

in paragraph (c)(7)(iv) of this section, reporting under paragraph (b)(4)(ii) of this section is waived for amounts properly reported on Form 1042-S (on either a specific payee or pooled basis) by a withholding agent described in paragraph (c)(7)(ii) of this section if the beneficial owner is described in paragraph (c)(7)(iii) of this section.

(ii) A withholding agent described in this paragraph (c)(7)(ii) is a U.S. financial institution, as defined in § 1.1441-1(c)(5) of this chapter, a qualified intermediary, as defined in § 1.1441-1(e)(5)(ii) of this chapter, a withholding foreign partnership, as defined § 1.1441-5(c)(2)(i) of this chapter, or a withholding foreign trust, as defined in § 1.1441-5(e)(5)(v) of this chapter.

(iii) A beneficial owner described in this paragraph (c)(7)(iii) of this section is a direct account holder of a U.S. financial institution or qualified intermediary, a direct partner of a withholding foreign partnership, or a direct beneficiary or owner of a simple or grantor trust that is a withholding foreign trust. A beneficial owner described in this paragraph (c)(7)(iii) also includes an account holder to which a qualified intermediary has applied section 4A.01 or 4A.02 of the qualified intermediary agreement, contained in Revenue Procedure 2000-12 (2000-1 C.B. 387), (as amended by Revenue Procedure 2003-64, (2003-2 C.B. 306); Revenue Procedure 2004-21 (2004-1 C.B. 702); Revenue Procedure 2005-77 (2005-51 I.R.B. 1176) (see § 601.601(b)(2) of this chapter) a partner to which a withholding foreign partnership has applied section 10.01 or 10.02 of the withholding foreign partnership agreement, and a beneficiary or owner to which a withholding foreign trust has applied section 10.01 or 10.02 of the withholding foreign trust agreement, contained in Revenue Procedure 2003-64, (2003-2 C.B. 306), (as amended by Revenue Procedure 2004-21 (2004-1 C.B. 702); Revenue Procedure 2005-77 (2005-51 I.R.B. 1176); (see § 601.601(b)(2) of this chapter).

(iv) Paragraph (c)(7)(i) of this section does not apply to any amounts for which reporting is specifically required under the instructions to Form 8833.

(8)(i) For taxable years ending after December 31, 2004, except as provided in paragraph (c)(8)(ii) of this section, reporting under paragraph (b)(4)(ii) of this section is waived for taxpayers that are not individuals or States and that receive amounts of income that have been properly reported on Form 1042-S, that do not exceed \$500,000 in the aggregate for the taxable year and that

are not received through an account with an intermediary, as defined in § 1.1441-1(c) (13), or with respect to interest in a flow-through entity, as defined in § 1.1441-1(c)(23), (ii) The exception contained in paragraph (c)(8)(i) of this section does not apply to any amounts for which reporting is specifically required under the instructions to Form 8833.

\* \* \* \* \*

**Mark E. Matthews,**

*Deputy Commissioner for Services and Enforcement.*

Approved: February 27, 2006.

**Eric Solomon,**

*Acting Deputy Assistant Secretary of the Treasury (Tax Policy).*

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## DEPARTMENT OF THE TREASURY

### Internal Revenue Service

#### 26 CFR Parts 1 and 602

[TD 9254]

RIN 1545-BB25

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

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Final rule and removal of temporary regulations.

**SUMMARY:** This document contains final regulations under section 1502 of the Internal Revenue Code of 1986. The regulations apply when a member of a consolidated group transfers subsidiary stock at a loss. They also apply when a member holds loss shares of subsidiary stock and the subsidiary ceases to be a member of the group. These regulations finalize § 1.1502-35T without substantive change.

**DATES:** *Effective Date:* These regulations are effective March 9, 2006.

*Applicability Date:* For dates of applicability, see §§ 1.1502-21(h)(8), 1.1502-32(h)(6), 1.1502-35(f), and 1.1502-35(j).

**FOR FURTHER INFORMATION CONTACT:** Theresa Abell (202) 622-7700 or Martin Huck (202) 622-7750 (not toll-free numbers).

#### SUPPLEMENTARY INFORMATION:

##### Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in

accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545-1828.

The collection of information in these regulations is in §§ 1.1502-35(c), 1.1502-35(c)(5)(iii), and 1.1502-35(g)(3). This information is required by the IRS to verify compliance with section 1502 of the Code. This information will be used to determine whether the amount of tax has been calculated correctly. The collection of information is required to properly determine the amount permitted to be taken into account as a loss. The respondents are corporations filing consolidated returns. The collection of information is required to obtain a benefit.

*Estimated average annual burden per respondent and/or recordkeeper:* 2 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be directed to the Office of Management and Budget, Attn: Desk Officer for the Department of Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number.

Books or records relating to the collection of information must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

#### Background

On September 19, 1991, the IRS and Treasury Department published § 1.1502-20 (the loss disallowance rule, or LDR). See TD 8364, 56 FR 47379. The LDR addressed two problems arising in the consolidated return context: the circumvention of *General Utilities* repeal and the duplication of loss.

On July 6, 2001, in *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001), the Court of Appeals for the Federal Circuit held that the duplicated loss provisions of the LDR were an invalid exercise of regulatory authority. In response to the court's decision, the IRS and Treasury Department promulgated two regulations to replace the LDR. The first, § 1.337(d)-2T (temporary *General Utilities* regulation),

was published on March 12, 2002, to address the circumvention of *General Utilities* repeal. See TD 8984, 67 FR 11034. The second, § 1.1502–35T, was published on March 14, 2003, to address the inappropriate duplication of loss. See TD 9048, 68 FR 12287. TD 9048 also included certain related provisions promulgated under §§ 1.1502–21T and 1.1502–32T.

**Comments and Explanation of Revisions**

On March 3, 2005, the temporary *General Utilities* regulation was adopted without substantive change as final regulation § 1.337(d)–2. See TD 9187, 70 FR 10319. The preamble in TD 9187 states that the IRS and Treasury Department are continuing to study the issues and intend to publish proposed regulations adopting an alternative approach to addressing the circumvention of *General Utilities* repeal.

In response to the promulgation of § 1.337(d)–2 (in both its temporary and final form) and § 1.1502–35T, practitioners have provided many comments on the operation and effect of the rules contained therein. The IRS and Treasury Department have studied, and continue to study, the comments and the issues addressed in both regulations. As a result, the IRS and Treasury Department intend to publish proposed regulations that address both the circumvention of *General Utilities* repeal and the inappropriate duplication of loss in a single integrated regulation. The IRS and Treasury Department intend to publish the proposed regulations in the near term.

Until those proposed regulations are published as final or temporary regulations, however, the circumvention of *General Utilities* repeal will continue to be addressed by § 1.337(d)–2 and the duplication of loss will continue to be addressed by the rules of § 1.1502–35T. Accordingly, this Treasury decision adopts the rules of § 1.1502–35T (as in effect on February 1, 2006) as final regulation § 1.1502–35. The final regulations do not change the rules of the temporary regulations substantively. They do, however, modify certain examples in the temporary regulations to reflect the enactment of section 362(e)(2). These modifications do not change the operation of the regulations or address the application of section 362(e)(2) to transactions between members of a consolidated group. The final regulations also correct an error in Example 2 in paragraph (g)(5) of the proposed regulations. This Treasury decision also adopts, without substantive change, the related

provisions in §§ 1.1502–21T and 1.1502–32T as final regulations.

**Special Analyses**

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations will primarily affect affiliated groups of corporations that have elected to file consolidated returns, which tend to be larger businesses. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, the NPRM and the temporary regulation preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

**Drafting Information**

The principal authors of these regulations are Theresa Abell and Martin Huck of the Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

**List of Subjects**

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

**Adoption of Amendments to the Regulations**

■ Accordingly, 26 CFR parts 1 and 602 are amended as follows:

**PART 1—INCOME TAXES**

■ **Paragraph 1.** The authority citation for part 1 is amended by adding entries in numerical order to read in part as follows:

**Authority:** 26 U.S.C. 7805 \* \* \*  
Section 1.1502–21(b)(1) and (b)(3)(v) also issued under 26 U.S.C. 1502. \* \* \*

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

Section 1.1502–35 also issued under 26 U.S.C. 1502. \* \* \*

■ **Par. 2.** Section 1.1502–21 is amended by:

■ 1. Removing the language “§ 1.1502–21T” from paragraph (b)(1) and adding the language “§ 1.1502–21” in its place.

■ 2. Revising paragraphs (b)(3)(v) and (h)(8). The revisions read as follows.

**§ 1.1502–21 Net operating losses.**

\* \* \* \* \*

(b) \* \* \*

(3) \* \* \*

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

\* \* \* \* \*

(h) \* \* \*

(8) *Losses treated as expired under § 1.1502–35(f)(1).* Paragraph (b)(3)(v) of this section is effective for losses treated as expired under § 1.1502–35(f) on and after March 10, 2006. For rules regarding losses treated as expired before March 10, 2006, see § 1.1502–21T(h)(8) as contained in 26 CFR part 1 in effect on January 1, 2006.

**§ 1.1502–21T [Amended]**

■ **Par. 3.** Section 1.1502–21T is amended by removing paragraphs (b)(3)(v) and (h)(8).

■ **Par. 4.** Section 1.1502–32 is amended by revising paragraphs (a)(2), (b)(3)(iii)(C) and (D), (b)(4)(vi), and (h)(6) to read as follows:

**§ 1.1502–32 Investment adjustments.**

(a) \* \* \*

(1) \* \* \*

(2) *Application of other rules of law.* The rules of this section are in addition to other rules of law. See, e.g., section 358 (basis determinations for distributees), section 1016 (adjustments to basis), § 1.1502–11(b) (limitations on the use of losses), § 1.1502–19 (treatment of excess loss accounts), § 1.1502–31 (basis after a group structure change), and § 1.1502–35 (additional rules relating to stock loss, including losses attributable to worthlessness and certain dispositions not followed by a separate return year). P’s basis in S’s stock must not be adjusted under this section and other rules of law in a manner that has the effect of duplicating an adjustment. For example, if pursuant to § 1.1502–35(c)(3) and paragraph (b)(3)(iii)(C) of this section the basis in stock is reduced to take into account a loss suspended under § 1.1502–35(c)(1), such basis shall not be further reduced to take into account such loss, or a portion of such loss, if any, that is later allowed pursuant to § 1.1502–35(c)(5). See also paragraph (h)(5) of this section for basis reductions applicable to certain former subsidiaries.

\* \* \* \* \*

(b) \* \* \*

(3) \* \* \*

(iii) \* \* \*

(C) *Loss suspended under § 1.1502-35(c)*. Any loss suspended pursuant to § 1.1502-35(c) is treated as a noncapital, nondeductible expense incurred during the taxable year that includes the date of the disposition to which such section applies. See § 1.1502-35(c)(3). Consequently, the basis of a higher-tier member's stock of P is reduced by the suspended loss in the year it is suspended.

(D) *Loss disallowed under § 1.1502-35(g)(3)(iii)*. Any loss or deduction the use of which is disallowed pursuant to § 1.1502-35(g)(3)(iii) (other than a loss or deduction described in § 1.1502-35(g)(3)(i)(B)(11)), and with respect to which no waiver described in paragraph (b)(4) of this section is filed, is treated as a noncapital, nondeductible expense incurred during the taxable year that such loss would otherwise be absorbed. See § 1.1502-35(g)(3)(iv).

\* \* \* \* \*

(4) \* \* \*

(vi) *Special rules in the case of certain transactions subject to § 1.1502-35*. If a member of a consolidated group transfers stock of a subsidiary and such stock has a basis that exceeds its value immediately before such transfer or a subsidiary is deconsolidated and any stock of such subsidiary owned by members of the group immediately before such deconsolidation has a basis that exceeds its value, all members of the group are subject to the provisions of § 1.1502-35(b), which generally require a redetermination of members' basis in all shares of subsidiary stock.

\* \* \* \* \*

(h) \* \* \*

(6) *Loss suspended under § 1.1502-35(c) or disallowed under § 1.1502-35(g)(3)(iii)*. Paragraphs (a)(2), (b)(3)(iii)(C), (b)(3)(iii)(D) and (b)(4)(vi) of this section are applicable on and after March 10, 2006. For rules applicable before March 10, 2006, see § 1.1502-32T(h)(6) as contained in 26 CFR part 1 in effect on January 1, 2006.

\* \* \* \* \*

#### § 1.1502-32T [Removed]

■ **Par. 5.** Section 1.1502-32T is removed.

■ **Par. 6.** Section 1.1502-35 is added to read as follows:

#### § 1.1502-35 Transfers of subsidiary stock and deconsolidations of subsidiaries.

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

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

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

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

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

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

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

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

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

(A) During the taxable year of such transfer, in one or more fully taxable transactions, the members of the group dispose of all of the shares of the subsidiary stock that they own immediately before the transfer, other than the shares the transfer of which would otherwise trigger the application of paragraph (b)(1) of this section, to a person or persons that are not members of the group;

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

trigger the application of paragraph (b)(1) of this section; or

(C) Such transfer is to a member of the group and section 332 (provided the stock is transferred to an 80-percent distributee), section 351, section 354, or section 361 applies to such transfer.

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

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

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

(C) The members of the group are allowed a worthless stock loss under section 165(g) with respect to all of the shares of the subsidiary stock that they own immediately before the deconsolidation;

(D) The deconsolidation of the subsidiary results from the deconsolidation of a higher-tier subsidiary and, immediately after the deconsolidation of the subsidiary, none of the stock of the subsidiary is owned by a group member; or

(E) The deconsolidation of the subsidiary results from a termination of the group.

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

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

a portion of its shares of the lower-tier subsidiary stock, the common parent must adjust its basis in its subsidiary stock under the principles of § 1.1502–32 to reflect the adjustments that the subsidiary must make to its basis in its stock of the lower-tier subsidiary.

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

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

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

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

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

(3) *Treatment of suspended loss.* For purposes of the rules of § 1.1502–32, any loss suspended pursuant to paragraph (c)(1) or (c)(2) of this section is treated as a noncapital, nondeductible expense of the member that disposes of subsidiary stock, incurred during the taxable year that includes the date of the disposition of stock to which paragraph (c)(1) or (c)(2) of this section applies. See § 1.1502–32(b)(3)(iii)(C).

Consequently, the basis of a higher-tier member's stock of the member that disposes of subsidiary stock is reduced by the suspended loss in the year it is suspended.

(4) *Reduction of suspended loss—(i) General rule.* The amount of any loss

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

(ii) *Operating rules—(A) Year in which deduction or loss is taken into account.* For purposes of paragraph (c)(4)(i) of this section, a subsidiary's (or any successor's) deductions and losses are treated as taken into account when and to the extent they are absorbed by the subsidiary (or any successor) or any other member. To the extent that the subsidiary's (or any successor's) deduction or loss is absorbed in the year it arises or is carried forward and absorbed in a subsequent year (e.g., under section 172, 465, or 1212), the deduction is treated as taken into account in the year in which it is absorbed. To the extent that a subsidiary's (or any successor's) deduction or loss is carried back and absorbed in a prior year (whether consolidated or separate), the deduction or loss is treated as taken into account in the year in which it arises and not in the year in which it is absorbed.

(B) *Determination of items that are allocable to the post-disposition, pre-deconsolidation period.* For purposes of paragraph (c)(4)(i) of this section, the determination of whether a subsidiary's

(or any successor's) items of deduction and loss and allocable share of items of deduction and loss of all lower-tier subsidiaries are allocable to the period beginning on the date of the disposition of subsidiary stock that gave rise to the suspended loss and ending on the day before the first date on which the subsidiary (or any successor) is not a member of the consolidated group of which it was a member immediately prior to the disposition (or any successor group) is determined pursuant to the rules of § 1.1502-76(b)(2), without regard to § 1.1502-76(b)(2)(ii)(D), as if the subsidiary ceased to be a member of the group at the end of the day before the disposition and filed separate returns for the period beginning on the date of the disposition and ending on the day before the first date on which it is not a member of such group.

(5) *Allowable loss—(i) General rule.* To the extent not reduced under paragraph (c)(4) of this section, any loss suspended pursuant to paragraph (c)(1) or (c)(2) of this section shall be allowed, to the extent otherwise allowable under applicable provisions of the Internal Revenue Code and regulations thereunder, on a return filed by the group of which the subsidiary was a member on the date of the disposition of subsidiary stock that gave rise to the suspended loss (or any successor group) for the taxable year that includes the day before the first date on which the subsidiary (and any successor) is not a member of such group or the date the group is allowed a worthless stock loss under section 165(g) (taking into account the provisions of § 1.1502-80(c)) with respect to all of the subsidiary stock owned by members.

(ii) *No tiering up of certain adjustments.* No adjustments shall be made to a member's basis of stock of a subsidiary (or any successor) for a suspended loss that is taken into account under paragraph (c)(5)(i) of this section. See § 1.1502-32(a)(2).

(iii) *Statement of allowed loss.* Paragraph (c)(5)(i) of this section applies only if the separate statement required under this paragraph (c)(5)(iii) is filed with, or as part of, the taxpayer's return for the year in which the loss is allowable. The statement must be entitled "ALLOWED LOSS UNDER § 1.1502-35(c)(5)" and must contain the name and employer identification number of the subsidiary the stock of which gave rise to the loss.

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

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

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

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

(7) *Coordination with loss deferral, loss disallowance, and other rules—(i)*

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

(ii) *Overriding events.* For purposes of paragraph (c)(7)(i) of this section, the following are overriding events—

(A) The stock ceases to be owned by a member of the consolidated group;

(B) The stock is canceled or redeemed (regardless of whether it is retired or held as treasury stock); or

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

(8) *Application.* This paragraph (c) shall not be applied in a manner that permanently disallows a deduction for an economic loss, provided that such deduction is otherwise allowable. If the application of any provision of this paragraph (c) results in such a disallowance, proper adjustment may be made to prevent such a disallowance. Whether a provision of this paragraph

(c) has resulted in such a disallowance is determined on the date on which the subsidiary (or any successor) the disposition of the stock of which gave rise to a suspended stock loss is not a member of the group or the date the group is allowed a worthless stock loss under section 165(g) (taking into account the provisions of § 1.1502-80(c)) with respect to all of such subsidiary stock owned by members. Proper adjustment in such cases shall be made by restoring the suspended stock loss immediately before the subsidiary ceases to be a member of the group or the group is allowed a worthless stock loss under section 165(g) (taking into account the provisions of § 1.1502-80(c)) with respect to all of such subsidiary stock owned by members, to the extent that its reduction pursuant to paragraph (c)(4) of this section had the result of permanently disallowing a deduction for an economic loss.

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

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

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

(3) *Value* means fair market value.

(4) *Duplicated loss—(i) In general.*

Duplicated loss is determined immediately after a disposition and equals the excess, if any, of—

(A) The sum of—

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

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

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

(B) The sum of—

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

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

(ii) *Special rules.* (A) The amounts determined under paragraph (d)(4)(i) (other than amounts described in paragraph (d)(4)(i)(B)(1)) of this section with respect to a subsidiary include its allocable share of corresponding amounts with respect to all lower-tier subsidiaries. If 80 percent or more in value of the stock of a subsidiary is

acquired by purchase in a single transaction (or in a series of related transactions during any 12-month period), the value of the subsidiary's stock may not exceed the purchase price of the stock divided by the percentage of the stock (by value) so purchased. For this purpose, stock is acquired by purchase if the transferee is not related to the transferor within the meaning of sections 267(b) and 707(b)(1), using the language "10 percent" instead of "50 percent" each place that it appears, and the transferee's basis in the stock is determined wholly by reference to the consideration paid for such stock.

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

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

- (i) To which section 381(a) applies;
- (ii) In which substantially all of the assets of the transferor are transferred to members in a complete liquidation;
- (iii) In which the successor's basis in assets is determined (directly or indirectly, in whole or in part) by reference to the transferor's basis in such assets, but the transferee is a successor only with respect to the assets the basis of which is so determined; or
- (iv) Which is an intercompany transaction, but only with respect to assets that are being accounted for by the transferor in a prior intercompany transaction.

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

- (i) The acquisition by a member of another consolidated group of either the assets of the common parent of the terminating group in a reorganization described in section 381(a)(2), or the stock of the common parent of the terminating group; or
- (ii) The application of the principles of § 1.1502-75(d)(2) or (3).

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

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

(9) *Lower-tier.* A subsidiary is *lower-tier* with respect to a member if or to the extent investment basis adjustments

under § 1.1502-32 with respect to the stock of the former member would affect investment basis adjustments with respect to the stock of the latter member.

(e) *Examples.* For purposes of the examples in this section, unless otherwise stated, all groups file consolidated returns on a calendar-year basis, the facts set forth the only corporate activity, all transactions are between unrelated persons, and tax liabilities are disregarded. In addition, all transactions described in section 362(a) are completed before October 22, 2004, and therefore are not subject to section 362(e)(2). The principles of paragraphs (a) through (d) of this section are illustrated by the following examples:

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

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

*Example 2. Deconsolidating sale of common stock—(i) Facts.* In Year 1, in a transfer to which section 351 applies, P contributes Asset A with a basis of \$900 and a value of \$200 to S in exchange for one share of S common stock (CS1). In Years 2 and 3, in successive but unrelated transfers to which section 351 applies, P transfers \$200 to S in exchange for one share of S common stock (CS2), Asset B with a basis of \$300 and a value of \$200 in exchange for one share of S common stock (CS3), and Asset C with a basis of \$1000 and a value of \$200 in

exchange for one share of S common stock (CS4). In Year 4, S sells Asset A for \$200, recognizing \$700 of loss that is used to offset income of P recognized during Year 4. As a result of the sale of Asset A, the basis of each of P's four shares of S common stock is reduced by \$175. Therefore, the basis of CS1 is \$725. The basis of CS2 is \$25. The basis of CS3 is \$125, and the basis of CS4 is \$825. In Year 5 in a transaction that is not part of a plan that includes the Year 1 contribution, P sells CS4 for \$200. Immediately after the sale of CS4, S is not a member of the P group.

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

*Example 3. Nondeconsolidating sale of common stock—(i) Facts.* In Year 1, P forms S with a contribution of \$80 in exchange for 80 shares of the common stock of S, which at that time represents all of the outstanding stock of S. S becomes a member of the P group. In Year 2, P contributes Asset A with a basis of \$50 and a value of \$20 in exchange for 20 shares of the common stock of S in a transfer to which section 351 applies. In Year 4, in a transaction that is not part of the plan that includes the Year 2 contribution, P sells the 20 shares of the common stock of S that it acquired in Year 2 for \$20. Immediately after the Year 4 stock sale, S is a member of the P group. At the time of the Year 4 stock sale, S has \$80 and Asset A. In Year 5, S sells Asset A, the basis and value of which have not changed since its contribution to S. On the sale of Asset A for \$20, S recognizes a \$30 loss. The P group cannot establish that all or a portion of the \$30 loss was not reflected in the calculation of the duplicated loss of S on the date of the Year 4 stock sale. The \$30 loss is used on the P group return to offset income of P. In Year 6, P sells its remaining S common stock for \$80.

(ii) *Application of basis redetermination and loss suspension rules.* Because P's basis in the common stock sold exceeds its value immediately prior to the sale and S is a member of the P group immediately after the sale, P's basis in all of the stock of S is redetermined pursuant to paragraph (b)(1) of this section. Of P's total basis of \$130 in the S common stock, a proportionate amount is

allocated to each of the 100 shares of S common stock. Accordingly, \$26 is allocated to the common stock of S that is sold and \$104 is allocated to the common stock of S that is retained. On P's sale of the 20 shares of the common stock of S for \$20, P recognizes a loss of \$6. Because the sale of the 20 shares of common stock of S does not result in the deconsolidation of S, under paragraph (c)(1) of this section, that loss is suspended to the extent of the duplicated loss with respect to the shares sold. The duplicated loss with respect to the shares sold is \$6. Therefore, the entire \$6 loss is suspended.

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

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

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

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

of the \$5 loss was not reflected in the calculation of the duplicated loss of S2 on the date of the Year 4 stock sale. The \$5 loss is used on the P group return to offset income of P. In Year 6, S1 sells its remaining S2 common stock for \$100.

(ii) *Application of basis redetermination and loss suspension rules.* Because S1's basis in the S2 common stock sold exceeds its value immediately prior to the sale and S2 is a member of the P group immediately after the sale, S1's basis in all of the stock of S2 is redetermined pursuant to paragraph (b)(1) of this section. Of S1's total basis of \$130 in the S2 common stock, a proportionate amount is allocated to each of the 100 shares of S2 common stock. Accordingly, a total of \$26 is allocated to the common stock of S2 that is sold and \$104 is allocated to the common stock of S2 that is retained. On S1's sale of the 20 shares of the common stock of S2 for \$20, S1 recognizes a loss of \$6. Because the sale of the 20 shares of common stock of S2 does not result in the deconsolidation of S2, under paragraph (c)(1) of this section, that loss is suspended to the extent of the duplicated loss with respect to the shares sold. The duplicated loss with respect to the shares sold is \$6. Therefore, the entire \$6 loss is suspended. Pursuant to paragraph (c)(3) of this section and § 1.1502-32(b)(3)(iii)(C), the suspended loss is treated as a noncapital, nondeductible expense incurred by S1 during the tax year that includes the date of the disposition of stock to which paragraph (c)(1) of this section applies. Accordingly, P's basis in its S1 stock is reduced from \$200 to \$194.

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

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

(v) *Effect of subsequent stock sale.* In Year 6, when S1 sells its remaining S2 stock for \$100, it recognizes \$0 gain/loss. Pursuant to paragraph (c)(5) of this section, the remaining

\$5 of the suspended loss is allowed on the P group's return for Year 5 when S1 sells its remaining S2 stock.

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

(ii) *Application of basis redetermination and loss suspension rules.* Pursuant to paragraph (b)(4) of this section, because immediately before P's transfer of S1 stock S1 owns stock of S2 (another subsidiary of the same group) that has a basis that exceeds its value, paragraph (b) of this section applies as if S1 had transferred its stock of S2. Because S2 is a member of the group immediately after the transfer of the S1 stock, the group member's basis in the S2 stock is redetermined pursuant to paragraph (b)(1) of this section immediately prior to the sale of the S1 stock. Of the group members' total basis of \$130 in the S2 stock, \$26 is allocated to S1's 20 shares of S2 common stock and \$104 is allocated to P's 80 shares of S2 common stock. Pursuant to paragraph (b)(5) of this section, the redetermination of S1's basis in the stock of S2 results in an adjustment to P's basis in the stock of S1. In particular, P's basis in the stock of S1 is decreased by \$24 to \$26. On P's sale of its 100 shares of S1 common stock for \$20, P recognizes a loss of \$6. Because S1 is not a member of the P group immediately after P's sale of the S1 stock, paragraph (c)(1) of this section does not apply to suspend such loss. However, because P recognizes a loss with respect to the disposition of the S1 stock and S1 owns stock of S2 (which is a member of the P group immediately after the disposition), paragraph (c)(2) of this section does apply to suspend up to \$6 of that loss, an amount equal to the amount by which the duplicated loss with respect to the stock of S1 sold is attributable to S2's adjusted basis in its assets, loss carryforwards, and deferred deductions.

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

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

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

*Example 6. Loss recognized on asset with basis determined by reference to stock basis of subsidiary—(i) Facts.* In Year 1, P forms S with a contribution of \$80 in exchange for 80 shares of common stock of S which at that time represents all of the outstanding stock of S. S becomes a member of the P group. In Year 2, P contributes Asset A with a basis of \$50 and a value of \$20 in exchange for 20 shares of common stock of S in a transfer to which section 351 applies. In Year 4, in a transaction that is not part of a plan that includes the Year 1 and Year 2 contributions, P contributes the 20 shares of S common stock it acquired in Year 2 to PS, a partnership, in exchange for a 20 percent capital and profits interest in a transaction described in section 721. Immediately after the contribution to PS, S is a member of the P group. In Year 5, P sells its interest in PS for \$20, recognizing a \$30 loss.

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

(iii) *Application of loss suspension rule on disposition of asset with basis determined by reference to stock basis of subsidiary.* P recognizes a \$6 loss on its disposition of its interest in PS. Because P's basis in its interest in PS was determined by reference to the basis of S stock and at the time of the determination of P's basis in its interest in PS such S stock had a duplicated loss of \$6, and, immediately after the disposition, S is a

member of the P group, such loss is suspended to the extent of such duplicated loss. Principles similar to those of paragraphs (c)(3), (c)(4), and (c)(5) of this section shall apply to such suspended loss.

(f) *Worthlessness not followed by separate return years.* Notwithstanding any other provision in the regulations under section 1502, if a member of a group (the claiming group) treats stock of a subsidiary as worthless under section 165 (taking into account the provisions of § 1.1502–80(c)) and, on the day following the last day of the claiming group's taxable year in which the worthless stock deduction is claimed, the subsidiary (or its successor, determined without regard to paragraphs (d)(5)(iii) and (iv) of this section) is a member of a group that includes any corporation that, during that taxable year, was a member of the claiming group (other than a lower-tier subsidiary of the subsidiary) or is a successor (determined without regard to paragraphs (d)(5)(iii) and (iv) of this section) of such a member, then all losses treated as attributable to the subsidiary under the principles of § 1.1502–21(b)(2)(iv) shall be treated as expired as of the beginning of the day following the last day of the claiming group's taxable year in which the worthless stock deduction is claimed. In addition, notwithstanding any other provision in the regulations under section 1502, if a member recognizes a loss with respect to subsidiary stock and on the following day the subsidiary is not a member of the group and does not have a separate return year, then all losses treated as attributable to the subsidiary under the principles of § 1.1502–21(b)(2)(iv) shall be treated as expired as of the beginning of the day following the last day of the group's taxable year in which the stock loss is claimed. For purposes of this paragraph (f), the determination of the losses attributable to the subsidiary shall be made after computing the taxable income of the group for the taxable year in which the group treats the stock of the subsidiary as worthless or the subsidiary liquidates and after computing the taxable income for any taxable year to which such losses may be carried back. The loss treated as expired under this paragraph (f) shall not be treated as a noncapital, nondeductible expense under § 1.1502–32(b)(2)(iii). This paragraph (f) applies to worthlessness determinations and liquidations that occur on or after March 10, 2006. For rules applicable to worthlessness determinations and liquidations before March 10, 2006, see § 1.1502–35T(f)(1) and (2) as contained

in 26 CFR part 1 in effect on January 1, 2006.

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

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

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

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

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

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

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

(3) In a transaction described in section 381 or section 351, any member

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

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

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

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

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

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

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

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

(11) Any losses or deferred deductions of the subsidiary (or any successor) that were losses or deferred deductions of the subsidiary (or any successor) on the date of a disposition of stock of such subsidiary (or any successor), that are attributable to any asset that was owned by the subsidiary (or any successor) on the date of a disposition of stock of such subsidiary (or any successor) and that had a basis in excess of value on such date, that are attributable to any asset that had a basis that reflected, directly or indirectly, in whole or in part, the basis of any asset that was owned by the subsidiary (or any successor) on the date of a disposition of stock of such subsidiary (or any successor) and that had a basis in excess of value on such date, or that are attributable to a liability (within the meaning of section 358(h)(3)) of the subsidiary (or any successor) on the date of a disposition of stock of such subsidiary (or any successor) are carried back to a pre-disposition taxable year of the subsidiary.

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

of all lower-tier subsidiaries and as owning its allocable share of each asset of all lower-tier subsidiaries.

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

(C) For purposes of paragraph (g)(3)(i)(B)(10) of this section, unless the group can establish otherwise, if a member of such group (or any successor group) succeeds to any losses or deferred deductions of the subsidiary (or any successor), such losses and deferred deductions shall be treated as losses or deferred deductions that were losses or deferred deductions of the subsidiary (or any successor) on the date of a disposition of stock of such subsidiary (or any successor), losses or deferred deductions that are attributable to assets that were owned by the subsidiary (or any successor) on the date of a disposition of stock of such subsidiary (or any successor) and that had bases in excess of value on such date, losses or deferred deductions that are attributable to assets that had bases that reflected, directly or indirectly, in whole or in part, the bases of assets that were owned by the subsidiary (or any successor) on the date of a disposition of stock of such subsidiary (or any successor) and that had bases in excess of value on such date, or losses or deferred deductions attributable to a liability (within the meaning of section 358(h)(3)) of the subsidiary (or any

successor) on the date of a disposition of stock of such subsidiary (or any successor).

(D) For purposes of paragraph (g)(3)(i)(B)(11) of this section, unless the group can establish otherwise, if any losses or deferred deductions of the subsidiary (or any successor) are carried back to a pre-disposition taxable year of the subsidiary, such losses and deferred deductions shall be treated as losses or deferred deductions that were losses or deferred deductions of the subsidiary (or any successor) on the date of a disposition of stock of such subsidiary (or any successor), losses or deferred deductions that are attributable to assets that were owned by the subsidiary (or any successor) on the date of a disposition of stock of such subsidiary (or any successor) and that had a basis in excess of value on such date, losses or deferred deductions that are attributable to assets that had bases that reflected, directly or indirectly, in whole or in part, the bases of assets that were owned by the subsidiary (or any successor) on the date of a disposition of stock of such subsidiary (or any successor) and that had a basis in excess of value on such date, or losses or deferred deductions that are attributable to a liability (within the meaning of section 358(h)(3)) of the subsidiary (or any successor) on the date of a disposition of stock of such subsidiary (or any successor).

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

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

(B) Any loss recognized that is attributable to, directly or indirectly, an asset that has a basis that reflects, directly or indirectly, in whole or in part, the basis of any asset that was owned by the subsidiary (or any successor) on the date of a disposition

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

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

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

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

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

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

(5) *Examples.* For purposes of the examples in this section, all transactions described in section 362(a) are

completed before October 22, 2004, and therefore are not subject to section 362(e)(2). The principles of this paragraph (g) are illustrated by the following examples:

*Example 1. Transfers of property in avoidance of basis redetermination rule—(i) Facts.* In Year 1, P forms S with a contribution of \$100 in exchange for 100 shares of common stock of S which at that time represents all of the outstanding stock of S. S becomes a member of the P group. In Year 2, P contributes 20 shares of common stock of S to PS, a partnership, in exchange for a 20 percent capital and profits interest in a transaction described in section 721. In Year 3, P contributes Asset A with a basis of \$50 and a value of \$20 to PS in exchange for an additional capital and profits interest in PS in a transaction described in section 721. Also in Year 3, PS contributes Asset A to S and P contributes an additional \$80 to S in transfers to which section 351 applies. In Year 4, S sells Asset A for \$20, recognizing a loss of \$30. The P group uses that loss to offset income of P. In Year 5, P sells its entire interest in PS for \$40, recognizing a loss of \$30.

(ii) *Analysis.* Pursuant to paragraph (g)(2) of this section, if P's contributions of S stock and Asset A to PS were undertaken with a view to avoiding the application of the basis redetermination or the loss suspension rule, adjustments must be made such that the group does not obtain more than one tax benefit from the \$30 loss inherent in Asset A.

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

(ii) *Analysis.* P's \$50 loss on the sale of S stock is entirely attributable to duplicated loss. Therefore, pursuant to paragraph (g)(3) of this section, assuming the P group cannot establish otherwise, M's \$10 net operating loss is treated as attributable to assets that were owned by S on the date of the disposition and that had bases in excess of value on such date. Without regard to any

other limitations on the group's use of M's net operating loss, the P group cannot use M's \$10 net operating loss pursuant to paragraph (g)(3)(iii)(D) of this section. Pursuant to paragraph (g)(3)(iv) of this section and § 1.1502-32(b)(3)(iii)(D), such loss is treated as a noncapital, nondeductible expense of M incurred during the taxable year that it would otherwise be absorbed, namely in Year 9. In addition, the P group is denied the use of \$10 of the loss recognized on the sale of Asset C. Finally, the P group is denied the use of \$10 of the loss recognized on the sale of Asset D. Pursuant to paragraph (g)(3)(iv) of this section and § 1.1502-32(b)(3)(iii)(D), each such disallowed loss is treated as a noncapital, nondeductible expense of M incurred during the taxable year that includes the date of the disposition of the asset with respect to which such loss was recognized.

**Example 3. Transfers to avoid recognition of gain—(i) Facts.** P owns all of the stock of S1 and S2. The S2 stock has a basis of \$400 and a value of \$500. S1 owns 50% of the stock of the S3 common stock with a basis of \$150. S2 owns the remaining 50% of the S3 common stock with a basis of \$100 and a value of \$200 and one share of S3 preferred stock with a basis of \$10 and a value of \$9. P intends to sell all of its S2 stock to an unrelated buyer. P, therefore, engages in the following steps to dispose of S2 without recognizing a substantial portion of the built-in gain in S2. First, P causes a

recapitalization of S3 in which S2's S3 common stock is exchanged for new S3 preferred shares. P then sells all of its S2 stock. Immediately after the sale of the S2 stock, S3 is a member of the P group.

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

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

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

(i) [Reserved].

(j) **Effective date.** This section, except for paragraph (g)(3) of this section, applies with respect to stock transfers, deconsolidations of subsidiaries, determinations of worthlessness, and stock dispositions on or after March 10, 2006. For rules applicable before March 10, 2006, see § 1.1502-35T(j) as contained in 26 CFR part 1 in effect on January 1, 2006.

**§ 1.1502-35T [Removed]**

■ **Par. 7.** Section 1.1502-35T is removed.

■ **Par. 8.** For each section listed in the table remove the language in the "Remove" column and add in its place the language in the "Add" column as set forth below:

Section	Remove	Add
§ 1.267(f)-1(k) .....	§ 1.1502-35T .....	§ 1.1502-35
§ 1.597-4(g)(2)(v) .....	§ 1.1502-35T .....	§ 1.1502-35
§ 1.1502-11(b)(3)(ii)(c) .....	§ 1.1502-35T .....	§ 1.1502-35
§ 1.1502-12(r) .....	§ 1.1502-35T .....	§ 1.1502-35
§ 1.1502-15(b)(2)(iii) .....	§ 1.1502-35T .....	§ 1.1502-35
§ 1.1502-21(b)(1) .....	§ 1.1502-35T(f)(1) .....	§ 1.1502-35(f)
§ 1.1502-32(b)(3)(iii)(B) .....	§ 1.1502-35T .....	§ 1.1502-35
§ 1.1502-80(c) .....	§ 1.1502-35T .....	§ 1.1502-35
§ 1.1502-80T(c) .....	§ 1.1502-35T .....	§ 1.1502-35
§ 1.1502-91(h)(2) .....	§ 1.1502-35T .....	§ 1.1502-35

**PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT**

■ **Par. 9.** The authority citation for part 602 continues to read as follows:

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

■ **Par. 10.** In § 602.101, paragraph (b) is amended by removing the entry for § 1.1502-35T and adding an entry to the table in numerical order to read as follows:

**§ 602.101 OMB Control numbers.**

\* \* \* \* \*

(b) \* \* \*

CFR part or section where identified and described	Current OMB control No.
* * * *	*
1.1502-35 .....	1545-1828
* * * *	*

**Mark E. Matthews,**  
*Deputy Commissioner for Services and Enforcement.*

Approved: March 7, 2006.

**Eric Solomon,**  
*Acting Deputy Assistant Secretary of the Treasury.*

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**DEPARTMENT OF THE TREASURY**

**Office of the Secretary**

**31 CFR Part 10**

**Practice Before the Internal Revenue Service**

*CFR Correction*

In Title 31 of the Code of Federal Regulations, parts 0 to 199, revised as of July 1, 2005, on page 178, part 10 is corrected by reinstating § 10.53 to read as follows:

**§ 10.53 Receipt of information concerning practitioner.**

(a) *Officer or employee of the Internal Revenue Service.* If an officer or employee of the Internal Revenue Service has reason to believe that a practitioner has violated any provision