$0 gain or loss taken into account and the recomputed gain or loss.

(c) *Acceleration of S's intercompany items.* Under the acceleration rule of paragraph (d) of this section, S's \$30 gain is taken into account in computing consolidated taxable income (and consolidated tax liability) immediately before the effect of treating S and B as divisions of a single corporation cannot be produced. Because the effect cannot be produced once S becomes a nonmember, S takes its \$30 gain into account in Year 3 immediately before becoming a nonmember. S's gain is reflected under § 1.1502-32 in P's basis in the S stock immediately before P's sale of the stock. Under § 1.1502-32, P's basis in the S stock is increased by \$30, and therefore P's gain is reduced (or loss is increased) by \$18 (60% of \$30). See also §§ 1.1502-33 and 1.1502-76(b). (The results would be the same if S sold the land to B in an installment sale to which section 453 would otherwise apply, because S must take its intercompany gain into account under this section.)

(d) *B's corresponding items.* Notwithstanding the acceleration of S's gain, B continues to take its corresponding items into account under its accounting method. Thus, B's items from the land are taken into account based on subsequent events (e.g., its sale of the land).

(e) *Sale of B's stock.* The facts are the same as in paragraph (a) of this *Example 1*, except that P sells 60% of B's stock (rather than S stock) to X for \$60 and, as a result, B becomes a nonmember. Because the effect of treating S and B as divisions of a single corporation cannot be produced once B becomes

a nonmember, S takes its \$30 gain into account under the acceleration rule immediately before B becomes a nonmember. (The results would be the same if S sold the land to B in an installment sale to which section 453 would otherwise apply, because S must take its intercompany gain into account under this section.)

(f) *Discontinue filing consolidated returns.* The facts are the same as in paragraph (a) of this *Example 1*, except that the P group receives permission under § 1.1502-75(c) to discontinue filing consolidated returns beginning in Year 3. Under the acceleration rule, S takes its \$30 gain into account on December 31 of Year 2.

(g) *No subgroups.* The facts are the same as in paragraph (a) of this *Example 1*, except that P simultaneously sells all of the stock of both S and B to X (rather than 60% of S's stock), and S and B become members of the X consolidated group. Because the effect of treating S and B as divisions of a single corporation in the P group cannot be produced once S and B become nonmembers, S takes its \$30 gain into account under the acceleration rule immediately before S and B become nonmembers. (Paragraph (j)(5) of this section does not apply to treat the X consolidated group as succeeding to the P group because the X group acquired only the stock of S and B.) However, so long as S and B continue to join with each other in the filing of consolidated returns, B continues to treat S and B as divisions of a single corporation for purposes of determining the attributes of B's corresponding items from the land.

*Example 2. Becoming a nonmember—attributes.* (a) *Facts.* S holds land for investment with a basis of \$70. On January 1 of Year 1, S sells the land to B for \$100. B holds the land for sale to customers in the ordinary course of business, and expends substantial resources over a two-year period subdividing, developing, and marketing the land. On July 1 of Year 3, before B has sold any of the land, P sells 60% of S's stock to X for \$60 and, as a result, S becomes a nonmember.

(b) *Attributes.* Under the acceleration rule, the attributes of S's gain are redetermined under the principles of the matching rule as if B sold the land to an affiliated corporation that is not a member of the group for a cash payment equal to B's adjusted basis in the land (because the land continues to be held within the group). Thus, whether S's gain is capital gain or ordinary income depends on the activities of both S and B. Because S and B no longer join with each other in the filing of consolidated returns, the attributes of B's corresponding items (e.g., from its subsequent sale of the land) are redetermined under the principles of the matching rule as if the S division (but not the B division) were transferred by the single corporation to an unrelated person at the time of P's sale of

the S stock. Thus, B continues to take into account the activities of S with respect to the land before the intercompany transaction.

(c) *Depreciable property.* The facts are the same as in paragraph (a) of this *Example 2*, except that the property sold by S to B is depreciable property. Section 1239 applies to treat all of S's gain as ordinary income because it is taken into account as a result of B's deemed sale of the property to an affiliated corporation that is not a member of the group (a related person within the meaning of section 1239(b)).

*Example 3. Selling member's disposition of installment note.* (a) *Facts.* S owns land with a basis of \$70. On January 1 of Year 1, S sells the land to B in exchange for B's \$110 note. The note bears a market rate of interest in excess of the applicable Federal rate, and provides for principal payments of \$55 in Year 4 and \$55 in Year 5. On July 1 of Year 3, S sells B's note to X for \$110.

(b) *Timing.* S's intercompany gain is taken into account under this section, and not under the rules of section 453. Consequently, S's sale of B's note does not result in its intercompany gain from the land being taken into account (e.g., under section 453B). The sale does not prevent S's intercompany items and B's corresponding items from being taken into account in determining the group's consolidated taxable income under the matching rule, and X does not reflect any aspect of the intercompany transaction (X has its own cost basis in the note). S will take the intercompany gain into account under the matching rule or acceleration rule based on subsequent events (e.g., B's sale of the land). See also paragraph (g) of this section for additional rules applicable to B's note as an intercompany obligation.

*Example 4. Cancellation of debt and attribute reduction under section 108(b).* (a) *Facts.* S holds land for investment with a basis of \$0. On January 1 of Year 1, S sells the land to B for \$100. B also holds the land for investment. During Year 3, B is insolvent and B's nonmember creditors discharge \$60 of B's indebtedness. Because of insolvency, B's \$60 discharge is excluded from B's gross income under section 108(a), and B reduces the basis of the land by \$60 under sections 108(b) and 1017.

(b) *Acceleration rule.* As a result of B's basis reduction under section 1017, \$60 of S's intercompany gain will not be taken into account under the matching rule (because there is only a \$40 difference between B's \$40 basis in the land and the \$0 basis the land would have if S and B were divisions of a single corporation). Accordingly, S takes \$60 of its gain into account under the acceleration rule in Year 3. S's gain is long-term capital gain, determined under paragraph (d)(1)(ii) of this section as if B sold the land to an affiliated corporation that is not a member of the

group for \$100 immediately before the basis reduction.

(c) *Purchase price adjustment.* Assume instead that S sells the land to B in exchange for B's \$100 purchase money note, B remains solvent, and S subsequently agrees to discharge \$60 of the note as a purchase price adjustment to which section 108(e)(5) applies. Under applicable principles of tax law, \$60 of S's gain and \$60 of B's basis in the land are eliminated and never taken into account. Similarly, the note is not treated as satisfied and reissued under paragraph (g) of this section.

*Example 5. Section 481.* (a) *Facts.* S operates several trades or businesses, including a manufacturing business. S receives permission to change its method of accounting for valuing inventory for its manufacturing business. S increases the basis of its ending inventory by \$100, and the related \$100 positive section 481(a) adjustment is to be taken into account ratably over six taxable years, beginning in Year 1. During Year 3, S sells all of the assets used in its manufacturing business to B at a gain. Immediately after the transfer, B does not use the same inventory valuation method as S. On a separate entity basis, S's sale results in an acceleration of the balance of the section 481(a) adjustment to Year 3.

(b) *Timing and attributes.* Under paragraph (b)(2) of this section, the balance of S's section 481(a) adjustment accelerated to Year 3 is intercompany income. However, S's \$100 basis increase before the intercompany transaction eliminates the related difference for this amount between B's corresponding items taken into account and the recomputed corresponding items in subsequent periods. Because the accelerated section 481(a) adjustment will not be taken into account in determining the group's consolidated taxable income (and consolidated tax liability) under the matching rule, the balance of S's section 481 adjustment is taken into account under the acceleration rule as ordinary income at the time of the intercompany transaction. (If S's sale had not resulted in accelerating S's section 481(a) adjustment on a separate entity basis, S would have no intercompany income to be taken into account under this section.)

(e) *Simplifying rules—(1) Dollar-value LIFO inventory methods—(i) In general.* This paragraph (e)(1) applies if either S or B uses a dollar-value LIFO inventory method to account for intercompany transactions. Rather than applying the matching rule separately to each intercompany inventory transaction, this paragraph (e)(1) provides methods to apply an aggregate approach that is based on dollar-value LIFO inventory accounting. Any meth-

od selected under this paragraph (e)(1) must be applied consistently.

(ii) *B uses dollar-value LIFO—(A) In general.* If B uses a dollar-value LIFO inventory method to account for its intercompany inventory purchases, and includes all of its inventory costs incurred for a year in its cost of goods sold for the year (that is, B has no inventory increment for the year), S takes into account all of its intercompany inventory items for the year. If B does not include all of its inventory costs incurred for the year in its cost of goods sold for the year (that is, B has an inventory increment for the year), S does not take all of its intercompany inventory income or loss into account. The amount not taken into account is determined under either the increment averaging method of paragraph (e)(1)(ii)(B) of this section or the increment valuation method of paragraph (e)(1)(ii)(C) of this section. Separate computations are made for each pool of B that receives intercompany purchases from S, and S's amount not taken into account is layered based on B's LIFO inventory layers.

(B) *Increment averaging method.* Under this paragraph (e)(1)(ii)(B), the amount not taken into account is the amount of S's intercompany inventory income or loss multiplied by the ratio of the LIFO value of B's current-year costs of its layer of increment to B's total inventory costs incurred for the year under its LIFO inventory method. If B includes more than its inventory costs incurred during any subsequent year in its cost of goods sold (a decrement), S takes into account the intercompany inventory income or loss layers in the same manner and proportion as B takes into account its inventory decrements.

(C) *Increment valuation method.* Under this paragraph (e)(1)(ii)(C), the amount not taken into account is the amount of S's intercompany inventory income or loss for the appropriate period multiplied by the ratio of the LIFO value of B's current-year costs of its layer of increment to B's total inventory costs incurred in the appropriate period under its LIFO inventory method. The principles of paragraph (e)(1)(ii)(B) of this section otherwise apply. The appropriate period is the period of B's

year used to determine its current-year costs.

(iii) *S uses dollar-value LIFO.* If S uses a dollar-value LIFO inventory method to account for its intercompany inventory sales, S may use any reasonable method of allocating its LIFO inventory costs to intercompany transactions. LIFO inventory costs include costs of prior layers if a decrement occurs. For example, a reasonable allocation of the most recent costs incurred during the consolidated return year can be used to compute S's intercompany inventory income or loss for the year if S has an inventory increment and uses the earliest acquisitions costs method, but S must apportion costs from the most recent appropriate layers of increment if an inventory decrement occurs for the year.

(iv) *Other reasonable methods.* S or B may use a method not specifically provided in this paragraph (e)(1) that is expected to reasonably take into account intercompany items and corresponding items from intercompany inventory transactions. However, if the method used results, for any year, in a cumulative amount of intercompany inventory items not taken into account by S that significantly exceeds the cumulative amount that would not be taken into account under paragraph (e)(1)(ii) or (iii) of this section, S must take into account for that year the amount necessary to eliminate the excess. The method is thereafter applied with appropriate adjustments to reflect the amount taken into account.

(v) *Examples.* The inventory rules of this paragraph (e)(1) are illustrated by the following examples.

*Example 1. Increment averaging method.* (a) *Facts.* Both S and B use a double-extension, dollar-value LIFO inventory method, and both value inventory increments using the earliest acquisitions cost valuation method. During Year 2, S sells 25 units of product Q to B on January 15 at \$10/unit. S sells another 25 units on April 15, on July 15, and on September 15, at \$12/unit. S's earliest cost of product Q is \$7.50/unit and S's most recent cost of product Q is \$8.00/unit. Both S and B have an inventory increment for the year. B's total inventory costs incurred during Year 2 are \$6,000 and the LIFO value of B's Year 2 layer of increment is \$600.

(b) *Intercompany inventory income.* Under paragraph (e)(1)(iii) of this section, S must use a reasonable method of allocating its

LIFO inventory costs to intercompany transactions. Because S has an inventory increment for Year 2 and uses the earliest acquisitions cost method, a reasonable method of determining its intercompany cost of goods sold for product Q is to use its most recent costs. Thus, its intercompany cost of goods sold is \$800 (\$8.00 most recent cost, multiplied by 100 units sold to B), and its intercompany inventory income is \$350 (\$1,150 sales proceeds from B minus \$800 cost).

(c) *Timing.* (i) Under the increment averaging method of paragraph (e)(1)(ii)(B) of this section, \$35 of S's \$350 of intercompany inventory income is not taken into account in Year 2, computed as follows:

$$\frac{\text{LIFO value of B's Year 2 layer of increment}}{\text{B's total inventory costs for Year 2}} = \frac{\$600}{\$6,000} = 10\%$$

$$10\% \times \text{S's \$350 intercompany inventory income} = \$35$$

(ii) Thus, \$315 of S's intercompany inventory income is taken into account in Year 2 (\$350 of total intercompany inventory income minus \$35 not taken into account).

(d) *S incurs a decrement.* The facts are the same as in paragraph (a) of this *Example 1*, except that in Year 2, S incurs a decrement equal to 50% of its Year 1 layer. Under paragraph (e)(1)(iii) of this section, S must reasonably allocate the LIFO cost of the decrement to the cost of goods sold to B to determine S's intercompany inventory income.

(e) *B incurs a decrement.* The facts are the same as in paragraph (a) of this *Example 1*, except that B incurs a decrement in Year 2. S must take into account the entire \$350 of Year 2 intercompany inventory income because all 100 units of product Q are deemed sold by B in Year 2.

*Example 2. Increment valuation method.* (a) The facts are the same as in *Example 1*. In addition, B's use of the earliest acquisition's cost method of valuing its increments results in B valuing its year-end inventory using costs incurred from January through March; \$1,428 in the period January through March; \$1,498 in the period April through June; \$1,524 in the period July through September; and \$1,550 in the period October through December. S's intercompany inventory income for these periods is: \$50 in the period January through March ((25 × \$10) - (25 × \$8)); \$100 in the period April through June ((25 × \$12) - (25 × \$8)); \$100 in the period July through September ((25 × \$12) - (25 × \$8)); and \$100 in the period October through December ((25 × \$12) - (25 × \$8)).

(b) *Timing.* (i) Under the increment valuation method of paragraph (e)(1)(ii)(C) of this section, \$21 of S's \$350 of intercompany in-

ventory income is not taken into account in Year 2, computed as follows:

$$\frac{\text{LIFO value of B's Year 2 layer of increment}}{\text{B's total inventory costs from January through March of Year 2}} = \frac{\$600}{\$1,428} = 42\%$$

$$42\% \times \text{S's \$50 intercompany inventory income for the period from January through March} = \$21$$

(ii) Thus, \$329 of S's intercompany inventory income is taken into account in Year 2 (\$350 of total intercompany inventory income minus \$21 not taken into account).

(c) *B incurs a subsequent decrement.* The facts are the same as in paragraph (a) of this Example 2. In addition, assume that in Year 3, B experiences a decrement in its pool that receives intercompany purchases from S. B's decrement equals 20% of the base-year costs for its Year 2 layer. The fact that B has incurred a decrement means that all of its inventory costs incurred for Year 3 are included in cost of goods sold. As a result, S takes into account its entire amount of intercompany inventory income from its Year 3 sales. In addition, S takes into account \$4.20 of its Year 2 layer of intercompany inventory income not already taken into account (20% of \$21).

*Example 3. Other reasonable inventory methods.* (a) *Facts.* Both S and B use a dollar-value LIFO inventory method for their inventory transactions. During Year 1, S sells inventory to B and to X. Under paragraph (e)(1)(iv) of this section, to compute its intercompany inventory income and the amount of this income not taken into account, S computes its intercompany inventory income using the transfer price of the inventory items less a FIFO cost for the goods, takes into account these items based on a FIFO cost flow assumption for B's corresponding items, and the LIFO methods used by S and B are ignored for these computations. These computations are comparable to the methods used by S and B for financial reporting purposes, and the book methods and results are used for tax purposes. S adjusts the amount of intercompany inventory items not taken into account as required by section 263A.

(b) *Reasonable method.* The method used by S is a reasonable method under paragraph (e)(1)(iv) of this section if the cumulative amount of intercompany inventory items

not taken into account by S is not significantly greater than the cumulative amount that would not be taken into account under the methods specifically described in paragraph (e)(1) of this section. If, for any year, the method results in a cumulative amount of intercompany inventory items not taken into account by S that significantly exceeds the cumulative amount that would not be taken into account under the methods specifically provided, S must take into account for that year the amount necessary to eliminate the excess. The method is thereafter applied with appropriate adjustments to reflect the amount taken into account (e.g., to prevent the amount from being taken into account more than once).

(2) *Reserve accounting*—(i) *Banks and thrifts.* Except as provided in paragraph (g)(4)(v) of this section (deferral of items from an intercompany obligation), a member's addition to, or reduction of, a reserve for bad debts that is maintained under section 585 is taken into account on a separate entity basis. For example, if S makes a loan to a nonmember and subsequently sells the loan to B, any deduction for an addition to a bad debt reserve under section 585 and any recapture income (or reduced bad debt deductions) are taken into account on a separate entity basis rather than as intercompany items or corresponding items taken into account under this section. Any gain or loss of S from its sale of the loan to B is taken into account under this section, however, to the extent it is not attributable to recapture of the reserve.

(ii) *Insurance companies*—(A) *Direct insurance*. If a member provides insurance to another member in an intercompany transaction, the transaction is taken into account by both members on a separate entity basis. For example, if one member provides life insurance coverage for another member with respect to its employees, the premiums, reserve increases and decreases, and death benefit payments are determined and taken into account by both members on a separate entity basis rather than taken into account under this section as intercompany items and corresponding items.

(B) *Reinsurance*—(1) *In general*. Paragraph (e)(2)(ii)(A) of this section does not apply to a reinsurance transaction that is an intercompany transaction. For example, if a member assumes all or a portion of the risk on an insurance contract written by another member, the amounts transferred as reinsurance premiums, expense allowances, benefit reimbursements, reimbursed policyholder dividends, experience rating adjustments, and other similar items are taken into account under the matching rule and the acceleration rule. For purposes of this section, the assuming company is treated as B and the ceding company is treated as S.

(2) *Reserves determined on a separate entity basis*. For purposes of determining the amount of a member's increase or decrease in reserves, the amount of any reserve item listed in section 807(c) or 832(b)(5) resulting from a reinsurance transaction that is an intercompany transaction is determined on a separate entity basis. But see section 845, under which the Commissioner may allocate between or among the members any items, recharacterize any such items, or make any other adjustments necessary to reflect the proper source and character of the separate taxable income of a member.

(3) *Consent to treat intercompany transactions on a separate entity basis*—(i) *General rule*. The common parent may request consent to take into account on a separate entity basis items from intercompany transactions other than intercompany transactions with respect to stock or obligations of members. Consent may be granted for all

items, or for items from a class or classes of transactions. The consent is effective only if granted in writing by the Internal Revenue Service. Unless revoked with the written consent of the Internal Revenue Service, the separate entity treatment applies to all affected intercompany transactions in the consolidated return year for which consent is granted and in all subsequent consolidated return years. Consent under this paragraph (e)(3) does not apply for purposes of taking into account losses and deductions deferred under section 267(f).

(ii) *Time and manner for requesting consent*. The request for consent described in paragraph (e)(3)(i) of this section must be made in the form of a ruling request. The request must be signed by the common parent, include any information required by the Internal Revenue Service, and be filed on or before the due date of the consolidated return (not including extensions of time) for the first consolidated return year to which the consent is to apply. The Internal Revenue Service may impose terms and conditions for granting consent. A copy of the consent must be attached to the group's consolidated returns (or amended returns) as required by the terms of the consent.

(iii) *Effect of consent on methods of accounting*. A consent for separate entity accounting under this paragraph (e)(3), and a revocation of that consent, may require changes in members' methods of accounting for intercompany transactions. Because the consent, or a revocation of the consent, is effective for all intercompany transactions occurring in the consolidated return year for which the consent or revocation is first effective, any change in method is effected on a cut-off basis. Section 446(e) consent is granted for any changes in methods of accounting for intercompany transactions that are necessary solely to conform a member's methods to a binding consent with respect to the group under this paragraph (e)(3) or the revocation of that consent, provided the changes are made in the first consolidated return year for which the consent or revocation under this paragraph (e)(3) is effective. Therefore, section 446(e) consent must be separately

requested under applicable administrative procedures if a member has failed to conform its practices to the separate entity accounting provided under this paragraph (e)(3) or the revocation of that treatment in the first consolidated return year for which the consent to use separate entity accounting or revocation of that consent is effective.

(iv) *Consent to treat intercompany transactions on a separate entity basis under prior law.* A group that has received consent that is in effect as of the first day of the first consolidated return year beginning on or after July 12, 1995 to treat certain intercompany transactions as provided in §1.1502-13(c)(3) of the regulations (as contained in the 26 CFR part 1 edition revised as of April 1, 1995) will be considered to have obtained the consent of the Commissioner to take items from intercompany transactions into account on a separate entity basis as provided in paragraph (e)(3)(i) of this section. This treatment is applicable only to the items, class or classes of transactions for which consent was granted under prior law.

(f) *Stock of members—(1) In general.* In addition to the general rules of this section, the rules of this paragraph (f) apply to stock of members.

(2) *Intercompany distributions to which section 301 applies—(i) In general.* This paragraph (f)(2) provides rules for intercompany transactions to which section 301 applies (intercompany distributions). For purposes of determining whether a distribution is an intercompany distribution, it is treated as occurring under the principles of the entitlement rule of paragraph (f)(2)(iv) of this section. A distribution is not an intercompany distribution to the extent it is deducted by the distributing member. See, for example, section 1382(c)(1).

(ii) *Distributee member.* An intercompany distribution is not included in the gross income of the distributee member (B). However, this exclusion applies to a distribution only to the extent there is a corresponding negative adjustment reflected under §1.1502-32 in B's basis in the stock of the distributing member (S). For example, no amount is included in B's gross income

under section 301(c)(3) from a distribution in excess of the basis of the stock of a subsidiary that results in an excess loss account under §1.1502-32(a) which is treated as negative basis under §1.1502-19. B's dividend received deduction under section 243(a)(3) is determined without regard to any intercompany distributions under this paragraph (f)(2) to the extent they are not included in gross income. See §1.1502-26(b) (applicability of the dividends received deduction to distributions not excluded from gross income, such as a distribution from the common parent to a subsidiary owning stock of the common parent).

(iii) *Distributing member.* The principles of section 311(b) apply to S's loss, as well as gain, from an intercompany distribution of property. Thus, S's loss is taken into account under the matching rule if the property is subsequently sold to a nonmember. However, section 311(a) continues to apply to distributions to nonmembers (for example, loss is not recognized).

(iv) *Entitlement rule—(A) In general.* For all Federal income tax purposes, an intercompany distribution is treated as taken into account when the shareholding member becomes entitled to it (generally on the record date). For example, if B becomes entitled to a cash distribution before it is made, the distribution is treated as made when B becomes entitled to it. For this purpose, B is treated as entitled to a distribution no later than the time the distribution is taken into account under the Internal Revenue Code (e.g., under section 305(c)). To the extent a distribution is not made, appropriate adjustments must be made as of the date it was taken into account.

(B) *Nonmember shareholders.* If nonmembers own stock of the distributing corporation at the time the distribution is treated as occurring under this paragraph (f)(2)(iv), appropriate adjustments must be made to prevent the acceleration of the distribution to members from affecting distributions to nonmembers.

(3) *Boot in an intercompany reorganization—(i) Scope.* This paragraph (f)(3)



provides additional rules for an intercompany transaction in which the receipt of money or other property (nonqualifying property) results in the application of section 356. For example, the distribution of stock of a lower-tier member to a higher-tier member in an intercompany transaction to which section 355 would apply but for the receipt of nonqualifying property is a transaction to which this paragraph (f)(3) applies. This paragraph (f)(3) does not apply if a party to the transaction becomes a member or nonmember as part of the same plan or arrangement. For example, if S merges into a nonmember in a transaction described in section 368(a)(1)(A), this paragraph (f)(3) does not apply.

(ii) *Treatment.* Nonqualifying property received as part of a transaction described in this paragraph (f)(3) is treated as received by the member shareholder in a separate transaction. See, for example, sections 302 and 311 (rather than sections 356 and 361). The nonqualifying property is treated as taken into account immediately after the transaction if section 354 would apply but for the fact that nonqualifying property is received. It is treated as taken into account immediately before the transaction if section 355 would apply but for the fact that nonqualifying property is received. The treatment under this paragraph (f)(3)(ii) applies for all Federal income tax purposes.

(4) *Acquisition by issuer of its own stock.* If a member acquires its own stock, or an option to buy or sell its own stock, in an intercompany transaction, the member's basis in that stock or option is treated as eliminated for all purposes. Accordingly, S's intercompany items from the stock or options of B are taken into account under this section if B acquires the stock or options in an intercompany transaction (unless, for example, B acquires the stock in exchange for successor property within the meaning of paragraph (j)(1) of this section in a nonrecognition transaction). For example, if B redeems its stock from S in a transaction to which section 302(a) applies, S's gain from the transaction is taken into account immediately under the acceleration rule.

(5) *Certain liquidations and distributions—(i) Netting allowed.* S's intercompany item from a transfer to B of the stock of another corporation (T) is taken into account under this section in certain circumstances even though the T stock is never held by a nonmember after the intercompany transaction. For example, if S sells all of T's stock to B at a gain, and T subsequently liquidates into B in a separate transaction to which section 332 applies, S's gain is taken into account under the matching rule. Under paragraph (c)(6)(ii) of this section, S's intercompany gain taken into account as a result of a liquidation under section 332 or a comparable nonrecognition transaction is not redetermined to be excluded from gross income. Under this paragraph (f)(5)(i), if S has both intercompany income or gain and intercompany deduction or loss attributable to stock of the same corporation having the same material terms, only the income or gain in excess of the deduction or loss is subject to paragraph (c)(6)(ii) of this section. This paragraph (f)(5)(i) applies only to a transaction in which B's basis in its T stock is permanently eliminated in a liquidation under section 332 or any comparable nonrecognition transaction, including—

(A) A merger of B into T under section 368(a);

(B) A distribution by B of its T stock in a transaction described in section 355; or

(C) A deemed liquidation of T resulting from an election under section 338(h)(10).

(ii) *Elective relief—(A) In general.* If an election is made pursuant to this paragraph (f)(5)(ii), certain transactions are recharacterized to prevent S's items from being taken into account or to provide offsets to those items. This paragraph (f)(5)(ii) applies only if T is a member throughout the period beginning with S's transfer and ending with the completion of the nonrecognition transaction.

(B) *Section 332—(1) In general.* If section 332 would otherwise apply to T's (old T's) liquidation into B, and B transfers substantially all of old T's assets to a new member (new T), and if a direct transfer of substantially all of

old T's assets to new T would qualify as a reorganization described in section 368(a), then, for all Federal income tax purposes, T's liquidation into B and B's transfer of substantially all of old T's assets to new T will be disregarded and instead, the transaction will be treated as if old T transferred substantially all of its assets to new T in exchange for new T stock and the assumption of T's liabilities in a reorganization described in section 368(a). (Under paragraph (j)(1) of this section, B's stock in new T would be a successor asset to B's stock in old T, and S's gain would be taken into account based on the new T stock.)

(2) *Time limitation and adjustments.* The transfer of old T's assets to new T qualifies under paragraph (f)(5)(ii)(B)(I) of this section only if B has entered into a written plan, on or before the due date of the group's consolidated income tax return (including extensions) for the tax year that includes the date of old T's liquidation, to transfer the old T assets to new T, and the statement described in paragraph (f)(5)(ii)(E) of this section is included on or with a timely filed consolidated income tax return (including extensions) for the tax year that includes the date of the liquidation. However, in the case of a liquidation of old T on or after October 25, 2007, by a taxpayer whose original tax return for the year of liquidation was filed on or before November 3, 2009, see § 1.1502-13T(f)(5)(ii)(F)(3) as contained in 26 CFR part 1, revised April 1, 2012. In either case, the transfer of substantially all of T's assets to new T must be completed within 12 months of the filing of the return. Appropriate adjustments are made to reflect any events occurring before the formation of new T and to reflect any assets not transferred to new T, or liabilities not assumed by new T. For example, if B retains an asset of old T, the asset is treated under paragraph (f)(3) of this section as acquired by new T but distributed to B immediately after the reorganization.

(C) *Sections 338(h)(10) and 336(e).*— (1) *In general.* This paragraph (f)(5)(ii)(C) applies to a deemed liquidation of T under section 332 as the result of an election under section 338(h)(10) or section 336(e). This paragraph (f)(5)(ii)(C)

does not apply if paragraph (f)(5)(ii)(B) of this section is applied to the deemed liquidation. Under this paragraph, B is treated with respect to each share of its T stock as recognizing as a corresponding item any loss or deduction it would recognize (determined after adjusting stock basis under § 1.1502-32) if section 331 applied to the deemed liquidation. For all other Federal income tax purposes, the deemed liquidation remains subject to section 332.

(2) *Limitation on amount of loss.* The amount of B's loss or deduction under this paragraph (f)(5)(ii)(C) is limited as follows—

(i) The aggregate amount of loss recognized with respect to T stock cannot exceed the amount of S's intercompany income or gain that is in excess of S's intercompany deduction or loss with respect to shares of T stock having the same material terms as the shares giving rise to S's intercompany income or gain; and

(ii) The aggregate amount of loss recognized under this paragraph (f)(5)(ii)(C) from T's deemed liquidation cannot exceed the net amount of deduction or loss (if any) that would be taken into account from the deemed liquidation if section 331 applied with respect to all T shares.

(3) *Asset sale, etc.* The principles of this paragraph (f)(5)(ii)(C) apply, with appropriate adjustments, if T transfers all of its assets to a nonmember and completely liquidates in a transaction comparable to the section 338(h)(10) transaction described in paragraph (f)(5)(ii)(C)(I) of this section. For example, if S sells all of T's stock to B at a gain followed by T's merger into a nonmember in exchange for a cash payment to B in a transaction treated for Federal income tax purposes as T's sale of its assets to the nonmember and complete liquidation, the merger is ordinarily treated as a comparable transaction.

(D) *Section 355.* If B distributes the T stock in an intercompany transaction to which section 355 applies (including an intercompany transaction to which 355 applies because of the application of paragraph (f)(3) of this section), the redetermination of the basis of the T stock under section 358 could cause S's gain or loss to be taken into account

under this section. This paragraph (f)(5)(ii)(D) applies to treat B's distribution as subject to sections 301 and 311 (as modified by this paragraph (f)), rather than section 355. The election will prevent S's gain or loss from being taken into account immediately to the extent matching remains possible, but B's gain or loss from the distribution will also be taken into account under this section.

(E) *Election.* An election to apply paragraph (f)(5)(ii) of this section is made in a separate statement entitled, "[INSERT NAME AND EMPLOYER IDENTIFICATION NUMBER OF COMMON PARENT] HEREBY ELECTS THE APPLICATION OF § 1.1502-13(f)(5)(ii) FOR AN INTERCOMPANY TRANSACTION INVOLVING [INSERT NAME AND EMPLOYER IDENTIFICATION NUMBER OF S] AND [INSERT NAME AND EMPLOYER IDENTIFICATION NUMBER OF T]." A separate election must be made for each such application. The election must be filed by including the statement on or with the consolidated group's income tax return for the year of T's liquidation (or other transaction). The Commissioner may impose reasonable terms and conditions to the application of paragraph (f)(5)(ii) of this section that are consistent with the purposes of such section. The statement must—

(1) Identify S's intercompany transaction and T's liquidation (or other transaction); and

(2) Specify which provision of paragraph (f)(5)(ii) of this section applies and how it alters the otherwise applicable results under this section (including, for example, the amount of S's intercompany items and the amount deferred or offset as a result of paragraph (f)(5)(ii) of this section).

(F) *Effective/applicability date—(1) General rule.* Paragraphs (f)(5)(ii)(B)(1) and (2) of this section apply to transactions in which old T's liquidation into B occurs on or after October 25, 2007.

(2) *Prior periods.* For transactions in which old T's liquidation into B occurs before October 25, 2007, see paragraphs (f)(5)(ii)(B)(1) and (2) of this section in effect prior to October 25, 2007, as contained in 26 CFR part 1, revised April 1, 2009.

(6) *Stock of common parent.* In addition to the general rules of this section, this paragraph (f)(6) applies to parent stock (P stock) and positions in P stock held or entered into by another member. For this purpose, P stock is any stock of the common parent held (directly or indirectly) by another member or any stock of a member (the issuer) that was the common parent if the stock was held (directly or indirectly) by another member while the issuer was the common parent.

(i) *Loss stock—(A) Recognized loss.* Any loss recognized, directly or indirectly, by a member with respect to P stock is permanently disallowed and does not reduce earnings and profits. See § 1.1502-32(b)(3)(iii)(A) for a corresponding reduction in the basis of the member's stock.

(B) *Other cases.* If a member, M, owns P stock, the stock is subsequently owned by a nonmember, and, immediately before the stock is owned by the nonmember, M's basis in the share exceeds its fair market value, then, to the extent paragraph (f)(6)(i)(A) of this section does not apply, M's basis in the share is reduced to the share's fair market value immediately before the share is held by the nonmember. For example, if M owns shares of P stock with a \$100x basis and M becomes a nonmember at a time when the P shares have a value of \$60x, M's basis in the P shares is reduced to \$60x immediately before M becomes a nonmember. Similarly, if M contributes the P stock to a nonmember in a transaction subject to section 351, M's basis in the shares is reduced to \$60x immediately before the contribution. See § 1.1502-32(b)(3)(iii)(B) for a corresponding reduction in the basis of M's stock.

(C) *Waiver of built-in loss on P stock—*

(1) *In general.* If a nonmember that owns P stock with a basis in excess of its fair market value becomes a member of the P consolidated group in a qualifying cost basis transaction, the group may make an irrevocable election to reduce the basis of the P stock to its fair market value immediately before the nonmember becomes a member of the P group. If the nonmember was a member of another consolidated group immediately before becoming a

member of the P group, the reduction in basis is treated as occurring immediately after it ceases to be a member of the prior group. A qualifying cost basis transaction is the purchase (i.e., a transaction in which basis is determined under section 1012) by members of the P consolidated group (while they are members) in a 12-month period of an amount of the nonmember's stock satisfying the requirements of section 1504(a)(2).

(2) *Election.* The election described in paragraph (f)(6)(i)(C)(I) of this section must be made in a separate statement entitled, "ELECTION TO REDUCE BASIS OF P STOCK UNDER §1.1502-13(f)(6) HELD BY [INSERT NAME AND EMPLOYER IDENTIFICATION NUMBER OF MEMBER WHOSE BASIS IN P STOCK IS REDUCED]." The election must be filed by including the statement on or with the consolidated group's income tax return for the year in which the nonmember becomes a member. The statement must identify the member's basis in the P stock (taking into account the effect of this election) and the number of shares of P stock held by the member.

(ii) *Gain stock.* For dispositions of P stock occurring before May 16, 2000, see §1.1502-13(f)(6)(ii) as contained in 26 CFR part 1 in effect on April 1, 2000. For dispositions of P stock occurring on or after May 16, 2000, see §1.1032-3.

(iii) *Mark-to-market of P stock.* Paragraphs (f)(6)(i) and (ii) of this section shall not apply to any gain or loss from a share of P stock held by a member, M, if—

(A) M regularly trades in P stock (of the same class) with customers in the ordinary course of its business as a dealer;

(B) The gain or loss on the share is taken into account by M pursuant to section 475(a);

(C) M's basis in the share is not adjusted by reference to the basis of any other property or by reference to income, gain, deduction, or loss from other property; and

(D) Neither M nor any other member of the group has structured or engaged in any transaction while a member (or in anticipation of becoming a member), during the taxable year or in any year within the preceding five taxable years

that is open for assessment under section 6501, with a principal purpose of avoiding gain or creating loss on P stock subject to section 475(a).

(iv) *Options, warrants, and other positions—(A) In general.* This paragraph (f)(6) applies with appropriate adjustments to positions in P stock to the extent that P's gain or loss from an equivalent position would not be recognized under section 1032. Thus, if M purchases an option to buy or sell P stock and sells the option at a loss, the loss is permanently disallowed under paragraph (f)(6)(i)(A) of this section. Similarly, if M is the grantor of such an option and becomes a nonmember, then the principles of paragraph (f)(6)(i)(B) of this section apply to the extent that M would recognize loss from cash settlement of the option at its fair market value immediately before M becomes a nonmember, and proper adjustments must be made in the amount of any gain or loss subsequently realized from the position by M. If P grants M an option to acquire P stock in a transaction meeting the requirements of §1.1032-3, M is treated as having purchased the option from P for fair market value with cash contributed to M by P.

(B) *Mark-to-market of positions in P stock.* For purposes of paragraph (f)(6)(iii) of this section, gain or loss with respect to a position taken into account under section 1256(a) is treated as taken into account under section 475(a) to the extent that the gain or loss would be taken into account under the principles of section 475.

(v) *Effective date.* This paragraph (f)(6) applies to gain or loss taken into account on or after July 12, 1995, and to transactions occurring on or after July 12, 1995. For example, if S sells P stock to B at a loss prior to July 12, 1995, and B sells the P stock to a nonmember after July 12, 1995, S's loss is disallowed because it is taken into account after July 12, 1995. If a taxpayer takes a gain or loss into account or engages in a transaction on or after July 12, 1995, during a tax year ending prior to December 31, 1995, the taxpayer may treat the gain or loss or the transaction under the rules published in 1995-32 I.R.B. 47, instead of under the rules of this paragraph (f)(6).

(7) *Examples—In general.* The application of this section to intercompany transactions with respect to stock of members is illustrated by the following examples.

*Example 1. Dividend exclusion and property distribution.* (a) *Facts.* S owns land with a \$70 basis and \$100 value. On January 1 of Year 1, P's basis in S's stock is \$100. During Year 1, S declares and makes a dividend distribution of the land to P. Under section 311(b), S has a \$30 gain. Under section 301(d), P's basis in the land is \$100. On July 1 of Year 3, P sells the land to X for \$110.

(b) *Dividend elimination and stock basis adjustments.* Under paragraph (b)(1) of this section, S's distribution to P is an intercompany distribution. Under paragraph (f)(2)(ii) of this section, P's \$100 of dividend income is not included in gross income. Under § 1.1502-32, P's basis in S's stock is reduced from \$100 to \$0 in Year 1.

(c) *Matching rule and stock basis adjustments.* Under the matching rule (treating P as the buying member and S as the selling member), S takes its \$30 gain into account in Year 3 to reflect the \$30 difference between P's \$10 gain taken into account and the \$40 recomputed gain. Under § 1.1502-32, P's basis in S's stock is increased from \$0 to \$30 in Year 3.

(d) *Loss property.* The facts are the same as in paragraph (a) of this *Example 1*, except that S has a \$130 (rather than \$70) basis in the land. Under paragraph (f)(2)(iii) of this section, the principles of section 311(b) apply to S's loss from the intercompany distribution. Thus, S has a \$30 loss that is taken into account under the matching rule in Year 3 to reflect the \$30 difference between P's \$10 gain taken into account and the \$20 recomputed loss. (The results are the same under section 267(f).) Under § 1.1502-32, P's basis in S's stock is reduced from \$100 to \$0 in Year 1, and from \$0 to a \$30 excess loss account in Year 3. (If P had distributed the land to its shareholders, rather than selling the land to X, P would take its \$10 gain under section 311(b) into account, and S would take its \$30 loss into account under the matching rule with \$10 offset by P's gain and \$20 recharacterized as a noncapital, nondeductible amount.)

(e) *Entitlement rule.* The facts are the same as in paragraph (a) of this *Example 1*, except that, after P becomes entitled to the distribution but before the distribution is made, S issues additional stock to the public and becomes a nonmember. Under paragraph (f)(2)(i) of this section, the determination of whether a distribution is an intercompany distribution is made under the entitlement rule of paragraph (f)(2)(iv) of this section. Treating S's distribution as made when P becomes entitled to it results in the distribution being an intercompany distribution. Under paragraph (f)(2)(ii) of this section, the

distribution is not included in P's gross income. S's \$30 gain from the distribution is intercompany gain that is taken into account under the acceleration rule immediately before S becomes a nonmember. Thus, there is a net \$70 decrease in P's basis in its S stock under § 1.1502-32 (\$100 decrease for the distribution and a \$30 increase for S's \$30 gain). Under paragraph (f)(2)(iv) of this section, P does not take the distribution into account again under separate return rules when received, and P is not entitled to a dividends received deduction.

*Example 2. Excess loss accounts.* (a) *Facts.* S owns all of T's only class of stock with a \$10 basis and \$100 value. S has substantial earnings and profits, and T has \$10 of earnings and profits. On January 1 of Year 1, S declares and distributes a dividend of all of the T stock to P. Under section 311(b), S has a \$90 gain. Under section 301(d), P's basis in the T stock is \$100. During Year 3, T borrows \$90 and declares and makes a \$90 distribution to P to which section 301 applies, and P's basis in the T stock is reduced under § 1.1502-32 from \$100 to \$10. During Year 6, T has \$5 of earnings that increase P's basis in the T stock under § 1.1502-32 from \$10 to \$15. On December 1 of Year 9, T issues additional stock to X and, as a result, T becomes a nonmember.

(b) *Dividend exclusion.* Under paragraph (f)(2)(ii) of this section, P's \$100 of dividend income from S's distribution of the T stock, and its \$10 of dividend income from T's \$90 distribution, are not included in gross income.

(c) *Matching and acceleration rules.* Under § 1.1502-19(b)(1), when T becomes a nonmember P must include in income the amount of its excess loss account (if any) in T stock. P has no excess loss account in the T stock. Therefore P's corresponding item from the deconsolidation of T is \$0. Treating S and P as divisions of a single corporation, the T stock would continue to have a \$10 basis after the distribution, and the adjustments under § 1.1502-32 for T's \$90 distribution and \$5 of earnings would result in a \$75 excess loss account. Thus, the recomputed corresponding item from the deconsolidation is \$75. Under the matching rule, S takes \$75 of its \$90 gain into account in Year 9 as a result of T becoming a nonmember, to reflect the difference between P's \$0 gain taken into account and the \$75 recomputed gain. S's remaining \$15 of gain is taken into account under the matching and acceleration rules based on subsequent events (for example, under the matching rule if P subsequently sells its T stock, or under the acceleration rule if S becomes a nonmember).

(d) *Reverse sequence.* The facts are the same as in paragraph (a) of this *Example 2*, except that T borrows \$90 and makes its \$90 distribution to S before S distributes T's stock

to P. Under paragraph (f)(2)(ii) of this section, T's \$90 distribution to S (\$10 of which is a dividend) is not included in S's gross income. The corresponding negative adjustment under § 1.1502-32 reduces S's basis in the T stock from \$10 to an \$80 excess loss account. Under section 311(b), S has a \$90 gain from the distribution of T stock to P. Under section 301(d) P's initial basis in the T stock is \$10 (the stock's fair market value), and the basis increases to \$15 under § 1.1502-32 as a result of T's earnings in Year 6. The timing and attributes of S's gain are determined in the manner provided in paragraph (c) of this *Example 2*. Thus, \$75 of S's gain is taken into account under the matching rule in Year 9 as a result of T becoming a nonmember, and the remaining \$15 is taken into account under the matching and acceleration rules based on subsequent events.

(e) *Partial stock sale.* The facts are the same as in paragraph (a) of this *Example 2*, except that P sells 10% of T's stock to X on December 1 of Year 9 for \$1.50 (rather than T's issuing additional stock and becoming a nonmember). Under the matching rule, S takes \$9 of its gain into account to reflect the difference between P's \$0 gain taken into account (\$1.50 sale proceeds minus \$1.50 basis) and the \$9 recomputed gain (\$1.50 sale proceeds plus \$7.50 excess loss account).

(f) *Loss, rather than cash distribution.* The facts are the same as in paragraph (a) of this *Example 2*, except that T retains the loan proceeds and incurs a \$90 loss in Year 3 that is absorbed by the group. The timing and attributes of S's gain are determined in the same manner provided in paragraph (c) of this *Example 2*. Under § 1.1502-32, the loss in Year 3 reduces P's basis in the T stock from \$100 to \$10, and T's \$5 of earnings in Year 6 increase the basis to \$15. Thus, \$75 of S's gain is taken into account under the matching rule in Year 9 as a result of T becoming a nonmember, and the remaining \$15 is taken into account under the matching and acceleration rules based on subsequent events. (The timing and attributes of S's gain would be determined in the same manner provided in paragraph (d) of this *Example 2* if T incurred the \$90 loss before S's distribution of the T stock to P.)

(g) *Stock sale, rather than stock distribution.* The facts are the same as in paragraph (a) of this *Example 2*, except that S sells the T stock to P for \$100 (rather than distributing the stock). The timing and attributes of S's gain are determined in the same manner provided in paragraph (c) of this *Example 2*. Thus, \$75 of S's gain is taken into account under the matching rule in Year 9 as a result of T becoming a nonmember, and the remaining \$15 is taken into account under the matching and acceleration rules based on subsequent events.

*Example 3. Intercompany reorganization.* (a) *Facts.* P forms S and B by contributing \$200

to the capital of each. During Years 1 through 4, S and B each earn \$50, and under § 1.1502-32 P adjusts its basis in the stock of each to \$250. (See § 1.1502-33 for adjustments to earnings and profits.) On January 1 of Year 5, the fair market value of S's assets and its stock is \$500, and S merges into B in a tax-free reorganization. Pursuant to the plan of reorganization, P receives B stock with a fair market value of \$350 and \$150 of cash.

(b) *Treatment as a section 301 distribution.* The merger of S into B is a transaction to which paragraph (f)(3) of this section applies. P is treated as receiving additional B stock with a fair market value of \$500 and, under section 358, a basis of \$250. Immediately after the merger, \$150 of the stock received is treated as redeemed, and the redemption is treated under section 302(d) as a distribution to which section 301 applies. Because the \$150 distribution is treated as not received as part of the merger, section 356 does not apply and no basis adjustments are required under section 358(a)(1)(A) and (B). Because B is treated under section 381(c)(2) as receiving S's earnings and profits and the redemption is treated as occurring after the merger, \$100 of the distribution is treated as a dividend under section 301 and P's basis in the B stock is reduced correspondingly under § 1.1502-32. The remaining \$50 of the distribution reduces P's basis in the B stock. Section 301(c)(2) and § 1.1502-32. Under paragraph (f)(2)(ii) of this section, P's \$100 of dividend income is not included in gross income. Under § 1.302-2(c), proper adjustments are made to P's basis in its B stock to reflect its basis in the B stock redeemed, with the result that P's basis in the B stock is reduced by the entire \$150 distribution.

(c) *Depreciated property.* The facts are the same as in paragraph (a) of this *Example 3*, except that property of S with a \$200 basis and \$150 fair market value is distributed to P (rather than cash of B). As in paragraph (b) of this *Example 3*, P is treated as receiving additional B stock in the merger and a \$150 distribution to which section 301 applies immediately after the merger. Under paragraph (f)(2)(iii) of this section, the principles of section 311(b) apply to B's \$50 loss and the loss is taken into account under the matching and acceleration rules based on subsequent events (e.g., under the matching rule if P subsequently sells the property, or under the acceleration rule if B becomes a nonmember). The results are the same under section 267(f).

(d) *Divisive transaction.* Assume instead that, pursuant to a plan, S distributes the stock of a lower-tier subsidiary in a spin-off transaction to which section 355 applies together with \$150 of cash. The distribution of stock is a transaction to which paragraph (f)(3) of this section applies. P is treated as receiving the \$150 of cash immediately before

the section 355 distribution, as a distribution to which section 301 applies. Section 356(b) does not apply and no basis adjustments are required under section 358(a)(1) (A) and (B). Because the \$150 distribution is treated as made before the section 355 distribution, the distribution reduces P's basis in the S stock under § 1.1502-32, and the basis allocated under section 358(c) between the S stock and the lower-tier subsidiary stock received reflects this basis reduction.

*Example 4. All cash intercompany reorganization under section 368(a)(1)(D).* (a) *Facts.* P owns all of the stock of M and B. M owns all of the stock of S with a basis of \$25. On January 1 of Year 2, the fair market value of S's assets and its stock is \$100, and S sells all of its assets to B for \$100 cash and liquidates. The transaction qualifies as a reorganization described in section 368(a)(1)(D). Pursuant to § 1.368-2(l), B will be deemed to issue a nominal share of B stock to S in addition to the \$100 of cash actually exchanged for the S assets, and S will be deemed to distribute all of the consideration to M. M will be deemed to distribute the nominal share of B stock to P.

(b) *Treatment as a section 301 distribution.* The sale of S's assets to B is a transaction to which paragraph (f)(3) of this section applies. In addition to the nominal share issued by B to S under § 1.368-2(l), S is treated as receiving additional B stock with a fair market value of \$100 (in lieu of the \$100) and, under section 358, a basis of \$25 which S distributes to M in liquidation. Immediately after the sale, the B stock (with the exception of the nominal share which is still held by M) received by M is treated as redeemed for \$100, and the redemption is treated under section 302(d) as a distribution to which section 301 applies. M's basis of \$25 in the B stock is reduced under § 1.1502-32(b)(3)(v), resulting in an excess loss account of \$75 in the nominal share. (See § 1.302-2(c)). M's deemed distribution of the nominal share of B stock to P under § 1.368-2(l) will result in M generating an intercompany gain under section 311(b) of \$75, to be subsequently taken into account under the matching and acceleration rules.

*Example 5. Stock redemptions and distributions.* (a) *Facts.* Before becoming a member of the P group, S owns P stock with a \$30 basis. On January 1 of Year 1, P buys all of S's stock. On July 1 of Year 3, P redeems the P stock held by S for \$100 in a transaction to which section 302(a) applies.

(b) *Gain under section 302.* Under paragraph (f)(4) of this section, P's basis in the P stock acquired from S is treated as eliminated. As a result of this elimination, S's intercompany item will never be taken into account under the matching rule because P's basis in the stock does not reflect S's intercompany item. Therefore, S's \$70 gain is taken into account under the acceleration rule in Year 3. The attributes of S's item are determined under paragraph (d)(1)(ii) of this section by

applying the matching rule as if P had sold the stock to an affiliated corporation that is not a member of the group at no gain or loss. Although P's corresponding item from a sale of its stock would have been excluded from gross income under section 1032, paragraph (c)(6)(ii) of this section prevents S's gain from being treated as excluded from gross income; instead S's gain is capital gain.

(c) *Gain under section 311.* The facts are the same as in paragraph (a) of this *Example 4*, except that S distributes the P stock to P in a transaction to which section 301 applies (rather than the stock being redeemed), and S has a \$70 gain under section 311(b). The timing and attributes of S's gain are determined in the manner provided in paragraph (b) of this *Example 4*.

(d) *Loss stock.* The facts are the same as in paragraph (a) of this *Example 4*, except that S has a \$130 (rather than \$30) basis in the P stock and has a \$30 loss under section 302(a). The limitation under paragraph (c)(6)(ii) of this section does not apply to intercompany losses. Thus, S's loss is taken into account in Year 3 as a noncapital, nondeductible amount.

*Example 6. Intercompany stock sale followed by section 332 liquidation.* (a) *Facts.* S owns all of the stock of T, with a \$70 basis and \$100 value, and T's assets have a \$10 basis and \$100 value. On January 1 of Year 1, S sells all of T's stock to B for \$100. On July 1 of Year 3, when T's assets are still worth \$100, T distributes all of its assets to B in an unrelated complete liquidation to which section 332 applies.

(b) *Timing and attributes.* Under paragraph (b)(3)(ii) of this section, B's unrecognized gain or loss under section 332 is a corresponding item for purposes of applying the matching rule. In Year 3 when T liquidates, B has \$0 of unrecognized gain or loss under section 332 because B has a \$100 basis in the T stock and receives a \$100 distribution with respect to its T stock. Treating S and B as divisions of a single corporation, the recomputed corresponding item would have been \$30 of unrecognized gain under section 332 because B would have succeeded to S's \$70 basis in the T stock. Thus, under the matching rule, S's \$30 intercompany gain is taken into account in Year 3 as a result of T's liquidation. Under paragraph (c)(1)(i) of this section, the attributes of S's gain and B's corresponding item are redetermined as if S and B were divisions of a single corporation. Although S's gain ordinarily would be redetermined to be treated as excluded from gross income to reflect the nonrecognition of B's gain under section 332, S's gain remains capital gain because B's unrecognized gain under section 332 is not permanently and explicitly disallowed under the Code. See paragraph (c)(6)(ii) of this section. However, relief may be elected under paragraph (f)(5)(ii) of this section.

(c) *Intercompany sale at a loss.* The facts are the same as in paragraph (a) of this *Example 5*, except that S has a \$130 (rather than \$70) basis in the T stock. The limitation under paragraph (c)(6)(ii) of this section does not apply to intercompany losses. Thus, S's intercompany loss is taken into account in Year 3 as a noncapital, nondeductible amount. However, relief may be elected under paragraph (f)(5)(ii) of this section.

*Example 7. Intercompany stock sale followed by section 355 distribution.* (a) *Facts.* S owns all of the stock of T with a \$70 basis and a \$100 value. On January 1 of Year 1, S sells all of T's stock to M for \$100. On June 1 of Year 6, M distributes all of its T stock to its non-member shareholders in a transaction to which section 355 applies. At the time of the distribution, M has a basis in T stock of \$100 and T has a value of \$150.

(b) *Timing and attributes.* Under paragraph (b)(3)(ii) of this section, M's \$50 gain not recognized on the distribution under section 355 is a corresponding item. Treating S and M as divisions of a single corporation, the recomputed corresponding item would be \$80 of unrecognized gain under section 355 because M would have succeeded to S's \$70 basis in the T stock. Thus, under the matching rule, S's \$30 intercompany gain is taken into account in Year 6 as a result of the distribution. Under paragraph (c)(1)(i) of this section, the attributes of S's intercompany item and M's corresponding item are redetermined to produce the same effect on consolidated taxable income as if S and M were divisions of a single corporation. Although S's gain ordinarily would be redetermined to be treated as excluded from gross income to reflect the nonrecognition of M's gain under section 355(c), S's gain remains capital gain because M's unrecognized gain under section 355(c) is not permanently and explicitly disallowed under the Code. See paragraph (c)(6)(ii) of this section. Because M's distribution of the T stock is not an intercompany transaction, relief is not available under paragraph (f)(5)(ii) of this section.

(c) *Section 355 distribution within the group.* The facts are the same as under paragraph (a) of this *Example 6*, except that M distributes the T stock to B (another member of the group), and B takes a \$75 basis in the T stock under section 358. Under paragraph (j)(2) of this section, B is a successor to M for purposes of taking S's intercompany gain into account, and therefore both M and B might have corresponding items with respect to S's intercompany gain. To the extent it is possible, matching with respect to B's corresponding items produces the result most consistent with treating S, M, and B as divisions of a single corporation. See paragraphs (j)(3) and (j)(4) of this section. However, because there is only \$5 difference between B's \$75 basis in the T stock and the \$70 basis the stock would have if S, M, and B were divi-

sions of a single corporation, only \$5 can be taken into account under the matching rule with respect to B's corresponding items. (This \$5 is taken into account with respect to B's corresponding items based on subsequent events.) The remaining \$25 of S's \$30 intercompany gain is taken into account in Year 6 under the matching rule with respect to M's corresponding item from its distribution of the T stock. The attributes of S's remaining \$25 of gain are determined in the same manner as in paragraph (b) of this *Example 6*.

(d) *Relief elected.* The facts are the same as in paragraph (c) of this *Example 6* except that P elects relief pursuant to paragraph (f)(5)(ii)(D) of this section. As a result of the election, M's distribution of the T stock is treated as subject to sections 301 and 311 instead of section 355. Accordingly, M recognizes \$50 of intercompany gain from the distribution, B takes a basis in the stock equal to its fair market value of \$150, and S and M take their intercompany gains into account with respect to B's corresponding items based on subsequent events. (None of S's gain is taken into account in Year 6 as a result of M's distribution of the T stock.)

(g) *Obligations of members—(1) In general.* In addition to the general rules of this section, the rules of this paragraph (g) apply to intercompany obligations.

(2) *Definitions.* For purposes of this section, the following definitions apply—

(i) *Obligation of a member* is a debt or security of a member.

(A) *Debt of a member* is any obligation of the member constituting indebtedness under general principles of Federal income tax law (for example, under nonstatutory authorities, or under section 108, section 163, or § 1.1275-1(d)), but not an executory obligation to purchase or provide goods or services.

(B) *Security of a member* is any security of the member described in section 475(c)(2)(D) or (E), and any commodity of the member described in section 475(e)(2)(A), (B), or (C), but not if the security or commodity is a position with respect to the member's stock. See paragraphs (f)(4) and (f)(6) of this section for special rules applicable to positions with respect to a member's stock.

(ii) *Intercompany obligation* is an obligation between members, but only for the period during which both parties are members.



(iii) *Intercompany obligation subgroup* is comprised of two or more members that include the creditor and debtor on an intercompany obligation if the creditor and debtor bear the relationship described in section 1504(a)(1) to each other through an intercompany obligation subgroup parent.

(iv) *Intercompany obligation subgroup parent* is the corporation (including either the creditor or debtor) that bears the same relationship to the other members of the intercompany obligation subgroup as a common parent bears to the members of a consolidated group. Any reference to an intercompany obligation subgroup parent includes, as the context may require, a reference to a predecessor or successor. For this purpose, a predecessor is a transferor of assets to a transferee (the successor) in a transaction to which section 381(a) applies.

(v) *Tax benefit* is the benefit of, for Federal tax purposes, a net reduction in income or gain, or a net increase in loss, deduction, credit, or allowance. A tax benefit includes, but is not limited to, the use of a built-in item or items from an intercompany obligation to reduce gain or increase loss on the sale of member stock, or to create or absorb a tax attribute of a member or subgroup.

(vi) *Eighty-percent chain* is a chain of two or more corporations in which stock meeting the requirements of section 1504(a)(2) of each lower-tier member is held directly by a higher-tier member of such chain.

(3) *Deemed satisfaction and reissuance of intercompany obligations in triggering transactions*—(i) *Scope*—(A) *Triggering transactions*. For purposes of this paragraph (g)(3), a triggering transaction includes the following:

(I) *Assignment and extinguishment transactions*. Any intercompany transaction in which a member realizes an amount, directly or indirectly, from the assignment or extinguishment of all or part of its remaining rights or obligations under an intercompany obligation or any comparable transaction in which a member realizes any such amount, directly or indirectly, from an intercompany obligation (for example, a mark to fair market value of an obligation or a bad debt deduction). However, a reduction of the basis of an

intercompany obligation pursuant to § 1.1502-36(d) (attribute reduction to prevent duplication of loss), or pursuant to sections 108 and 1017 and § 1.1502-28 (basis reductions upon the exclusion from gross income of discharge of indebtedness) or any other provision that adjusts the basis of an intercompany obligation as a substitute for income, gain, deduction, or loss, is not a comparable transaction.

(2) *Outbound transactions*. Any transaction in which an intercompany obligation becomes an obligation that is not an intercompany obligation.

(B) *Exceptions*. Except as provided in paragraph (g)(3)(i)(C) of this section, a transaction is not a triggering transaction as described in paragraph (g)(3)(i)(A) of this section if any of the exceptions in this paragraph (g)(3)(i)(B) apply. In making this determination, if a creditor or debtor realizes an amount in a transaction in which a creditor assigns all or part of its rights under an intercompany obligation to the debtor, or a debtor assigns all or part of its obligations under an intercompany obligation to the creditor, the transaction will be treated as an extinguishment and will be excepted from the definition of “triggering transaction” only if either of the exceptions in paragraphs (g)(3)(i)(B)(5) or (6) of this section apply. The exceptions are as follows.

(I) *Intercompany section 361, 332, or 351 exchange*. The transaction is an intercompany exchange to which section 361(a), sections 332 and 337(a), or (except as provided in the following sentence) section 351 applies in which no amount of income, gain, deduction or loss is recognized by the creditor or debtor. The assignment of an intercompany obligation by a creditor member in an intercompany exchange to which section 351 applies is a triggering transaction, notwithstanding the preceding sentence, if a member of the group is described in, or engages in a transaction that is described in, any of the following paragraphs.

(i) The transferor or transferee member has a loss subject to a limitation (for example, a loss from a separate return limitation year that is subject to limitation under § 1.1502-21(c), or a dual consolidated loss that is subject to limitation under § 1.1503(d)-4), but only if

the other member is not subject to a comparable limitation;

(ii) The transferor or transferee member has a special status within the meaning of § 1.1502-13(c)(5) (for example, a bank defined in section 581, or a life insurance company subject to tax under section 801) that the other member does not also possess;

(iii) A member of the group realizes discharge of indebtedness income that is excluded from gross income under section 108(a) within the same taxable year as that of the exchange, and the tax attributes attributable to either the transferor or the transferee member are reduced under sections 108, 1017, and § 1.1502-28 (except if the attribute reduction results solely from the application of § 1.1502-28(a)(4) (reduction of certain tax attributes attributable to other members));

(iv) The transferee member has a nonmember shareholder;

(v) The transferee member issues preferred stock to the transferor member in exchange for the assignment of the intercompany obligation; or

(vi) The stock of the transferee member (or a higher-tier member other than a higher-tier member of an 80-percent chain that includes the transferor and transferee) is disposed of within 12 months from the assignment of the intercompany obligation, unless at the time of the assignment, the transferor member, transferee member (or in the case of successive section 351 exchanges, each transferor and transferee member) and the debtor member are all in the same 80-percent chain; and all of the stock of the transferee (or in the case of successive section 351 exchanges, the lowest-tier transferee) held by members of the group is disposed of as part of the same plan or arrangement, either directly or indirectly, to persons that are not members of the group.

(2) *Intercompany assumption transaction.* All of the debtor's obligations under an intercompany obligation are assumed in connection with the debtor's sale or other disposition of property (other than solely money) in an intercompany transaction in which gain or loss is recognized under section 1001.

(3) *Exception to the application of section 108(e)(4).* The obligation became an intercompany obligation by reason of an event described in § 1.108-2(e)(2) (exception to the application of section 108(e)(4) in the case of acquisitions by securities dealers).

(4) *Reserve accounting.* The amount realized is from reserve accounting under section 585 (see paragraph (g)(4)(v) of this section for special rules).

(5) *Intercompany extinguishment transaction.* All or part of the rights and obligations under the intercompany obligation are extinguished in an intercompany transaction (other than an exchange or deemed exchange of an intercompany obligation for a newly issued intercompany obligation), the adjusted issue price of the obligation is equal to the creditor's basis in the obligation, and the debtor's corresponding item and the creditor's intercompany item (after taking into account the special rules of paragraph (g)(4)(i)(C) of this section) with respect to the obligation offset in amount.

(6) *Routine modification of intercompany obligation.* All of the rights and obligations under the intercompany obligation are extinguished in an intercompany transaction that is an exchange (or deemed exchange) for a newly issued intercompany obligation, and the issue price of the newly issued obligation equals both the adjusted issue price of the extinguished obligation and the creditor's basis in the extinguished obligation. Solely for purposes of the preceding sentence, a newly issued intercompany obligation includes an obligation that is issued (or deemed issued) by a member other than the original debtor if such other member assumes the original debtor's obligations under the original obligation in a transaction that is described in either paragraph (g)(3)(i)(B)(1) or (g)(3)(i)(B)(2) of this section and the assumption results in a significant modification of the original obligation under § 1.1001-3(e)(4) and a deemed exchange under § 1.1001-3(b).

(7) *Outbound distribution of newly issued intercompany obligation.* The intercompany obligation becomes an obligation that is not an intercompany obligation in a transaction in which a

member that is a party to the reorganization exchanges property in pursuance of the plan of reorganization for a newly issued intercompany obligation of another member that is a party to the reorganization and distributes such intercompany obligation to a nonmember shareholder or nonmember creditor in a transaction to which section 361(c) applies.

(8) *Outbound subgroup exception.* The intercompany obligation becomes an obligation that is not an intercompany obligation in a transaction in which the members of an intercompany obligation subgroup cease to be members of a consolidated group, neither the creditor nor the debtor recognize any income, gain, deduction, or loss with respect to the intercompany obligation, and such members constitute an intercompany obligation subgroup of another consolidated group immediately after the transaction.

(C) *Tax benefit rule.* If an assignment or extinguishment of an intercompany obligation in an intercompany transaction is otherwise excepted from the definition of triggering transaction under paragraph (g)(3)(i)(B)(1), (2), (5), or (6) of this section (and not also under paragraph (g)(3)(i)(B)(3) or (4) of this section), and the assignment or extinguishment is engaged in with a view to shift items of built-in gain, loss, income, or deduction from the obligation from one member to another member in order to secure a tax benefit (as defined in paragraph (g)(2)(v) of this section) that the group or its members would not otherwise enjoy in a consolidated or separate return year, then the assignment or extinguishment will be a triggering transaction to which paragraph (g)(3)(ii) of this section applies.

(ii) *Application of deemed satisfaction and reissuance.* This paragraph (g)(3)(ii) applies if a triggering transaction occurs.

(A) *General rule.* If the intercompany obligation is debt of a member, then (except as provided in the following sentence) the debt is treated for all Federal income tax purposes as having been satisfied by the debtor for cash in an amount equal to its fair market value, and then as having been reissued as a new obligation (with a new holding period but otherwise identical terms)

for the same amount of cash, immediately before the triggering transaction. However, if the creditor realizes an amount with respect to the debt in the triggering transaction that differs from the debt's fair market value, and the triggering transaction is not an exchange (or deemed exchange) of debt of a member for newly issued debt of a member, then the debt is treated for all Federal income tax purposes as having been satisfied by the debtor for cash in an amount equal to such amount realized, and reissued as a new obligation (with a new holding period but otherwise identical terms) for the same amount of cash, immediately before the triggering transaction. If the triggering transaction is a mark to fair market value under section 475, then the intercompany obligation will be deemed satisfied and reissued for its fair market value (as determined under section 475 and applicable regulations) and section 475 will not otherwise apply with respect to that triggering transaction. If the intercompany obligation is a security of a member, similar principles apply (with appropriate adjustments) to treat the security as having been satisfied and reissued immediately before the triggering transaction.

(B) *Treatment as separate transaction.* The deemed satisfaction and deemed reissuance are treated as transactions separate and apart from the triggering transaction. The deemed satisfaction and reissuance of a member's debt will not cause the debt to be recharacterized as other than debt for Federal income tax purposes.

(4) *Special rules—(i) Timing and attributes.* For purposes of applying the matching rule and the acceleration rule to a transaction involving an intercompany obligation (other than a transaction to which paragraph (g)(5) of this section applies)—

(A) Paragraph (c)(6)(i) of this section (treatment of intercompany items if corresponding items are excluded or nondeductible) will not apply to exclude any amount of income or gain attributable to a reduction of the basis of the intercompany obligation pursuant to § 1.1502-36(d), or pursuant to sections 108 and 1017 and § 1.1502-28 or any other provision that adjusts the basis of an

intercompany obligation as a substitute for income or gain;

(B) Paragraph (c)(6)(ii) of this section (limitation on treatment of intercompany income or gain as excluded from gross income) does not apply to prevent any intercompany income or gain from the intercompany obligation from being excluded from gross income;

(C) Any income, gain, deduction, or loss from the intercompany obligation is not subject to section 108(a), section 354, section 355(a)(1), section 1091, or, in the case of an extinguishment of an intercompany obligation in a transaction in which the creditor transfers the obligation to the debtor in exchange for stock in such debtor, section 351(a); and

(D) Section 108(e)(7) does not apply upon the extinguishment of an intercompany obligation.

(ii) *Newly issued obligation in intercompany exchange.* If an intercompany obligation is exchanged (or is deemed exchanged) for a newly issued intercompany obligation and the exchange (or deemed exchange) is not a routine modification of an intercompany obligation (as described in paragraph (g)(3)(i)(B)(6) of this section), then the newly issued obligation will be treated for all Federal income tax purposes as having an issue price equal to its fair market value.

(iii) *Off-market issuance.* If an intercompany obligation is issued at a rate of interest that is materially off-market (off-market obligation) with a view to shift items of built-in gain, loss, income, or deduction from the obligation from one member to another member in order to secure a tax benefit (as defined in paragraph (g)(2)(v) of this section), then the intercompany obligation will be treated, for all Federal income tax purposes, as originally issued for its fair market value, and any difference between the amount loaned and the fair market value of the obligation will be treated as transferred between the creditor and the debtor at the time the obligation is issued. For example, if S lends \$100 to B in return for an off-market B note valued at \$130, and the note is issued with a view to shift items from the note to secure a tax benefit, then the B note will be treated as issued for \$130. The \$30 difference

will be treated as a distribution or capital contribution between S and B (as appropriate) at the time of issuance, and this amount will be reflected in future payments on the note as bond issuance premium. An adjustment to an off-market obligation under this paragraph (g)(4)(iii) will be made without regard to the application of, and in lieu of any adjustment under, section 467 (certain payments for the use of property or services), 482 (allocations among commonly controlled taxpayers), 483 (interest on certain deferred payments), 1274 (determination of issue price for certain debt instruments issued for property), or 7872 (treatment of loans with below-market interest rates).

(iv) *Deferral of loss or deduction with respect to nonmember indebtedness acquired in certain debt exchanges.* If a creditor transfers an intercompany obligation to a nonmember (former intercompany obligation) in exchange for newly issued debt of a nonmember (nonmember debt), and the issue price of the nonmember debt is not determined by reference to its fair market value (for example, the issue price is determined under section 1273(b)(4) or 1274(a) or any other provision of applicable law), then any loss of the creditor otherwise allowable on the subsequent disposition of the nonmember debt, or any comparable tax benefit that would otherwise be available in any other transaction that directly or indirectly results from the disposition of the nonmember debt, is deferred until the date the debtor retires the former intercompany obligation.

(v) *Bad debt reserve.* A member's deduction under section 585 for an addition to its reserve for bad debts with respect to an intercompany obligation is not taken into account, and is not treated as realized for purposes of paragraph (g)(3)(i)(A)(1) of this section, until the intercompany obligation is extinguished or becomes an obligation that is not an intercompany obligation.

(5) *Deemed satisfaction and reissuance of obligations becoming intercompany obligations—(i) Application of deemed satisfaction and reissuance—(A) In general.*

This paragraph (g)(5) applies if an obligation that is not an intercompany obligation becomes an intercompany obligation.

(B) *Exceptions.* This paragraph (g)(5) does not apply to an intercompany obligation if either of the following exceptions apply.

(1) *Exception to the application of section 108(e)(4).* The obligation becomes an intercompany obligation by reason of an event described in § 1.108-2(e)(2) (exception to the application of section 108(e)(4) in the case of acquisitions by securities dealers); or

(2) *Inbound subgroup exception.* The obligation becomes an intercompany obligation in a transaction in which the members of an intercompany obligation subgroup cease to be members of a consolidated group, neither the creditor nor the debtor recognize any income, gain, deduction, or loss with respect to the intercompany obligation, and such members constitute an intercompany obligation subgroup of another consolidated group immediately after the transaction.

(ii) *Deemed satisfaction and reissuance—*(A) *General rule.* If the intercompany obligation is debt of a member, then the debt is treated for all Federal income tax purposes, immediately after it becomes an intercompany obligation, as having been satisfied by the debtor for cash in an amount determined under the principles of § 1.108-2(f), and then as having been reissued as a new obligation (with a new holding period but otherwise identical terms) for the same amount of cash. If the intercompany obligation is a security of a member, similar principles apply (with appropriate adjustments) to treat the security, immediately after it becomes an intercompany obligation, as satisfied and reissued by the debtor for cash in an amount equal to its fair market value.

(B) *Treatment as separate transaction.* The deemed satisfaction and deemed reissuance are treated as transactions separate and apart from the transaction in which the debt becomes an intercompany obligation, and the tax consequences of the transaction in which the debt becomes an intercompany obligation must be determined before the deemed satisfaction and

reissuance occurs. (For example, if the debt becomes an intercompany obligation in a transaction to which section 351 applies, any limitation imposed by section 362(e) on the basis of the intercompany obligation in the hands of the transferee member is determined before the deemed satisfaction and reissuance.) The deemed satisfaction and reissuance of a member's debt will not cause the debt to be recharacterized as other than debt for Federal income tax purposes.

(6) *Special rules—*(i) *Timing and attributes.* If paragraph (g)(5) of this section applies to an intercompany obligation—

(A) Section 108(e)(4) does not apply;

(B) The attributes of all items taken into account from the satisfaction of the intercompany obligation are determined on a separate entity basis, rather than by treating S and B as divisions of a single corporation; and

(C) Any intercompany gain or loss realized by the creditor is not subject to section 354 or section 1091.

(ii) *Waiver of loss carryovers from separate return limitation years.* Solely for purposes of § 1.1502-32(b)(4) and the effect of any election under that provision, any loss taken into account under paragraph (g)(5) of this section by a corporation that becomes a member as a result of the transaction in which the obligation becomes an intercompany obligation is treated as a loss carryover from a separate return limitation year.

(iii) *Deduction of repurchase premium in certain debt exchanges.* If an obligation to which paragraph (g)(5) of this section applies is acquired in exchange for the issuance of an obligation to a nonmember and the issue price of this newly issued obligation is not determined by reference to its fair market value (for example, the issue price is determined under section 1273(b)(4) or 1274(a) or any other provision of applicable law), then, under the principles of § 1.163-7(c), any repurchase premium from the deemed satisfaction of the intercompany obligation under paragraph (g)(5)(ii) of this section will be amortized by the debtor over the term of the obligation issued to the nonmember in the same manner as if it were original issue discount and the

obligation to the nonmember had been issued directly by the debtor.

(7) *Examples*—(i) *In general.* For purposes of the examples in this paragraph (g), unless otherwise stated, interest is qualified stated interest under § 1.1273-1(c), and the intercompany obligations are capital assets and are not subject to section 475.

(ii) The application of this section to obligations of members is illustrated by the following examples:

*Example 1. Interest on intercompany obligation.* (i) *Facts.* On January 1 of year 1, B borrows \$100 from S in return for B's note providing for \$10 of interest annually at the end of each year, and repayment of \$100 at the end of year 5. B fully performs its obligations. Under their separate entity methods of accounting, B accrues a \$10 interest deduction annually under section 163, and S accrues \$10 of interest income annually under section 61(a)(4) and § 1.446-2.

(ii) *Matching rule.* Under paragraph (b)(1) of this section, the accrual of interest on B's note is an intercompany transaction. Under the matching rule, S takes its \$10 of income into account in each of years 1 through 5 to reflect the \$10 difference between B's \$10 of interest expense taken into account and the \$0 recomputed expense. S's income and B's deduction are ordinary items. (Because S's intercompany item and B's corresponding item would both be ordinary on a separate entity basis, the attributes are not redetermined under paragraph (c)(1)(i) of this section.)

(iii) *Original issue discount.* The facts are the same as in paragraph (i) of this *Example 1*, except that B borrows \$90 (rather than \$100) from S in return for B's note providing for \$10 of interest annually and repayment of \$100 at the end of year 5. The principles described in paragraph (ii) of this *Example 1* for stated interest also apply to the \$10 of original issue discount. Thus, as B takes into account its corresponding expense under section 163(e), S takes into account its intercompany income under section 1272. S's income and B's deduction are ordinary items.

(iv) *Tax-exempt income.* The facts are the same as in paragraph (i) of this *Example 1*, except that B's borrowing from S is allocable under section 265 to B's purchase of state and local bonds to which section 103 applies. The timing of S's income is the same as in paragraph (ii) of this *Example 1*. Under paragraph (c)(4)(i) of this section, the attributes of B's corresponding item of disallowed interest expense control the attributes of S's offsetting intercompany interest income. Paragraph (c)(6) of this section does not prevent the redetermination of S's intercompany item as excluded from gross income because section 265(a)(2) permanently and explicitly dis-

allows B's corresponding deduction and because, under paragraph (g)(4)(i)(B) of this section, paragraph (c)(6)(ii) of this section does not apply to prevent any intercompany income from the B note from being excluded from gross income. Accordingly, S's intercompany income is treated as excluded from gross income.

*Example 2. Intercompany obligation becomes nonintercompany obligation.* (i) *Facts.* On January 1 of year 1, B borrows \$100 from S in return for B's note providing for \$10 of interest annually at the end of each year, and repayment of \$100 at the end of year 5. As of January 1 of year 3, B has paid the interest accruing under the note and S sells B's note to X for \$70, reflecting an increase in prevailing market interest rates. B is never insolvent within the meaning of section 108(d)(3).

(ii) *Deemed satisfaction and reissuance.* Because the B note becomes an obligation that is not an intercompany obligation, the transaction is a triggering transaction under paragraph (g)(3)(i)(A)(2) of this section. Under paragraph (g)(3)(ii) of this section, B's note is treated as satisfied and reissued for its fair market value of \$70 immediately before S's sale to X. As a result of the deemed satisfaction of the note for less than its adjusted issue price, B takes into account \$30 of discharge of indebtedness income under § 1.61-12. On a separate entity basis, S's \$30 loss would be a capital loss under section 1271(a)(1). Under the matching rule, however, the attributes of S's intercompany item and B's corresponding item must be redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of B's \$30 of discharge of indebtedness income control the attributes of S's loss. Thus, S's loss is treated as ordinary loss. B is also treated as reissuing, immediately after the satisfaction, a new note to S with a \$70 issue price, a \$100 stated redemption price at maturity, and a \$70 basis in the hands of S. S is then treated as selling the new note to X for the \$70 received by S in the actual transaction. Because S has a basis of \$70 in the new note, S recognizes no gain or loss from the sale to X. After the sale, the new note held by X is not an intercompany obligation, it has a \$70 issue price, a \$100 stated redemption price at maturity, and a \$70 basis. The \$30 of original issue discount will be taken into account by B and X under sections 163(e) and 1272.

(iii) *Creditor deconsolidation.* The facts are the same as in paragraph (i) of this *Example 2*, except that P sells S's stock to X (rather than S selling B's note to X). Because the B note becomes an obligation that is not an intercompany obligation, the transaction is a triggering transaction under paragraph (g)(3)(i)(A)(2) of this section. Under paragraph (g)(3)(ii) of this section, B's note is treated as satisfied and reissued for its \$70

fair market value immediately before S becomes a nonmember. The treatment of S's \$30 of loss and B's \$30 of discharge of indebtedness income is the same as in paragraph (ii) of this *Example 2*. The new note held by S upon deconsolidation is not an intercompany obligation, it has a \$70 issue price, a \$100 stated redemption price at maturity, and a \$70 basis. The \$30 of original issue discount will be taken into account by B and S under sections 163(e) and 1272.

(iv) *Debtor deconsolidation*. The facts are the same as in paragraph (i) of this *Example 2*, except that P sells B's stock to X (rather than S selling B's note to X). The results to S and B are the same as in paragraph (iii) of this *Example 2*.

(v) *Subgroup exception*. The facts are the same as in paragraph (i) of this *Example 2*, except that P owns all of the stock of S, S owns all of the stock of B, and P sells all of the S stock to X, the parent of another consolidated group. Because B and S, members of an intercompany obligation subgroup, cease to be members of the P group in a transaction that does not cause either member to recognize an item with respect to the B note, and such members constitute an intercompany obligation subgroup in the X group, P's sale of S stock is not a triggering transaction under paragraph (g)(3)(i)(B)(8) of this section, and the note is not treated as satisfied and reissued under paragraph (g)(3)(ii) of this section. After the sale, the note held by S has a \$100 issue price, a \$100 stated redemption price at maturity, and a \$100 basis. The results are the same if the S stock is sold to an individual and the S-B affiliated group elects to file a consolidated return for the period beginning on the day after S and B cease to be members of the P group.

(vi) *Section 338 election*. The facts are the same as paragraph (i) of this *Example 2*, except that P sells S's stock to X and a section 338 election is made with respect to the stock sale. Under section 338, S is treated as selling all of its assets to new S, including the B note, at the close of the acquisition date. The aggregate deemed sales price (within the meaning of § 1.338-4) allocated to the B note is \$70. Because the B note becomes an obligation that is not an intercompany obligation, the transaction is a triggering transaction under paragraph (g)(3)(i)(A)(2) of this section. Under paragraph (g)(3)(ii) of this section, B's note is treated as satisfied and reissued immediately before S's deemed sale to new S for \$70, the amount realized with respect to the note (the aggregate deemed sales price allocated to the note under § 1.338-6). The results to S and B are the same as in paragraph (ii) of this *Example 2*.

(vii) *Appreciated note*. The facts are the same as in paragraph (i) of this *Example 2*, except that S sells B's note to X for \$130

(rather than \$70), reflecting a decline in prevailing market interest rates. Because the B note becomes an obligation that is not an intercompany obligation, the transaction is a triggering transaction under paragraph (g)(3)(i)(A)(2) of this section. Under paragraph (g)(3)(ii) of this section, B's note is treated as satisfied and reissued for its fair market value of \$130 immediately before S's sale to X. As a result of the deemed satisfaction of the note for more than its adjusted issue price, B takes into account \$30 of repurchase premium under § 1.163-7(c). On a separate entity basis, S's \$30 gain would be a capital gain under section 1271(a)(1). Under the matching rule, however, the attributes of S's intercompany item and B's corresponding item must be redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of B's premium deduction control the attributes of S's gain. Accordingly, S's gain is treated as ordinary income. B is also treated as reissuing, immediately after the satisfaction, a new note to S with a \$130 issue price, \$100 stated redemption price at maturity, and \$130 basis in the hands of S. S is then treated as selling the new note to X for the \$130 received by S in the actual transaction. Because S has a basis of \$130 in the new note, S recognizes no gain or loss from the sale to X. After the sale, the new note held by X is not an intercompany obligation, it has a \$130 issue price, a \$100 stated redemption price at maturity, and a \$130 basis. The treatment of B's \$30 of bond issuance premium under the new note is determined under § 1.163-13.

(viii) *Deferral of loss or deduction with respect to nonmember indebtedness acquired in debt exchange*. The facts are the same as in paragraph (i) of this *Example 2*, except that S sells B's note to X for a non-publicly traded X note with an issue price and face amount of \$100 and a fair market value of \$70, and that, subsequently, S sells the X note for \$70. Because the B note becomes an obligation that is not an intercompany obligation, the transaction is a triggering transaction under paragraph (g)(3)(i)(A)(2) of this section. Under paragraph (g)(3)(ii) of this section, B's note is treated as satisfied and reissued immediately before S's sale to X for \$100, the amount realized with respect to the note (determined under section 1274). As a result of the deemed satisfaction, neither S nor B take into account any items of income, gain, deduction, or loss. S is then treated as selling the new B note to X for the X note received by S in the actual transaction. Because S has a basis of \$100 in the new note, S recognizes no gain or loss from the sale to X. After the sale, the new B note held by X is not an intercompany obligation, it has a \$100 issue price, a \$100 stated redemption price at maturity, and a \$100 basis. S also

holds an X note with a basis of \$100 but a fair market value of \$70. When S disposes of the X note, S's loss on the disposition is deferred under paragraph (g)(4)(iv) of this section, until B retires its note (the former intercompany obligation in the hands of X).

*Example 3. Loss or bad debt deduction with respect to intercompany obligation.* (i) *Facts.* On January 1 of year 1, B borrows \$100 from S in return for B's note providing for \$10 of interest annually at the end of each year, and repayment of \$100 at the end of year 5. On January 1 of year 3, the fair market value of the B note has declined to \$60 and S sells the B note to P for property with a fair market value of \$60. B is never insolvent within the meaning of section 108(d)(3). The B note is not a security within the meaning of section 165(g)(2).

(ii) *Deemed satisfaction and reissuance.* Because S realizes an amount of loss from the assignment of the B note, the transaction is a triggering transaction under paragraph (g)(3)(i)(A)(I) of this section. Under paragraph (g)(3)(ii) of this section, B's note is treated as satisfied and reissued for its fair market value of \$60 immediately before S's sale to P. As a result of the deemed satisfaction of the note for less than its adjusted issue price (\$100), B takes into account \$40 of discharge of indebtedness income under § 1.61-12. On a separate entity basis, S's \$40 loss would be a capital loss under section 1271(a)(1). Under the matching rule, however, the attributes of S's intercompany item and B's corresponding item must be redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of B's \$40 of discharge of indebtedness income control the attributes of S's loss. Thus, S's loss is treated as ordinary loss. B is also treated as reissuing, immediately after the satisfaction, a new note to S with a \$60 issue price, \$100 stated redemption price at maturity, and \$60 basis in the hands of S. S is then treated as selling the new note to P for the \$60 of property received by S in the actual transaction. Because S has a basis of \$60 in the new note, S recognizes no gain or loss from the sale to P. After the sale, the note is an intercompany obligation, it has a \$60 issue price and a \$100 stated redemption price at maturity, and the \$40 of original issue discount will be taken into account by B and P under sections 163(e) and 1272.

(iii) *Partial bad debt deduction.* The facts are the same as in paragraph (i) of this *Example 3*, except that S claims a \$40 partial bad debt deduction under section 166(a)(2) (rather than selling the note to P). Because S realizes a deduction from a transaction comparable to an assignment of the B note, the transaction is a triggering transaction under paragraph (g)(3)(i)(A)(I) of this section. Under paragraph (g)(3)(ii) of this section, B's

note is treated as satisfied and reissued for its fair market value of \$60 immediately before section 166(a)(2) applies. The treatment of S's \$40 loss and B's \$40 of discharge of indebtedness income are the same as in paragraph (ii) of this *Example 3*. After the reissuance, S has a basis of \$60 in the new note. Accordingly, the application of section 166(a)(2) does not result in any additional deduction for S. The \$40 of original issue discount on the new note will be taken into account by B and S under sections 163(e) and 1272.

(iv) *Insolvent debtor.* The facts are the same as in paragraph (i) of this *Example 3*, except that B is insolvent within the meaning of section 108(d)(3) at the time that S sells the note to P. As explained in paragraph (ii) of this *Example 3*, the transaction is a triggering transaction and the B note is treated as satisfied and reissued for its fair market value of \$60 immediately before S's sale to P. On a separate entity basis, S's \$40 loss would be capital, B's \$40 income would be excluded from gross income under section 108(a), and B would reduce attributes under section 108(b) or section 1017 (see also § 1.1502-28). However, under paragraph (g)(4)(i)(C) of this section, section 108(a) does not apply to characterize B's income as excluded from gross income. Accordingly, the attributes of S's loss and B's income are redetermined in the same manner as in paragraph (ii) of this *Example 3*.

*Example 4. Intercompany nonrecognition transactions.* (i) *Facts.* On January 1 of year 1, B borrows \$100 from S in return for B's note providing for \$10 of interest annually at the end of each year, and repayment of \$100 at the end of year 5. As of January 1 of year 3, B has fully performed its obligations, but the note's fair market value is \$130, reflecting a decline in prevailing market interest rates. On January 1 of year 3, S transfers the note and other assets to a newly formed corporation, Newco, for all of Newco's common stock in an exchange to which section 351 applies.

(ii) *No deemed satisfaction and reissuance.* Because the assignment of the B note is an exchange to which section 351 applies and neither S nor B recognize gain or loss, the transaction is not a triggering transaction under paragraph (g)(3)(i)(B)(I) of this section, and the note is not treated as satisfied and reissued under paragraph (g)(3)(ii) of this section.

(iii) *Receipt of other property.* The facts are the same as in paragraph (i) of this *Example 4*, except that the other assets transferred to Newco have a basis of \$100 and a fair market value of \$260, and S receives, in addition to Newco common stock, \$15 of cash. Because S would recognize \$15 of gain under section 351(b), the assignment of the B note is a triggering transaction under paragraph



(g)(3)(i)(A)(I) of this section. Under paragraph (g)(3)(ii) of this section, B's note is treated as satisfied and reissued for its fair market value of \$130 immediately before the transfer to Newco. As a result of the deemed satisfaction of the note for more than its adjusted issue price, B takes into account \$30 of repurchase premium under § 1.163-7(c). On a separate entity basis, S's \$30 gain would be a capital gain under section 1271(a)(1). Under the matching rule, however, the attributes of S's intercompany item and B's corresponding item must be redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of B's premium deduction control the attributes of S's gain. Accordingly, S's gain is treated as ordinary income. B is also treated as reissuing, immediately after the satisfaction, a new note to S with a \$130 issue price, \$100 stated redemption price at maturity, and \$130 basis in the hands of S. S is then treated as transferring the new note to Newco for the Newco stock and cash received by S in the actual transaction. Because S has a basis of \$130 in the new B note, S recognizes no gain or loss with respect to the transfer of the note in the section 351 exchange, and S recognizes \$10 of gain with respect to the transfer of the other assets under section 351(b). After the transfer, the note has a \$130 issue price and a \$100 stated redemption price at maturity. The treatment of B's \$30 of bond issuance premium under the new note is determined under § 1.163-13.

(iv) *Transferee loss subject to limitation.* The facts are the same as in paragraph (i) of this Example 4, except that T is a member with a loss from a separate return limitation year that is subject to limitation under § 1.1502-21(c) (a SRLY loss), and on January 1 of year 3, S transfers the assets and the B note to T in an exchange to which section 351 applies. Because the transferee, T, has a loss that is subject to a limitation, the assignment of the B note is a triggering transaction under paragraph (g)(3)(i)(A)(I) of this section (the exception in paragraph (g)(3)(i)(B)(I) of this section does not apply). Under paragraph (g)(3)(ii) of this section, B's note is treated as satisfied and reissued for its fair market value, immediately before S's transfer to T. As a result of the deemed satisfaction of the note for more than its adjusted issue price, B takes into account \$30 of repurchase premium under § 1.163-7(c). On a separate entity basis, S's \$30 gain would be a capital gain under section 1271(a)(1). Under the matching rule, however, the attributes of S's intercompany item and B's corresponding item must be redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of B's premium deduction control the at-

tributes of S's gain. Accordingly, S's gain is treated as ordinary income. B is also treated as reissuing, immediately after the satisfaction, a new note to S with a \$130 issue price, \$100 stated redemption price at maturity, and \$130 basis in the hands of S. The treatment of B's \$30 of bond issuance premium under the new note is determined under § 1.163-13. S is then treated as transferring the new note to T as part of the section 351 exchange. Because T will have a fair market value basis in the reissued B note immediately after the exchange, T's intercompany item from the subsequent retirement of the B note will not reflect any of S's built-in gain (and the amount of T's SRLY loss that may be absorbed by such item will be limited to any appreciation in the B note accruing after the exchange).

(v) *Intercompany obligation transferred in section 332 transaction.* The facts are the same as in paragraph (i) of this Example 4, except that S transfers the B note to P in complete liquidation under section 332. Because the transaction is an exchange to which section 332 and section 337(a) applies, and neither S nor B recognize gain or loss, the transaction is not a triggering transaction under paragraph (g)(3)(i)(B)(I) of this section, and the note is not treated as satisfied and reissued under paragraph (g)(3)(ii) of this section.

*Example 5. Assumption of intercompany obligation.* (i) *Facts.* On January 1 of year 1, B borrows \$100 from S in return for B's note providing for \$10 of interest annually at the end of each year, and repayment of \$100 at the end of year 5. The note is fully recourse and is incurred for use in Business Z. As of January 1 of year 3, B has fully performed its obligations, but the note's fair market value is \$110 reflecting a decline in prevailing market interest rates. Business Z has a fair market value of \$95. On January 1 of year 3, B transfers all of the assets of Business Z and \$15 of cash (substantially all of B's assets) to member T in exchange for the assumption by T of all of B's obligations under the note in a transaction in which gain or loss is recognized under section 1001. The terms and conditions of the note are not modified in connection with the sales transaction, the transaction does not result in a change in payment expectations, and no amount of income, gain, deduction, or loss is recognized by S, B, or T with respect to the note.

(ii) *No deemed satisfaction and reissuance.* Because all of B's obligations under the B note are assumed by T in connection with the sale of the Business Z assets, the assignment of B's obligations under the note is not a triggering transaction under paragraph (g)(3)(i)(B)(2) of this section, and the note is not treated as satisfied and reissued under paragraph (g)(3)(ii) of this section.

*Example 6. Extinguishment of intercompany obligation.* (i) *Facts.* On January 1 of year 1, B borrows \$100 from S in return for B's note

providing for \$10 of interest annually at the end of each year, and repayment of \$100 at the end of year 20. The note is a security within the meaning of section 351(d)(2). As of January 1 of year 3, B has fully performed its obligations, but the fair market value of the B note is \$130, reflecting a decline in prevailing market interest rates, and S transfers the note to B in exchange for \$130 of B stock in a transaction to which both section 351 and section 354 applies.

(ii) *No deemed satisfaction and reissuance.* As a result of the satisfaction of the note for more than its adjusted issue price, B takes into account \$30 of repurchase premium under § 1.163-7(c). Although the transfer of the B note is a transaction to which both section 351 and section 354 applies, under paragraph (g)(4)(i)(C) of this section, any gain or loss from the intercompany obligation is not subject to either section 351(a) or section 354, and therefore, S has a \$30 gain under section 1001. Because the note is extinguished in a transaction in which the adjusted issue price of the note is equal to the creditor's basis in the note, and the debtor's and creditor's items offset in amount, the transaction is not a triggering transaction under paragraph (g)(3)(i)(B)(5) of this section, and the note is not treated as satisfied and reissued under paragraph (g)(3)(ii) of this section. On a separate entity basis, S's \$30 gain would be a capital gain under section 1271(a)(1). Under the matching rule, however, the attributes of S's intercompany item and B's corresponding item must be redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of B's premium deduction control the attributes of S's gain. Accordingly, S's gain is treated as ordinary income. Under paragraph (g)(4)(i)(D) of this section, section 108(e)(7) does not apply upon the extinguishment of the B note, and therefore, the B stock received by S in the exchange will not be treated as section 1245 property.

*Example 7. Exchange of intercompany obligations.* (i) *Facts.* On January 1 of year 1, B borrows \$100 from S in return for B's note providing for \$10 of interest annually at the end of each year, and repayment of \$100 at the end of year 20. As of January 1 of year 3, B has fully performed its obligations and, pursuant to a recapitalization to which section 368(a)(1)(E) applies, B issues a new note to S in exchange for the original B note. The new B note has an issue price, stated redemption price at maturity, and stated principal amount of \$100, but contains terms that differ sufficiently from the terms of the original B note to cause a realization event under § 1.1001-3. The original B note and the new B note are both securities (within the meaning of section 354(a)(1)).

(ii) *No deemed satisfaction and reissuance.* Because the original B note is extinguished in exchange for a newly issued B note and the issue price of the new B note is equal to both the adjusted issue price of the original B note and S's basis in the original B note, the transaction is not a triggering transaction under paragraph (g)(3)(i)(B)(6) of this section, and the note is not treated as satisfied and reissued under paragraph (g)(3)(ii) of this section. B has neither income from discharge of indebtedness under section 108(e)(10) nor a deduction for repurchase premium under § 1.163-7(c). Although the exchange of the original B note for the new B note is a transaction to which section 354 applies, under paragraph (g)(4)(i)(C) of this section, any gain or loss from the intercompany obligation is not subject to section 354. Under section 1001, S has no gain or loss from the exchange of notes.

*Example 8. Tax benefit rule.* (i) *Facts.* On January 1 of year 1, B borrows \$100 from S in return for B's note providing for \$10 of interest annually at the end of each year, and repayment of \$100 at the end of year 5. As of January 1 of year 3, B has fully performed its obligations, but the note's fair market value has depreciated, reflecting an increase in prevailing market interest rates. On that date, S transfers the B note to member T as part of an exchange for T common stock which is intended to qualify for nonrecognition treatment under section 351 but with a view to sell the T stock at a reduced gain. On February 1 of year 4, all of the stock of T is sold at a reduced gain.

(ii) *Deemed satisfaction and reissuance.* Because the assignment of the B note does not occur within 12 months of the sale of T stock, paragraph (g)(3)(i)(B)(i)(vi) of this section does not apply to treat the assignment as a triggering transaction. However, because the assignment of the B note was engaged in with a view to shift built-in loss from the obligation in order to secure a tax benefit that the group or its members would not otherwise enjoy, under paragraph (g)(3)(i)(C) of this section, the assignment of the B note is a triggering transaction to which paragraph (g)(3)(ii) of this section applies. Under paragraph (g)(3)(ii) of this section, B's note is treated as satisfied and reissued for its fair market value, immediately before S's transfer to T. As a result of the deemed satisfaction of the note for less than its adjusted issue price, B takes into account discharge of indebtedness income and S has a corresponding loss which is treated as ordinary loss. B is also treated as reissuing, immediately after the deemed satisfaction, a new note to S with an issue price and basis equal to its fair market value. S is then treated as transferring the new note to T as part of the section 351 exchange. Because S's basis in the T stock received with respect to the transferred B note is equal to its fair

market value, S's gain with respect to the T stock will not reflect any of the built-in loss attributable to the B note. (This example does not address common law doctrines or other authorities that might apply to re-characterize the transaction or to otherwise affect the tax treatment of the transaction.)

*Example 9. Issuance at off-market rate of interest.* (i) *Facts.* T is a member with a SRLY loss. T's sole shareholder, P, borrows an amount of cash from T in return for a P note that provides for a materially above market rate of interest. The P note is issued with a view to generate additional interest income to T over the term of the note to facilitate the absorption of T's SRLY loss.

(ii) *With a view.* Because the P note is issued with a view to shift interest income from the off-market obligation in order to secure a tax benefit that the group or its members would not otherwise enjoy, under paragraph (g)(4)(iii) of this section, the intercompany obligation is treated, for all Federal income tax purposes, as originally issued for its fair market value so T is treated as purchasing the note at a premium. The difference between the amount loaned and the fair market value of the obligation is treated as transferred from P to T as a capital contribution at the time the note is issued. Throughout the term of the note, T takes into account interest income and bond premium and P takes into account interest deduction and bond issuance premium under generally applicable Internal Revenue Code sections. The adjustment under paragraph (g)(4)(iii) of this section is made without regard to the application of, and in lieu of any adjustment under, section 482 or 1274.

*Example 10. Nonintercompany obligation becomes intercompany obligation.* (i) *Facts.* On January 1 of year 1, B borrows \$100 from X in return for B's note providing for \$10 of interest annually at the end of each year, and repayment of \$100 at the end of year 5. As of January 1 of year 3, B has fully performed its obligations, but the note's fair market value is \$70, reflecting an increase in prevailing market interest rates. On January 1 of year 3, P buys all of X's stock. B is solvent within the meaning of section 108(d)(3).

(ii) *Deemed satisfaction and reissuance.* Under paragraph (g)(5)(ii) of this section, B's note is treated as satisfied for \$70 (determined under the principles of § 1.108-2(f)(2)) immediately after it becomes an intercompany obligation. Both X's \$30 capital loss (under section 1271(a)(1)) and B's \$30 of discharge of indebtedness income (under § 1.61-12) are taken into account in determining consolidated taxable income for year 3. Under paragraph (g)(6)(i)(B) of this section, the attributes of items resulting from the satisfaction are determined on a separate entity basis. But see section 382 and § 1.1502-15 (as appropriate). B is also treated as reissuing a new note to X. The new note is an

intercompany obligation, it has a \$70 issue price and \$100 stated redemption price at maturity, and the \$30 of original issue discount will be taken into account by B and X in the same manner as provided in paragraph (iii) of *Example 1* of this paragraph (g)(7).

(iii) *Amortization of repurchase premium.* The facts are the same as in paragraph (i) of this *Example 10*, except that on January 1 of year 3, the B note has a fair market value of \$130 and rather than P purchasing the X stock, P purchases the B note from X by issuing its own note. The P note has an issue price, stated redemption price at maturity, stated principal amount, and fair market value of \$130. Under paragraph (g)(5)(ii) of this section, B's note is treated as satisfied for \$130 (determined under the principles of § 1.108-2(f)(1)) immediately after it becomes an intercompany obligation. As a result of the deemed satisfaction of the note, P has no gain or loss and B has \$30 of repurchase premium. Under paragraph (g)(6)(iii) of this section, B's \$30 of repurchase premium from the deemed satisfaction is amortized by B over the term of the newly issued P note in the same manner as if it were original issue discount and the newly issued P note had been issued directly by B. B is also treated as re-issuing a new note to P. The new note is an intercompany obligation, it has a \$130 issue price and \$100 stated redemption price at maturity, and the treatment of B's \$30 of bond issuance premium under the new B note is determined under § 1.163-13.

(iv) *Election to file consolidated returns.* Assume instead that B borrows \$100 from S during year 1, but the P group does not file consolidated returns until year 3. Under paragraph (g)(5)(ii) of this section, B's note is treated as satisfied and reissued as a new note immediately after the note becomes an intercompany obligation. The satisfaction and reissuance are deemed to occur on January 1 of year 3, for the fair market value of the obligation (determined under the principles of § 1.108-2(f)(2)) at that time.

*Example 11. Notional principal contracts.* (i) *Facts.* On April 1 of year 1, M1 enters into a contract with counterparty M2 under which, for a term of five years, M1 is obligated to make a payment to M2 each April 1, beginning in year 2, in an amount equal to the London Interbank Offered Rate (LIBOR), as determined by reference to LIBOR on the day each payment is due, multiplied by a \$1,000 notional principal amount. M2 is obligated to make a payment to M1 each April 1, beginning in year 2, in an amount equal to 8 percent multiplied by the same notional principal amount. LIBOR is 7.80 percent on April 1 of year 2, and therefore, M2 owes \$2 to M1.

(ii) *Matching rule.* Under § 1.446-3(d), the net income (or net deduction) from a notional principal contract for a taxable year is included in (or deducted from) gross income.

Under § 1.446-3(e), the ratable daily portion of M2's obligation to M1 as of December 31 of year 1 is \$1.50 (\$2 multiplied by 275/365). Under the matching rule, M1's net income for year 1 of \$1.50 is taken into account to reflect the difference between M2's net deduction of \$1.50 taken into account and the \$0 recomputed net deduction. Similarly, the \$.50 balance of the \$2 of net periodic payments made on April 1 of year 2 is taken into account for year 2 in M1's and M2's net income and net deduction from the contract. In addition, the attributes of M1's intercompany income and M2's corresponding deduction are redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of M2's corresponding deduction control the attributes of M1's intercompany income. (Although M1 is the selling member with respect to the payment on April 1 of year 2, it might be the buying member in a subsequent period if it owes the net payment.)

(iii) *Dealer.* The facts are the same as in paragraph (i) of this Example 11, except that M2 is a dealer in securities, and the contract with M1 is not inventory in the hands of M2. Under section 475, M2 must mark its securities to fair market value at year-end. Assume that under section 475, M2's loss from marking to fair market value the contract with M1 is \$10. Because M2 realizes an amount of loss from the mark to fair market value of the contract, the transaction is a triggering transaction under paragraph (g)(3)(i)(A)(I) of this section. Under paragraph (g)(3)(ii) of this section, M2 is treated as making a \$10 payment to M1 to terminate the contract immediately before a new contract is treated as reissued with an up-front payment by M1 to M2 of \$10. M1's \$10 of income from the termination payment is taken into account under the matching rule to reflect M2's deduction under § 1.446-3(h). The attributes of M1's intercompany income and M2's corresponding deduction are redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of M2's corresponding deduction control the attributes of M1's intercompany income. Accordingly, M1's income is treated as ordinary income. Under § 1.446-3(f), the deemed \$10 up-front payment by M1 to M2 in connection with the issuance of a new contract is taken into account over the term of the new contract in a manner reflecting the economic substance of the contract (for example, allocating the payment in accordance with the forward rates of a series of cash-settled forward contracts that reflect the specified index and the \$1,000 notional principal amount). (The timing of taking items into account is the same if M1, rather than M2, is the dealer subject to the mark-to-market re-

quirement of section 475 at year-end. However in this case, because the attributes of the corresponding deduction control the attributes of the intercompany income, M1's income from the deemed termination payment from M2 might be ordinary or capital). Under paragraph (g)(3)(ii)(A) of this section, section 475 does not apply to mark the notional principal contract to fair market value after its deemed satisfaction and reissuance.

(8) *Effective/applicability date.* The rules of this paragraph (g) apply to transactions involving intercompany obligations occurring in consolidated return years beginning on or after December 24, 2008.

(h) *Anti-avoidance rules—(1) In general.* If a transaction is engaged in or structured with a principal purpose to avoid the purposes of this section (including, for example, by avoiding treatment as an intercompany transaction), adjustments must be made to carry out the purposes of this section.

(2) *Examples.* The anti-avoidance rules of this paragraph (h) are illustrated by the following examples. The examples set forth below do not address common law doctrines or other authorities that might apply to recast a transaction or to otherwise affect the tax treatment of a transaction. Thus, in addition to adjustments under this paragraph (h), the Commissioner can, for example, apply the rules of section 269 or § 1.701-2 to disallow a deduction or to recast a transaction.

*Example 1. Sale of a partnership interest.* (a) *Facts.* S owns land with a \$10 basis and \$100 value. B has net operating losses from separate return limitation years (SRLYs) subject to limitation under § 1.1502-21(c). Pursuant to a plan to absorb the losses without limitation by the SRLY rules, S transfers the land to an unrelated, calendar-year partnership in exchange for a 10% interest in the capital and profits of the partnership in a transaction to which section 721 applies. The partnership does not have a section 754 election in effect. S later sells its partnership interest to B for \$100. In the following year, the partnership sells the land to X for \$100. Because the partnership does not have a section 754 election in effect, its \$10 basis in the land does not reflect B's \$100 basis in the partnership interest. Under section 704(c), the partnership's \$90 built-in gain is allocated to B, and B's basis in the partnership interest increases to \$190 under section 705. In a later year, B sells the partnership interest to a nonmember for \$100.

(b) *Adjustments.* Under § 1.1502-21(c), the partnership's \$90 built-in gain allocated to B ordinarily increases the amount of B's SRLY limitation, and B's \$90 loss from its sale of the partnership interest ordinarily is not subject to limitation under the SRLY rules. Because the contribution of property to the partnership and the sale of the partnership interest were part of a plan a principal purpose of which was to achieve a reduction in consolidated tax liability by creating offsetting gain and loss for B while deferring S's intercompany gain, B's allocable share of the partnership's gain from its sale of the land is treated under paragraph (h)(1) of this section as not increasing the amount of B's SRLY limitation.

*Example 2. Transitory status as an intercompany obligation.* (a) *Facts.* P historically has owned 70% of X's stock and the remaining 30% is owned by unrelated shareholders. On January 1 of Year 1, S borrows \$100 from X in return for S's note requiring \$10 of interest annually at the end of each year, and repayment of \$100 at the end of Year 20. As of January 1 of Year 3, the P group has substantial net operating loss carryovers, and the fair market value of S's note falls to \$70 due to an increase in prevailing market interest rates. X is not permitted under section 166(a)(2) to take into account a \$30 loss with respect to the note. Pursuant to a plan to permit X to take into account its \$30 loss without disposing of the note, P acquires an additional 10% of X's stock, causing X to become a member, and P subsequently resells the 10% interest. X's \$30 loss with respect to the note is a net unrealized built-in loss within the meaning of § 1.1502-15.

(b) *Adjustments.* Under paragraph (g)(4) of this section, X ordinarily would take into account its \$30 loss as a result of the note becoming an intercompany obligation, and S would take into account \$30 of discharge of indebtedness income. Under § 1.1502-22, X's loss is not combined with items of the other members and the loss would be carried to X's separate return years as a result of X becoming a nonmember. However, the transitory status of S's indebtedness to X as an intercompany obligation is structured with a principal purpose to accelerate the recognition of X's loss. Thus, S's note is treated under paragraph (h)(1) of this section as not becoming an intercompany obligation.

*Example 3. Corporate mixing bowl.* (a) *Facts.* M1 and M2 are subsidiaries of P. M1 operates a manufacturing business on land it leases from M2. The land is the only asset held by M2. P intends to dispose of the M1 business, including the land owned by M2; P's basis in the M1 stock is equal to the stock's fair market value. M2's land has a value of \$20 and a basis of \$0 and P has a \$0 basis in the stock of M2. In Year 1, with a principal purpose of avoiding gain from the sale of the land (by transferring the land to M1 with a carry-over

basis without affecting P's basis in the stock of M1 or M2), M1 and M2 form corporation T; M1 contributes cash in exchange for 80% of the T stock and M2 contributes the land in exchange for 20% of the stock. In Year 3, T liquidates, distributing \$20 cash to M2 and the land (plus \$60 cash) to M1. Under § 1.1502-34, section 332 applies to both M1 and M2. Under section 337, T recognizes no gain or loss from its liquidating distribution of the land to M1. T has neither gain nor loss on its distribution of cash to M2. In Year 4, P sells all of the stock of M1 to X and liquidates M2.

(b) *Adjustments.* A principal purpose for the formation and liquidation of T was to avoid gain from the sale of M2's land. Thus, under paragraph (h)(1) of this section, M2 must take \$20 of gain into account when the stock of M1 is sold to X.

*Example 4. Partnership mixing bowl.* (a) *Facts.* M1 owns a self-created intangible asset with a \$0 basis and a fair market value of \$100. M2 owns land with a basis of \$100 and a fair market value of \$100. In Year 1, with a principal purpose of creating basis in the intangible asset (which would be eligible for amortization under section 197), M1 and M2 form partnership PRS; M1 contributes the intangible asset and M2 contributes the land. X, an unrelated person, contributes cash to PRS in exchange for a substantial interest in the partnership. PRS uses the contributed assets in legitimate business activities. Five years and six months later, PRS liquidates, distributing the land to M1, the intangible to M2, and cash to X. The group reports no gain under sections 707(a)(2)(B) and 737(a) and claims that M2's basis in the intangible asset is \$100 under section 732 and that the asset is eligible for amortization under section 197.

(b) *Adjustments.* A principal purpose of the formation and liquidation of PRS was to create additional amortization without an offsetting increase in consolidated taxable income by avoiding treatment as an intercompany transaction. Thus, under paragraph (h)(1) of this section, appropriate adjustments must be made.

*Example 5. Sale and leaseback.* (a) *Facts.* S operates a factory with a \$70 basis and \$100 value, and has loss carryovers from SRLYs. Pursuant to a plan to take into account the \$30 unrealized gain while continuing to operate the factory, S sells the factory to X for \$100 and leases it back on a long-term basis. In the transaction, a substantial interest in the factory is transferred to X. The sale and leaseback are not recharacterized under general principles of Federal income tax law. As a result of S's sale to X, the \$30 gain is taken into account and increases S's SRLY limitation.

(b) *No adjustments.* Although S's sale was pursuant to a plan to accelerate the \$30 gain, it is not subject to adjustment under paragraph (h)(1) of this section. The sale is not treated as engaged in or structured with a

principal purpose to avoid the purposes of this section.

(i) [Reserved]

(j) *Miscellaneous operating rules.* For purposes of this section—

(1) *Successor assets.* Any reference to an asset includes, as the context may require, a reference to any other asset the basis of which is determined, directly or indirectly, in whole or in part, by reference to the basis of the first asset.

(2) *Successor persons—(i) In general.* Any reference to a person includes, as the context may require, a reference to a predecessor or successor. For this purpose, a predecessor is a transferor of assets to a transferee (the successor) in a transaction—

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

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

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

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

(ii) *Intercompany items.* If the assets of a predecessor are acquired by a successor member, the successor succeeds to, and takes into account (under the rules of this section), the predecessor's intercompany items. If two or more successor members acquire assets of the predecessor, the successors take into account the predecessor's intercompany items in a manner that is consistently applied and reasonably carries out the purposes of this section and applicable provisions of law.

(3) *Multiple triggers.* If more than one corresponding item can cause an intercompany item to be taken into account under the matching rule, the intercompany item is taken into account in connection with the corresponding item most consistent with the treatment of members as divisions of a single corporation. For example, if S sells a truck to B, its intercompany gain from the sale is not taken into account by

reference to B's depreciation if the depreciation is capitalized under section 263A as part of B's cost for a building; instead, S's gain relating to the capitalized depreciation is taken into account when the building is sold or as it is depreciated. Similarly, if B purchases appreciated land from S and transfers the land to a lower-tier member in exchange for stock, thereby duplicating the basis of the land in the basis of the stock, items with respect to both the stock and the land can cause S's intercompany gain to be taken into account; if the lower-tier member becomes a nonmember as a result of the sale of its stock, the attributes of S's intercompany gain are determined with respect to the land rather than the stock.

(4) *Multiple or successive intercompany transactions.* If a member's intercompany item or corresponding item affects the accounting for more than one intercompany transaction, appropriate adjustments are made to treat all of the intercompany transactions as transactions between divisions of a single corporation. For example, if S sells property to M, and M sells the property to B, then S, M, and B are treated as divisions of a single corporation for purposes of applying the rules of this section. Similar principles apply with respect to intercompany transactions that are part of the same plan or arrangement. For example, if S sells separate properties to different members as part of the same plan or arrangement, all of the participating members are treated as divisions of a single corporation for purposes of determining the attributes (which might also affect timing) of the intercompany items and corresponding items from each of the properties.

(5) *Acquisition of group—(i) Scope.* This paragraph (j)(5) applies only if a consolidated group (the terminating group) ceases to exist as a result of—

(A) The acquisition of either the assets of the common parent of the terminating group in a reorganization described in section 381(a)(2), or the stock of the common parent of the terminating group; or

(B) The application of the principles of § 1.1502-75(d)(2) or (d)(3).

(ii) *Application.* If the terminating group ceases to exist under circumstances described in paragraph (j)(5)(i) of this section, the surviving group is treated as the terminating group for purposes of applying this section to the intercompany transactions of the terminating group. For example, intercompany items and corresponding items from intercompany transactions between members of the terminating group are taken into account under the rules of this section by the surviving group. This treatment does not apply, however, to members of the terminating group that are not members of the surviving group immediately after the terminating group ceases to exist (for example, under section 1504(a)(3) relating to reconsolidation, or section 1504(c) relating to includible insurance companies).

(6) *Former common parent treated as continuation of group.* If a group terminates because the common parent is the only remaining member, the common parent succeeds to the treatment of the terminating group for purposes of applying this section so long as it neither becomes a member of an affiliated group filing separate returns nor becomes a corporation described in section 1504(b). For example, if the only subsidiary of the group liquidates into the common parent in a complete liquidation to which section 332 applies, or the common parent merges into the subsidiary and the subsidiary is treated as the common parent's successor under paragraph (j)(2)(i) of this section, the taxable income of the surviving corporation is treated as the group's consolidated taxable income in which the intercompany and corresponding items must be included. See § 1.267(f)-1 for additional rules applicable to intercompany losses or deductions.

(7) *Becoming a nonmember.* For purposes of this section, a member is treated as becoming a nonmember if it has a separate return year (including another group's consolidated return year). A member is not treated as having a separate return year if its items are treated as taken into account in computing the group's consolidated taxable income under paragraph (j)(5) or (6) of this section.

(8) *Recordkeeping.* Intercompany and corresponding items must be reflected on permanent records (including work papers). See also section 6001, requiring records to be maintained. The group must be able to identify from these permanent records the amount, location, timing, and attributes of the items, so as to permit the application of the rules of this section for each year.

(9) *Examples.* The operating rules of this paragraph (j) are illustrated generally throughout this section, and by the following examples.

*Example 1. Intercompany sale followed by section 351 transfer to member.* (a) *Facts.* S holds land for investment with a basis of \$70. On January 1 of Year 1, S sells the land to M for \$100. M also holds the land for investment. On July 1 of Year 3, M transfers the land to B in exchange for all of B's stock in a transaction to which section 351 applies. Under section 358, M's basis in the B stock is \$100. B holds the land for sale to customers in the ordinary course of business and, under section 362(b), B's basis in the land is \$100. On December 1 of Year 5, M sells 20% of the B stock to X for \$22. In an unrelated transaction on July 1 of Year 8, B sells 20% of the land for \$22.

(b) *Definitions.* Under paragraph (b)(1) of this section, S's sale of the land to M and M's transfer of the land to B are both intercompany transactions. S is the selling member and M is the buying member in the first intercompany transaction, and M is the selling member and B is the buying member in the second intercompany transaction. M has no intercompany items under paragraph (b)(2) of this section. Because B acquired the land in an intercompany transaction, B's items from the land are corresponding items to be taken into account under this section. Under the successor asset rule of paragraph (j)(1) of this section, references to the land include references to M's B stock. Under the successor person rule of paragraph (j)(2) of this section, references to M include references to B with respect to the land.

(c) *Timing and attributes resulting from the stock sale.* Under paragraph (c)(3) of this section, M is treated as owning and selling B's stock for purposes of the matching rule even though, as divisions, M could not own and sell stock in B. Under paragraph (j)(3) of this section, both M's B stock and B's land can cause S's intercompany gain to be taken into account under the matching rule. Thus, S takes \$6 of its gain into account in Year 5 to reflect the \$6 difference between M's \$2 gain taken into account from its sale of B stock and the \$8 recomputed gain. Under paragraph (j)(4) of this section, the attributes of this

gain are determined by treating S, M, and B as divisions of a single corporation. Under paragraph (c)(1) of this section, S's \$6 gain and M's \$2 gain are treated as long-term capital gain. The gain would be capital on a separate entity basis (assuming that section 341 does not apply), and this treatment is not inconsistent with treating S, M, and B as divisions of a single corporation because the stock sale and subsequent land sale are unrelated transactions and B remains a member following the sale.

(d) *Timing and attributes resulting from the land sale.* Under paragraph (j)(3) of this section, S takes \$6 of its gain into account in Year 8 under the matching rule to reflect the \$6 difference between B's \$2 gain taken into account from its sale of an interest in the land and the \$8 recomputed gain. Under paragraph (j)(4) of this section, the attributes of this gain are determined by treating S, M, and B as divisions of a single corporation and taking into account the activities of S, M, and B with respect to the land. Thus, both S's gain and B's gain might be ordinary income as a result of B's activities. (If B subsequently sells the balance of the land, S's gain taken into account is limited to its remaining \$18 of intercompany gain.)

(e) *Sale of successor stock resulting in deconsolidation.* The facts are the same as in paragraph (a) of this *Example 1*, except that M sells 60% of the B stock to X for \$66 on December 1 of Year 5 and B becomes a nonmember. Under the matching rule, M's sale of B stock results in \$18 of S's gain being taken into account (to reflect the difference between M's \$6 gain taken into account and the \$24 recomputed gain). Under the acceleration rule, however, the entire \$30 gain is taken into account (to reflect B becoming a nonmember, because its basis in the land reflects M's \$100 cost basis from the prior intercompany transaction). Under paragraph (j)(4) of this section, the attributes of S's gain are determined by treating S, M, and B as divisions of a single corporation. Because M's cost basis in the land will be reflected by B as a nonmember, all of S's gain is treated as from the land (rather than a portion being from B's stock), and B's activities with respect to the land might therefore result in S's gain being ordinary income.

*Example 2. Intercompany sale of member stock followed by recapitalization.* (a) *Facts.* Before becoming a member of the P group, S owns P stock with a basis of \$70. On January 1 of Year 1, P buys all of S's stock. On July 1 of Year 3, S sells the P stock to M for \$100. On December 1 of Year 5, P acquires M's original P stock in exchange for new P stock in a recapitalization described in section 368(a)(1)(E).

(b) *Timing and attributes.* Although P's basis in the stock acquired from M is eliminated under paragraph (f)(4) of this section, the new P stock received by M is exchanged

basis property (within the meaning of section 7701(a)(44)) having a basis under section 358 equal to M's basis in the original P stock. Under the successor asset rule of paragraph (j)(1) of this section, references to M's original P stock include references to M's new P stock. Because it is still possible to take S's intercompany item into account under the matching rule with respect to the successor asset, S's gain is not taken into account under the acceleration rule as a result of the basis elimination under paragraph (f)(4) of this section. Instead, the gain is taken into account based on subsequent events with respect to M's new P stock (for example, a subsequent distribution or redemption of the new stock).

*Example 3. Back-to-back intercompany transactions—matching.* (a) *Facts.* S holds land for investment with a basis of \$70. On January 1 of Year 1, S sells the land to M for \$90. M also holds the land for investment. On July 1 of Year 3, M sells the land for \$100 to B, and B holds the land for sale to customers in the ordinary course of business. During Year 5, B sells all of the land to customers for \$105.

(b) *Timing.* Under paragraph (b)(1) of this section, S's sale of the land to M and M's sale of the land to B are both intercompany transactions. S is the selling member and M is the buying member in the first intercompany transaction, and M is the selling member and B is the buying member in the second intercompany transaction. Under paragraph (j)(4) of this section, S, M and B are treated as divisions of a single corporation for purposes of determining the timing of their items from the intercompany transactions. See also paragraph (j)(2) of this section (B is treated as a successor to M for purposes of taking S's intercompany gain into account). Thus, S's \$20 gain and M's \$10 gain are both taken into account in Year 5 to reflect the difference between B's \$5 gain taken into account with respect to the land and the \$35 recomputed gain (the gain that B would have taken into account if the intercompany sales had been transfers between divisions of a single corporation, and B succeeded to S's \$70 basis).

(c) *Attributes.* Under paragraphs (j)(4) of this section, the attributes of the intercompany items and corresponding items of S, M, and B are also determined by treating S, M, and B as divisions of a single corporation. For example, the attributes of S's and M's intercompany items are determined by taking B's activities into account.

*Example 4. Back-to-back intercompany transactions—acceleration.* (a) *Facts.* During Year 1, S performs services for M in exchange for \$10 from M. S incurs \$8 of employee expenses. M capitalizes the \$10 cost of S's services under section 263 as part of M's cost to acquire real property from X. Under its separate entity method of accounting, S would take its income and expenses into account in Year 1. M



holds the real property for investment and, on July 1 of Year 5, M sells it to B at a gain. B also holds the real property for investment. On December 1 of Year 8, while B still owns the real property, P sells all of M's stock to X and M becomes a nonmember.

(b) *M's items.* M takes its gain into account immediately before it becomes a nonmember. Because the real property stays in the group, the acceleration rule redetermines the attributes of M's gain under the principles of the matching rule as if B sold the real property to an affiliated corporation that is not a member of the group for a cash payment equal to B's adjusted basis in the real property, and S, M, and B were divisions of a single corporation. Thus, M's gain is capital gain.

(c) *S's items.* Under paragraph (b)(2)(ii) of this section, S includes the \$8 of expenses in determining its \$2 intercompany income. In Year 1, S takes into account \$8 of income and \$8 of expenses. Under paragraph (j)(4) of this section, appropriate adjustments must be made to treat both S's performance of services for M and M's sale to B as occurring between divisions of a single corporation. Thus, S's \$2 of intercompany income is not taken into account as a result of M becoming a nonmember, but instead will be taken into account based on subsequent events (e.g., under the matching rule based on B's sale of the real property to a nonmember, or under the acceleration rule based on P's sale of the stock of S or B to a nonmember). See the successor person rules of paragraph (j)(2) of this section (B is treated as a successor to M for purposes of taking S's intercompany income into account).

(d) *Sale of S's stock.* The facts are the same as in paragraph (a) of this *Example 4*, except that P sells all of S's stock (rather than M's stock) and S becomes a nonmember on July 1 of Year 5. S's remaining \$2 of intercompany income is taken into account immediately before S becomes a nonmember. Because S's intercompany income is not from an intercompany sale, exchange, or distribution of property, the attributes of the intercompany income are determined on a separate entity basis. Thus, S's \$2 of intercompany income is ordinary income. M does not take any of its intercompany gain into account as a result of S becoming a nonmember.

(e) *Intercompany income followed by intercompany loss.* The facts are the same as in paragraph (a) of this *Example 4*, except that M sells the real property to B at a \$1 loss (rather than a gain). M takes its \$1 loss into account under the acceleration rule immediately before M becomes a nonmember. But see § 1.267(f)-1 (which might further defer M's loss if M and B remain in a controlled group relationship after M becomes a nonmember). Under paragraph (j)(4) of this section appropriate adjustments must be made to treat the group as if both intercompany trans-

actions occurred between divisions of a single corporation. Accordingly, P's sale of M stock also results in S taking into account \$1 of intercompany income as capital gain to offset M's \$1 of corresponding capital loss. The remaining \$1 of S's intercompany income is taken into account based on subsequent events.

*Example 5. Successor group.* (a) *Facts.* On January 1 of Year 1, B borrows \$100 from S in return for B's note providing for \$10 of interest annually at the end of each year, and repayment of \$100 at the end of Year 20. As of January 1 of Year 3, B has paid the interest accruing under the note. On that date, X acquires all of P's stock and the former P group members become members of the X consolidated group.

(b) *Successor.* Under paragraph (j)(5) of this section, although B's note ceases to be an intercompany obligation of the P group, the note is not treated as satisfied and reissued under paragraph (g) of this section as a result of X's acquisition of P stock. Instead, the X consolidated group succeeds to the treatment of the P group for purposes of paragraph (g) of this section, and B's note is treated as an intercompany obligation of the X consolidated group.

*Example 6. Liquidation—80% distributee.* (a) *Facts.* X has had preferred stock described in section 1504(a)(4) outstanding for several years. On January 1 of Year 1, S buys all of X's common stock for \$60, and B buys all of X's preferred stock for \$40. X's assets have a \$0 basis and \$100 value. On July 1 of Year 3, X distributes all of its assets to S and B in a complete liquidation. Under § 1.1502-34, section 332 applies to both S and B. Under section 337, X has no gain or loss from its liquidating distribution to S. Under sections 336 and 337(c), X has a \$40 gain from its liquidating distribution to B. B has a \$40 basis under section 334(a) in the assets received from X, and S has a \$0 basis under section 334(b) in the assets received from X.

(b) *Intercompany items from the liquidation.* Under the matching rule, X's \$40 gain from its liquidating distribution to B is not taken into account under this section as a result of the liquidation (and therefore is not yet reflected under §§ 1.1502-32 and 1.1502-33). Under the successor person rule of paragraph (j)(2)(i) of this section, S and B are both successors to X. Under section 337(c), X recognizes gain or loss only with respect to the assets distributed to B. Under paragraph (j)(2)(ii) of this section, to be consistent with the purposes of this section, S succeeds to X's \$40 intercompany gain. The gain will be taken into account by S under the matching and acceleration rules of this section based on subsequent events. (The allocation of the intercompany gain to S does not govern the allocation of any other attributes.)

*Example 7. Liquidation—no 80% distributee.* (a) *Facts.* X has only common stock outstanding. On January 1 of Year 1, S buys 60% of X's stock for \$60, and B buys 40% of X's stock for \$40. X's assets have a \$0 basis and \$100 value. On July 1 of Year 3, X distributes all of its assets to S and B in a complete liquidation. Under § 1.1502-34, section 332 applies to both S and B. Under sections 336 and 337(c), X has a \$100 gain from its liquidating distributions to S and B. Under section 334(b), S has a \$60 basis in the assets received from X and B has a \$40 basis in the assets received from X.

(b) *Intercompany items from the liquidation.* Under the matching rule, X's \$100 intercompany gain from its liquidating distributions to S and B is not taken into account under this section as a result of the liquidation (and therefore is not yet reflected under §§ 1.1502-32 and 1.1502-33). Under the successor person rule of paragraph (j)(2)(i) of this section, S and B are both successors to X. Under paragraph (j)(2)(ii) of this section, to be consistent with the purposes of this section, S succeeds to X's \$40 intercompany gain with respect to the assets distributed to B, and B succeeds to X's \$60 intercompany gain with respect to the assets distributed to S. The gain will be taken into account by S and B under the matching and acceleration rules of this section based on subsequent events. (The allocation of the intercompany gain does not govern the allocation of any other attributes.)

(k) *Cross references—(1) Section 108.* See § 1.108-3 for the treatment of intercompany deductions and losses as subject to attribute reduction under section 108(b).

(2) *Section 263A(f).* See section 263A(f) and § 1.263A-9(g)(5) for special rules regarding interest from intercompany transactions.

(3) *Section 267(f).* See section 267(f) and § 1.267(f)-1 for special rules applicable to certain losses and deductions from transactions between members of a controlled group.

(4) *Section 460.* See § 1.460-4(j) for special rules regarding the application of section 460 to intercompany transactions.

(5) *Section 469.* See § 1.469-1(h) for special rules regarding the application of section 469 to intercompany transactions.

(6) *§ 1.1502-80.* See § 1.1502-80 for the non-application of certain Internal Revenue Code rules.

(1) *Effective/applicability dates—(1) In general.* This section applies with respect to transactions occurring in

years beginning on or after July 12, 1995. If both this section and prior law apply to a transaction, or neither applies, with the result that items may be duplicated, omitted, or eliminated in determining taxable income (or tax liability), or items may be treated inconsistently, prior law (and not this section) applies to the transaction. For example, S's and B's items from S's sale of property to B which occurs in a consolidated return year beginning before July 12, 1995, are taken into account under prior law, even though B may dispose of the property in a consolidated return year beginning on or after July 12, 1995. Similarly, an intercompany distribution to which a shareholder becomes entitled in a consolidated return year beginning before July 12, 1995, but which is distributed in a consolidated return year beginning on or after that date is taken into account under prior law (generally when distributed), because this section generally takes dividends into account when the shareholder becomes entitled to them but this section does not apply at that time. If application of prior law to S's deferred gain or loss from a deferred intercompany transaction (as defined under prior law) occurring in a consolidated return year beginning prior to July 12, 1995, would be affected by an intercompany transaction (as defined under this section) occurring in a consolidated return year beginning on or after July 12, 1995, S's deferred gain or loss continues to be taken into account as provided under prior law, and the items from the subsequent intercompany transaction are taken into account under this section. Appropriate adjustments must be made to prevent items from being duplicated, omitted, or eliminated in determining taxable income as a result of the application of both this section and prior law to the successive transactions, and to ensure the proper application of prior law. Paragraphs (a)(4), (f)(6)(ii), (f)(6)(iv)(A), (g)(3)(ii)(B)(2), and (j)(5)(i)(A) of this section apply with respect to transactions occurring on or after September 17, 2008. However, taxpayers may apply paragraph (j)(5)(i)(A) of this section to transactions that occurred prior to September 17, 2008.

(2) *Avoidance transactions.* This paragraph (1)(2) applies if a transaction is engaged in or structured on or after April 8, 1994, with a principal purpose to avoid the rules of this section (and instead to apply prior law). If this paragraph (1)(2) applies, appropriate adjustments must be made in years beginning on or after July 12, 1995, to prevent the avoidance, duplication, omission, or elimination of any item (or tax liability), or any other inconsistency with the rules of this section. For example, if S is a dealer in real property and sells land to B on March 16, 1995 with a principal purpose of converting any future appreciation in the land to capital gain, B's gain from the sale of the land on May 11, 1997 might be characterized as ordinary income under this paragraph (1)(2).

(3) *Election for certain stock elimination transactions—(i) In general.* A group may elect pursuant to this paragraph (1)(3) to apply this section (including the elections available under paragraph (f)(5)(ii) of this section) to stock elimination transactions to which prior law would otherwise apply. If an election is made, this section, and not prior law, applies to determine the timing and attributes of S's and B's gain or loss from stock with respect to all stock elimination transactions.

(ii) *Stock elimination transactions.* For purposes of this paragraph (1)(3), a stock elimination transaction is a transaction in which stock transferred from S to B—

(A) Is cancelled or redeemed on or after July 12, 1995;

(B) Is treated as cancelled in a liquidation pursuant to an election under section 338(h)(10) with respect to a qualified stock purchase with an acquisition date on or after July 12, 1995;

(C) Is distributed on or after July 12, 1995; or

(D) Is exchanged on or after July 12, 1995 for stock of a member (determined immediately after the exchange) in a transaction that would cause S's gain or loss from the transfer to be taken into account under prior law.

(iii) *Time and manner of making election.* An election under this paragraph (1)(3) is made by attaching to a timely filed original return (including extensions) for the consolidated return year

including July 12, 1995 a statement entitled “[Insert Name and Employer Identification Number of Common Parent] HEREBY ELECTS THE APPLICATION OF §1.1502-13(1)(3).” See paragraph (f)(5)(ii)(E) of this section for the manner of electing the relief provisions of paragraph (f)(5)(ii) of this section.

(4) *Prior law.* For transactions occurring in S's years beginning before July 12, 1995, see the applicable regulations issued under section 1502. See §§1.1502-13, 1.1502-13T, 1.1502-14, 1.1502-14T, 1.1502-31, and 1.1502-32 (as contained in the 26 CFR part 1 edition revised as of April 1, 1995).

(5) *Consent to adopt method of accounting.* For intercompany transactions occurring in a consolidated group's first taxable year beginning on or after July 12, 1995, the Commissioner's consent under section 446(e) is hereby granted for any changes in methods of accounting that are necessary solely by reason of the timing rules of this section. Changes in method of accounting for these transactions are to be effected on a cut-off basis.

(6) *Effective/applicability date.* (i) *In general.* Paragraph (f)(7)(i) *Example 4.* applies to transactions occurring on or after December 18, 2009.

(ii) [Reserved]

(m) *Effective/applicability date.* Paragraphs (f)(5)(ii)(E) and (f)(6)(i)(C)(2) of this section apply to any original consolidated Federal income tax return due (without extensions) after June 14, 2007. For original consolidated Federal income tax returns due (without extensions) after May 30, 2006, and on or before June 14, 2007, see §1.1502-13T as contained in 26 CFR part 1 in effect on April 1, 2007. For original consolidated Federal income tax returns due (without extensions) on or before May 30, 2006, see §1.1502-13 as contained in 26 CFR part 1 in effect on April 1, 2006. Paragraph (f)(5)(ii)(C) of this section is applicable to any qualified stock disposition (as defined in §1.336-1(b)(6)) for which the disposition date (as defined in §1.336-1(b)(8)) is on or after May 15, 2013.

[T.D. 8597, 60 FR 36685, July 18, 1995]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting §1.1502-13, see the List of CFR Sections Affected, which appears in the

## § 1.1502-15

## 26 CFR Ch. I (4-1-17 Edition)

Finding Aids section of the printed volume and at [www.fdsys.gov](http://www.fdsys.gov).

### § 1.1502-15 SRLY limitation on built-in losses.

(a) *SRLY limitation.* Except as provided in paragraph (f) of this section (relating to built-in losses of the common parent) and paragraph (g) of this section (relating to an overlap with section 382), built-in losses are subject to the SRLY limitation under §§ 1.1502-21(c) and 1.1502-22(c) (including applicable subgroup principles). Built-in losses are treated as deductions or losses in the year recognized, except for the purpose of determining the amount of, and the extent to which the built-in loss is limited by, the SRLY limitation for the year in which it is recognized. Solely for such purpose, a built-in loss is treated as a hypothetical net operating loss carryover or net capital loss carryover arising in a SRLY, instead of as a deduction or loss in the year recognized. To the extent that a built-in loss is allowed as a deduction under this section in the year it is recognized, it offsets any consolidated taxable income for the year before any loss carryovers or carrybacks are allowed as a deduction. To the extent not so allowed, it is treated as a separate net operating loss or net capital loss carryover or carryback arising in the year of recognition and, under § 1.1502-21(c) or 1.1502-22(c), the year of recognition is treated as a SRLY.

(b) *Built-in losses—(1) Defined.* If a corporation has a net unrealized built-in loss under section 382(h)(3) (as modified by this section) on the day it becomes a member of the group (whether or not the group is a consolidated group), its deductions and losses are built-in losses under this section to the extent they are treated as recognized built-in losses under section 382(h)(2)(B) (as modified by this section). This paragraph (b) generally applies separately with respect to each member, but see paragraph (c) of this section for circumstances in which it is applied on a subgroup basis.

(2) *Operating rules.* Solely for purposes of applying paragraph (b)(1) of this section, the principles of § 1.1502-94(c) apply with appropriate adjustments, including the following:

(i) *Stock acquisition.* A corporation is treated as having an ownership change under section 382(g) on the day the corporation becomes a member of a group, and no other events (e.g., a subsequent ownership change under section 382(g) while it is a member) are treated as causing an ownership change.

(ii) *Asset acquisition.* In the case of an asset acquisition by a group, the assets and liabilities acquired directly from the same transferor (whether corporate or non-corporate, foreign or domestic) pursuant to the same plan are treated as the assets and liabilities of a corporation that becomes a member of the group (and has an ownership change) on the date of the acquisition.

(iii) *Recognized built-in gain or loss.* A loss that is included in the determination of net unrealized built-in gain or loss and that is recognized but disallowed or deferred (e.g., under § 1.337(d)-2, § 1.1502-35, § 1.1502-36, or section 267) is not treated as a built-in loss unless and until the loss would be allowed during the recognition period without regard to the application of this section. Section 382(h)(1)(B)(ii) does not apply to the extent it limits the amount of recognized built-in loss that may be treated as a pre-change loss to the amount of the net unrealized built-in loss.

(c) *Built-in losses of subgroups—(1) In general.* In the case of a subgroup, the principles of paragraph (b) of this section apply to the subgroup, and not separately to its members. Thus, the net unrealized built-in loss and recognized built-in loss for purposes of paragraph (b) of this section are based on the aggregate amounts for each member of the subgroup.

(2) *Members of subgroups.* A subgroup is composed of those members that have been continuously affiliated with each other for the 60 consecutive month period ending immediately before they become members of the group in which the loss is recognized. A member remains a member of the subgroup until it ceases to be affiliated with the loss member. For this purpose, the principles of § 1.1502-21(c)(2)(iv) through (vi) apply with appropriate adjustments.

(3) *Coordination of 60 month affiliation requirement with the overlap rule.* If one