DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–140668–07]

RIN 1545–BH16

Regulations Regarding the Application of Section 172(h) Including Consolidated Groups

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations under section 172(h) and section 1502 of the Internal Revenue Code. These proposed regulations provide guidance regarding the treatment of corporate equity reduction transactions (CERTs), including the treatment of multiple step plans for the acquisition of stock and CERTs involving members of a consolidated group. These proposed regulations also provide guidance regarding certain elections relating to the carryback of consolidated net operating losses (CNOLs) to separate return years. These proposed regulations will affect C corporations and corporations filing consolidated returns.

DATES: Written or electronic comments and requests for a public hearing must be received by December 17, 2012.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–140668–07), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–140668–07), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC, or sent electronically, via the Federal eRulemaking Portal at *www.regulations.gov* (IRS REG–140668–07).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Amie Colwell Breslow or Marie C. Milnes-Vasquez at (202) 622–7530; concerning submissions of comments and request for public hearing, Oluwafunmilayo Taylor at *Oluwafunmilayo.P.Taylor@irscounsel.treas.gov* or (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545–2171. Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the 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. Comments on the collection of information should be received by November 16, 2012. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information;

How the quality, utility and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of service to provide information.

The collection of information in these proposed regulations is in §§ 1.1502–21(b)(3)(ii)(B) and 1.1502–72(e).

The proposed regulations provide guidance regarding application of section 172(b)(1)(E) and (h) and section 1502.

The collection of information is required in order to obtain a benefit. The likely respondents are corporations that are members of consolidated groups.

Estimated total annual reporting burden: 120,000 hours.

Estimated average annual burden hours per respondent: 15 hours.

Estimated number of respondents: 8,000.

Estimated frequency of responses: Once.

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 assigned by the Office of Management and Budget.

Books or records relating to a 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

Section 172 provides rules relating to net operating loss (NOL) carrybacks and carryovers. Section 172(b)(1)(A) states that the NOL for any taxable year generally is carried back to each of the 2 years preceding the taxable year of the loss and carried over to each of the 20 years following the taxable year of the loss.

The corporate equity reduction transaction rules of section 172(b)(1)(E) and (h) were enacted in 1989 in response to the use of NOL carrybacks to finance leveraged buyout transactions. Congress enacted these rules to limit a corporation's ability to obtain tax refunds as the result of the carryback of NOLs that were attributable to interest deductions allocable to such transactions. See Explanation of Corporate Tax Refund Restriction Bill, 135 Cong. Rec. S9936–01, at S9944 (1989); 1989 WL 193512.

Section 172(h)(3)(A) defines a *corporate equity reduction transaction* (CERT) as a ''major stock acquisition'' (MSA) or an ''excess distribution'' (ED). Section 172(h)(3)(B) defines *major stock acquisition* as the acquisition by a corporation, pursuant to a plan of such corporation (or any group of persons acting in concert with such corporation), of stock in another corporation representing 50 percent or more (by vote or value) of the stock in such other corporation. Section 172(h)(3)(C) defines *excess distribution* as the excess (if any) of the aggregate distributions (including redemptions) made during a taxable year by a corporation with respect to its stock over the greater of: 150 percent of the average of such distributions during the 3 taxable years immediately preceding such taxable year, or 10 percent of the fair market value of the stock of the corporation at the beginning of such taxable year. Thus, the total of distributions that may be treated as an ED is limited to the amount that exceeds the greater of two baselines: One tied to a historical, three-year average and the other based on the fair market value of the distributor.

If an MSA or ED occurs, section 172(b)(1)(E) and (h) limit the carryback of the portion of an NOL that constitutes a ''corporate equity reduction interest loss'' (CERIL) of an ''applicable corporation'' in any ''loss limitation year.'' See section 172(b)(1)(E)(i).

Section 172(b)(1)(E)(iii) defines an *applicable corporation* as a C corporation that acquires stock, or the stock of which is acquired, in an MSA; a C corporation making distributions with respect to, or redeeming, its stock in connection with an ED; or a C corporation that is a successor to one of the other types of applicable corporations. Section 172(b)(1)(E)(ii) defines *loss limitation year* as the taxable year in which a CERT occurs and each of the two succeeding taxable years. Section 172(h)(1) defines *corporate equity reduction interest loss* as the excess of (1) the total NOL for a loss limitation year, over (2) the NOL for the loss limitation year computed without regard to the allocable interest deductions that are otherwise taken into account in computing the NOL. Section 172(h)(2)(A) defines *allocable interest deductions* as deductions allowed on the portion of any indebtedness allocable to a CERT.

Under section 172(h)(2)(B), except as provided in regulations or section 172(h)(2)(E), indebtedness is allocable to a CERT in the manner prescribed under section 263A(f)(2)(A) without regard to paragraph (i) thereof (relating to traced debt). Thus, a portion of the taxpayer's total interest expense is allocable to the CERT. See H.R. Rep. No. 101–247, at 1251 (Conf. Rep.). However, section 172(h)(2)(C) limits the amount of allocable interest deductions for any loss limitation year to (1) the amount allowable as a deduction for interest paid or accrued by the taxpayer during the loss limitation year, less (2) the average of deductions allowed for interest paid or accrued by the taxpayer for the three taxable years preceding the taxable year in which the CERT occurred. Therefore, the allocable interest deductions are limited to the increase in interest deductions over a historical, three-year baseline.

Section 172(h)(3)(C) and (E) sets forth specific rules for determining whether an ED has occurred. For purposes of determining a corporation's aggregate distributions for a taxable year under section 172(h)(3)(C)(i) and the average of such distributions during the three taxable years preceding the relevant taxable year under section 172(h)(3)(C)(ii)(I), section 172(h)(3)(E)(ii) provides that the distributions taken into account are reduced by the aggregate amount of stock issued by the corporation during the applicable period in exchange for money or property other than stock in the corporation. However, section 172(h)(3)(E)(i) provides that stock described in section 1504(a)(4) (certain preferred stock) and distributions (including redemptions) with respect to such stock are disregarded.

For purposes of applying section 172(b)(1)(E) and (h), an applicable corporation and all members of its consolidated group are treated as a single taxpayer. See section 172(h)(4)(C).

Currently, there are no regulations under section 172(b)(1)(E) and (h). Section 172(h)(5) grants the Secretary the authority to prescribe such regulations as may be necessary to carry out the purposes of section 172(h), including regulations: (A) For applying section 172(h) to successor corporations and to cases in which a taxpayer becomes (or ceases to be) a member of a consolidated group; (B) to prevent the avoidance of section 172(h) through the use of related parties, pass-through entities, and intermediaries; and (C) for applying section 172(h) when more than one corporation is involved in a CERT. In addition, section 172(h)(2)(B) grants the Secretary authority to issue regulations prescribing a method for allocating indebtedness to a CERT other than the method contained in section 263A(f)(2)(A). Section 1502 provides the Secretary with broad authority to prescribe rules applicable to corporations that file consolidated returns that are different from the income tax provisions that would apply if those corporations filed separate returns.

These proposed regulations provide general rules addressing whether a CERT has occurred, the computation of a CERIL, and the treatment of successors. The proposed regulations also address issues specific to the application of section 172(b)(1)(E) and (h) to consolidated groups, including: (1) Treatment of the consolidated group as a single taxpayer; (2) determination of the group's three-year average that is relevant to a particular consolidated return loss limitation year; (3) application of these rules if the corporation participating in a CERT becomes a member of a consolidated return group; (4) application of these rules if a group member deconsolidates after the group has participated in (or is treated as having participated in) a CERT; (5) apportionment of a CERIL (and other special status CNOLs) to members of a consolidated group for carryback or carryover to separate return years; and (6) application of section 172(b)(1)(E) and (h) to a life-nonlife group. The proposed regulations also provide rules that would amend the loss carryback waivers available to deconsolidating group members.

At this time, the Department of Treasury and the IRS are not providing rules addressing the application of section 172(h) to related parties, pass-through entities, or intermediaries. However, the Department of Treasury and the IRS continue to study the circumstances under which these persons should be subject to section 172(b)(1)(E) and (h). For example, the purposes of the statute may be furthered if section 172(b)(1)(E) and (h) apply to the acquisition of 100 percent of the stock of a target by a partnership in which a corporation (or consolidated group) holds a controlling interest. On the other hand, the purposes of the statute may not be advanced if 100 percent of the stock of a target is acquired in a single transaction, but the percentage of target stock indirectly attributable to corporate acquirers is relatively small. The Department of Treasury and the IRS request comments regarding the parameters for applying section 172(b)(1)(E) and (h) to indirect corporate acquirers, and what special computational rules, if any, would be needed to implement its application.

The Department of Treasury and the IRS considered inclusion of an anti-avoidance rule to prevent taxpayers from engaging in section 381 transactions to shorten loss limitation years. However, the Department of Treasury and the IRS believe that the detrimental effects of shortening tax years make it unlikely that taxpayers will attempt to undertake such transactions as a planning technique. For example, shortening a loss limitation year will reduce the income in that year, and, accordingly, will limit the ability to carry back any losses to that year. The Department of Treasury and the IRS continue to study whether an anti-abuse rule is needed and request comments on this issue.

In addition, the Department of Treasury and the IRS are not providing rules addressing the application of section 172(b)(1)(E) and (h) to transactions occurring before these rules are adopted as final regulations (transitional issues). However, the Department of Treasury and the IRS continue to study, and request comments on, transitional issues. For example, the Department of Treasury and the IRS request comments regarding the application of section 172(b)(1)(E) and (h) if a taxable year constitutes a loss limitation year with regard to more than one CERT, one occurring before and the other occurring after the adoption of these proposed regulations as final regulations.

Explanation of Provisions

1. General CERT Rules

A. Determination of Existence of a CERT

As discussed, a CERT is either an MSA or an ED. The statute does not exclude tax-free transactions from treatment as an MSA or an ED. In addition, the concerns targeted by Congress in enacting section 172(b)(1)(E) and (h) can exist in the context of both taxable and tax-free transactions. Accordingly, the proposed regulations provide that a tax-free transaction that meets the statutory definition of an MSA or an ED must be tested as a CERT under section 172(b)(1)(E) and (h) and these proposed regulations (collectively, the ''CERT rules''). For example, a section 355 transaction, a corporate organization under section 351, or a stock acquisition that qualifies for reorganization treatment under section 368(a)(1)(A) and (a)(2)(E) must be tested under the CERT rules.

These proposed regulations also provide that an integrated plan of stock acquisition including multiple steps will be tested as a single potential MSA for purposes of determining the consequences of the transaction under the CERT rules. This treatment applies even if a step in the plan might separately constitute an ED, or might so qualify in conjunction with other distributions in the same taxable year.

Section 172(h)(3)(C)(ii) limits the amount of distributions in a taxable year that may be treated as an ED. Under one prong of this limitation, the taxpayer's distributions are treated as an ED only to the extent that they exceed 150 percent of the taxpayer's average of distributions (three-year distribution average) made in the three taxable years preceding the taxable year in which a potential ED occurs (the distribution lookback period). These proposed regulations provide that, to the extent that a distribution is part of an integrated plan that is treated as an MSA, the distribution is excluded from the computation of the taxpayer's three-year distribution average that is relevant to any other potential ED. These proposed regulations provide additional rules for calculating the taxpayer's three-year distribution average under section 172(h)(3)(C)(ii)(I) relevant to potential EDs that occur in taxable years that are not full 12-month years.

B. Loss Limitation Years

The proposed regulations generally provide that the taxable year in which a CERT occurs and each of the two succeeding taxable years constitute loss limitation years with regard to the CERT. The proposed regulations also provide special rules addressing loss limitation years of successors, consolidated groups, and former members of consolidated groups.

C. Computation of a CERIL

Under section 172(h)(1), the term *CERIL* means, with respect to any loss limitation year, the excess (if any) of (1) the NOL for such taxable year, over (2) the NOL for such taxable year determined without regard to any allocable interest deductions otherwise taken into account in computing such loss. Section 172(h)(2)(A) defines *allocable interest deductions* as deductions allowed for interest on any indebtedness allocable to a CERT. Section 172(h)(2)(B) states that, except as provided in regulations and section 172(h)(2)(E), the indebtedness allocable to a CERT is determined under the avoided cost methodology of section 263A(f)(2)(A), with certain adjustments.

Under section 263A(f)(2)(A) and the regulations thereunder, allocable interest deductions are computed by multiplying the ''weighted average interest rate'' by ''average excess expenditures'' as those terms are defined in § 1.263A–9(c)(5)(ii) and (iii). Because section 263A contemplates transactions that are very different in nature from CERTs, it is often difficult to identify the costs associated with a CERT that are analogous to average excess expenditures. To ameliorate this difficulty, these proposed regulations provide MSA- and ED-specific rules for computing costs associated with a CERT (CERT costs). Further, these proposed regulations identify additional CERT costs by looking to the capitalization rules under section 263(a). Specifically, the proposed regulations treat as CERT costs amounts paid or incurred to facilitate an MSA or ED to the extent that those amounts are required to be capitalized under section 263(a) (with certain modifications), and any amounts disallowed under section 162(k). Because most CERTs occur under circumstances that already require application of section 263(a), invoking those rules should result in greater administrability. Once the CERT costs are identified, the interest allocable to those costs is computed under the principles of section 263A(f)(2)(A) and the regulations thereunder (with adjustments). The avoided cost methodology of section 263A(f)(2)(A) effectively allocates interest to a CERT to the extent that the taxpayer's interest costs could have been reduced if the taxpayer had not engaged in the CERT. For purposes of applying the avoided cost rules of section 263A(f)(2)(A), all CERT costs are treated as if they were cash expenditures.

Under the proposed regulations, *CERT costs* with regard to an MSA include the fair market value of the stock acquired, whether that stock is acquired in exchange for cash, stock of the acquirer, or other property. The inclusion of the fair market value of stock acquired in stock-for-stock exchanges ensures that such transactions are treated similarly to an issuance of acquirer's stock for cash followed by an MSA funded with the cash proceeds. Further, inclusion of the fair market value of stock acquired is consistent with the avoided cost methodology applied under section 172(h)(2) because the CERT statute rejects tracing and assumes that debt is used to fund all CERT costs.

In addition, CERT costs of an MSA include the fair market value of any distribution that is part of an integrated transaction constituting the MSA. CERT costs also include amounts paid or incurred to facilitate any step of the MSA to the extent that those amounts are required to be capitalized under section 263(a), and any amounts disallowed under section 162(k).

Under the proposed regulations, CERT costs associated with an ED include the fair market value of distributions to shareholders that are determined to be EDs during the year in which the CERT occurs. CERT costs also include a portion of amounts paid or incurred to facilitate the distributions to the extent that those amounts are required to be capitalized under section 263(a), and any amounts disallowed under section 162(k). However, if neither section 263(a) nor section 162(k) applies or if only section 162(k) applies to a distribution included in an ED, additional CERT costs associated with the distribution are determined under the principles of § 1.263(a)–4(e) (relating to the capitalization of costs that facilitate the acquisition or creation of intangibles), applied as if the ED were a transaction within the scope of § 1.263(a)–4.

As discussed, the rules of section 263(a) are applied in the CERT context with certain modifications. For the purpose of identifying CERT costs under these proposed regulations, modifications to the operation of § 1.263(a)–4 and –5 include treating certain borrowing costs as facilitative of an MSA or ED. Therefore, CERT costs will include these borrowing costs. Congress objected to the carryback of NOLs resulting from leveraging that directly or indirectly enables CERTs; therefore, the Department of Treasury and the IRS believe that it is appropriate to include borrowing costs in total CERT costs. However, the Department of Treasury and the IRS request comments regarding the extent to which borrowing costs should be included in CERT costs.

The computation of interest allocable to CERTs under the rules of section 263A(f)(2)(A) involves the time-weighted average of costs incurred as of various dates in the taxable year. Therefore, these proposed regulations set forth rules for determining when CERT costs should be taken into account. Under these proposed regulations, accumulated CERT costs as of a particular date are the total CERT costs that have been taken into account as of that date under the applicable corporation's method of accounting. A special proration rule is provided to determine accumulated CERT costs related to an ED. Finally, CERT costs incurred in any year prior to the year in which the CERT occurs are included in accumulated CERT costs beginning on the first day of the year in which the CERT occurs.

Section 172(h)(2)(E) requires that the allocation of interest to a CERT be reduced if an unforeseeable extraordinary adverse event occurs during a loss limitation year but after the CERT. The proposed regulations do not provide guidance with regard to unforeseeable extraordinary adverse events. However, the Department of Treasury and the IRS request comments regarding whether rules are necessary and, if so, what type of events should constitute unforeseeable extraordinary adverse events.

D. Limitation on Interest Deductions

The CERT rules generally provide that the portion of an NOL for any loss limitation year that is attributable to the interest deductions allocable to a CERT (that is, a CERIL) may not be carried back to any year prior to the year in which the CERT occurred. As discussed, section 172(h)(2)(C) limits the amount of interest treated as an allocable interest deduction to the excess of the amount allowable as a deduction for interest paid or accrued by the taxpayer during the loss limitation year, over the average of amounts allowable as a deduction for interest paid or accrued (the three-year average) during the three taxable years preceding the taxable year in which the CERT occurred (the lookback period). These proposed regulations provide special rules for computing the three-year average in special situations, such as if an applicable corporation is not in existence for the entire lookback period. Further, the proposed regulations adjust the three-year average if the relevant loss limitation year is not a full 12-month taxable period. These proposed regulations also set forth special rules for any taxable year that constitutes a loss limitation year with regard to multiple CERTs.

The legislative history indicates that Congress expected the Department of Treasury and the IRS to write rules that provide that increases attributable solely to fluctuations in interest rates would not be taken into account for purposes of applying the three-year average. Out of concern that the additional complexities of such rules would outweigh the benefit, these proposed regulations do not include rules that factor out increases in interest deductions attributable solely to fluctuations in interest rates. However, the Department of Treasury and the IRS are studying a rule that, for purposes of applying the three-year average, would factor out interest deductions that are attributable to increases in a taxpayer's interest rate that occur after the date of a CERT. Under the rule being considered, the measurement of a baseline interest rate after the CERT occurs would take into account the fact that CERT activity will often decrease a taxpayer's creditworthiness and increase its average cost of borrowing, and accordingly that the existence of the CERT, in and of itself, will increase a taxpayer's borrowing expenses. The Department of Treasury and the IRS request comments on whether such a baseline would effectively account for fluctuations in interest rates or whether an alternative measure would be more appropriate.

E. Predecessor and Successor

As discussed, the CERT rules apply only to applicable corporations. Under section 172(b)(1)(E)(iii)(III), an applicable corporation includes any corporation that is a successor of: a corporation that acquires stock in an MSA; a corporation the stock of which is acquired in an MSA; or a corporation making a distribution with respect to, or redeeming, its stock in connection with an ED. For purposes of applying the CERT rules, these proposed regulations define *successor* as a transferee or distributee in a transaction to which section 381(a) applies. Further, if a successor to a previous applicable corporation with regard to a CERT itself transfers assets to a further successor, the further successor corporation is treated as an applicable corporation with regard to that CERT. In addition, these proposed regulations set forth special rules for computing a successor's CERIL.

F. Operating Rules

The proposed regulations include special rules regarding the prohibition on carryback of a CERIL. These rules provide that no CERIL may be carried back to any taxable year that includes solely dates that precede the date on which the CERT at issue occurred. In applying this rule to multi-step MSAs and to EDs that include multiple distributions, the date on which the CERT occurs is the earliest date on which the requirements for CERT status have been satisfied. These proposed regulations also provide that, for purposes of determining whether an ED has occurred, the computation of any three-year distribution average under section 172(h)(3)(C)(ii)(I) will be reduced by the average of the stock issuances made by the applicable corporation during the three years of the distribution lookback period.

The principles of the proposed regulations apply to the computation of the alternative minimum tax net operating loss under section 56(d).

2. Special CERT Rules Applicable to Consolidated Groups

A. Single Entity Treatment

Section 172(h)(4)(C) states that, except as provided by regulation, all members of a consolidated group are treated as a single taxpayer for purposes of section 172(b)(1)(E) and (h). These proposed regulations provide further guidance regarding the application of single entity principles. These proposed regulations affirm that transactions and expenditures undertaken by a particular member are not separately tracked; rather, the entire group is treated as a single applicable corporation. For example, if multiple members of a group acquire in total 50 percent or more (by vote or value) of the stock of another corporation, the group has engaged in an MSA. Likewise, the computation of a group's CERIL under section 172(h)(1) for any loss limitation year that is a consolidated return year includes the debt of all members and all interest deductions that are allowed on the group's consolidated return.

Intercompany transactions (including interest accruals and payments on intercompany obligations) are generally disregarded under the proposed regulations. However, these proposed regulations provide that a transaction will not be disregarded if a party to the transaction becomes a non-member as a part of the same plan or arrangement.

The most difficult issues in the CERT area arise from the application of single entity concepts if different corporations join and deconsolidate from a group within the same three-year period. The fungibility of money and the ease of moving cash and debt within a consolidated group may provide a consolidated group with an unwarranted ability to manipulate the application of the CERT rules, further complicating the analysis. After considering different approaches, the Department of Treasury and the IRS have determined that application of single entity principles, under which corporations cease to be separately tracked for CERT purposes after their inclusion in a group, will limit complexity and promote administrability. Furthermore, single entity treatment is consistent with the statutory default of treating the consolidated group as a single taxpayer.

Consistent with single entity treatment, these proposed regulations provide that, if an applicable corporation with regard to a CERT occurring in a separate return year (pre-existing CERT member) joins a consolidated group, the group is treated as a single applicable corporation with regard to that CERT in the consolidated return year of the acquisition and any relevant succeeding year. The pre-existing CERT member will no longer have separate status as an applicable corporation. Beginning on the day the pre-existing CERT member is first included in the group, the only CERIL computation will be that of the group.

These proposed regulations also provide that, in the consolidated return context, both the debt of a new member acquired in a CERT and the corresponding interest expenses are included in the group's CERIL computation, even if the group would not have been in a position to pay off the debt of the acquired corporation if the CERT had not occurred. For example, if a target corporation acquired by a consolidated group has debt outstanding prior to the acquisition, the group takes into account interest incurred by the group that is attributable to the target's pre-existing debt, despite the fact that the group would have had no reason to satisfy the target's debt if the acquisition had not occurred. If the acquisition had not occurred, the debt of the target would not have become a liability of the applicable corporation (the group), and the associated interest expense would not have been deducted by the group. As will be discussed, the historical interest expense of the target is also included in the group's computation of the three-year average applied to limit the interest allocated to the CERT.

B. Applicable Corporation Status and Allocation of CERT Costs Following Deconsolidation From a Group

These proposed regulations provide that, if a member deconsolidates from a group on or after (1) the date on which the group engages in a CERT, or (2) the date on which the group acquires a pre-existing CERT member, then, following the deconsolidation, both the deconsolidating member and the group generally will be treated as applicable corporations with regard to the CERT. The deconsolidating member will be apportioned a pro rata share of the group's CERT costs incurred through the date of the deconsolidation. The proration is based on the relative fair market values of the deconsolidating corporation (immediately after its deconsolidation) and the entire group (immediately before the deconsolidation). This rule applies regardless of whether any particular corporation would have constituted an applicable corporation with regard to the CERT without the application of the single entity treatment. The Department of Treasury and the IRS request comments regarding alternatives for allocating CERT costs following deconsolidation from a group.

The CERT costs that are allocated and apportioned to the deconsolidating member are subtracted from the group's CERT costs and will not attract allocable interest in any loss limitation year of the group (or any separate return loss limitation year of another group member) after the year of deconsolidation. Therefore, the group may have less CERIL in the years following the deconsolidation. Apportionment of CERT costs to the deconsolidating member may result in that corporation having a CERIL in the period following its deconsolidation.

Under these proposed regulations, the deconsolidating member (or the common parent of any group that the deconsolidating member joins immediately after deconsolidation) may elect out of the general rule of apportionment. In making this election, the member or common parent permanently waives all carrybacks of losses allocable to the deconsolidating member to years of the former group and any preceding taxable years. If this election is made, the deconsolidating member will not be treated as an applicable corporation with regard to the CERT, and it will not be allocated any CERT costs. Applicable corporation status and CERT costs will remain with the former group. This is true even if the deconsolidating member directly engaged in the CERT. Further, none of the interest history of the group will be allocated to the deconsolidating member for CERT purposes, including determining the CERIL related to any future CERT. The resulting lack of interest history may increase the amount of a CERIL in future taxable years associated with other CERTs of the deconsolidating corporation. This election is available to any deconsolidating member, even if the former group is not an applicable corporation with regard to any CERT at the time of the deconsolidation.

C. Loss Limitation Years

Because all members of a consolidated group are treated as a single taxpayer under section 172(h)(4)(C), a consolidated group is treated as the ''applicable corporation'' with regard to a CERT. These proposed regulations provide special rules for determining loss limitation years of consolidated groups and former members of consolidated groups. Under these proposed regulations, the taxable year in which a CERT actually occurs is a loss limitation year. Any other taxable year (potential loss limitation year) of any applicable corporation (including a consolidated group) will constitute a loss limitation year with regard to the CERT only if, under the carryover rules of sections 172(b)(1)(A)(ii) and 381(c)(1), the potential loss limitation year would constitute the first or second taxable year following the taxable year of the corporation or consolidated group that actually engaged in the CERT, which includes the date of the CERT. For purposes of tracking taxable years, section 172 and 381 are applied as if the inclusion of any corporation in a consolidated group or the deconsolidation of any member from a group were a transaction described in section 381(a).

The proposed regulations provide that the separate return years of a corporation that deconsolidates from a consolidated group may be loss limitation years with regard to a CERT of the former group. This may occur only if the consolidated return year of the deconsolidation is a first or second loss limitation year with regard to that CERT. The taxable years of more than one applicable corporation (including a consolidated group) may be loss limitation years with regard to the same CERT, even if those taxable years include the same dates.

The special rules for determining loss limitation years can be illustrated as follows: T corporation maintains a calendar taxable year and does not join in the filing of a consolidated return. The X group holds 60 percent of the only class of T stock. On July 1, Year 5, T engages in a CERT. The X group, which includes member S, maintains a calendar taxable year. On December 31, Year 5, the X group acquires all of the remaining T stock. T is first included in the X group on January 1, Year 6. On June 30, Year 6, S deconsolidates from the X group, and thereafter S maintains a calendar taxable year. The first loss limitation year with respect to the T CERT is T's calendar Year 5. Pursuant to these proposed regulations, as a result of acquiring T, the X group is treated as an applicable corporation with respect to the T CERT. The X group's loss limitation years with respect to the T CERT are its calendar Years 6 and 7. Because no election is made with respect to the deconsolidation of S, following the deconsolidation, S is also treated as an applicable corporation with regard to the T CERT. Because consolidated return Year 6 (the year of the deconsolidation) is a second loss limitation year with regard to the CERT, S's short year ending December 31, Year 6 will be S's only loss limitation year with regard to the T CERT.

D. Determining the Three-Year Average of a Group

As discussed in section 1.D. of this preamble, under section 172(h)(2)(C), the interest deductions treated as allocable to a CERT are limited to the difference between the interest paid or accrued in the loss limitation year at issue and the average of the interest paid or accrued in the three years preceding the year of the CERT (three-year average). These proposed regulations adopt single entity concepts intended, in part, to decrease the complexity of the computation of the three-year average resulting from the entry of corporations into, and the deconsolidation of corporations from, a consolidated group. Under these proposed regulations, with regard to a corporation joining a group, the interest history of that corporation is combined with that of the acquiring group. For purposes of the CERT rules, this interest is thereafter generally treated as having been paid or accrued by the group and is no longer separately traced to the acquired corporation. Similarly, with regard to the deconsolidation of a member from a group, a portion of the group's entire interest history is generally apportioned to the deconsolidating member for purposes of the CERT rules. The apportionment is based on the relative fair market values of the deconsolidating corporation (immediately after its deconsolidation) and the entire group (immediately before the deconsolidation). Under these proposed regulations, the allocated and apportioned history is subtracted from the group's interest history solely for purposes of the CERT rules and is unavailable to the group with regard to any loss limitation year of the group (or any separate return loss limitation year of another group member) after the year of deconsolidation. Consistent with single entity treatment and rejection of a tracing regime, the interest allocated to a particular deconsolidating member is not tied to that member's actual interest history.

These proposed regulations also provide special rules relevant to any loss limitation year during which a corporation (partial-year member) becomes a member of, or ceases to be a member of, a group (transitional year). For purposes of computing any three-year average of a group that is relevant to a transitional year, these rules require proration of the interest history that is attributable to the partial-year member so that a group that includes a particular member for only a portion of a loss limitation year includes only a pro rata portion of that member's three-year interest history. These proposed regulations also provide special rules for computing the three-year average if a group is not in existence for three taxable years prior to the consolidated return year in which the CERT occurs (the lookback period) and for determining the lookback period if a group acquires a corporation that previously engaged in a CERT.

E. Excess Distributions in Groups

These proposed regulations contain rules pertaining to the computation of EDs of consolidated groups and of corporations that have been consolidated group members. Consistent with single entity treatment under section 172(h)(4)(C), the proposed regulations provide that the distributions relevant for purposes of computing an ED of a consolidated group generally include only non-intercompany distributions. However, this general rule does not apply if a party to the transaction deconsolidates as part of the same plan or arrangement. Under those circumstances, the distribution will be tested on a separate entity basis as a potential CERT.

As discussed in section 1.A. of this preamble, section 172(h)(3)(C)(ii) places a limitation on the amount of distributions in a taxable year that may be treated as ED, and the limitation is based in part on 150 percent of the taxpayer's average of distributions (three-year distribution average) made in the three taxable years preceding the taxable year of the potential ED. These proposed regulations provide that single entity principles generally apply to the computation of the three-year distribution average of a consolidated group or a corporation that has been a consolidated group member. That is, the only distributions taken into account are those made to non-member shareholders. However, in computing the three-year distribution average of a consolidated group that includes a member for less than the entire consolidated return year of a potential ED, the group takes into account only a pro rata portion of the actual distribution history of that member. Further, a corporation that deconsolidates from a group takes into account its actual history of non-intercompany distributions for purposes of applying the CERT rules in future separate return years. The corporation is not apportioned a pro rata share of the total distribution history of the group.

Additional rules apply with regard to computation of stock issuances and valuation of the group, which are intended to ensure that the rules in those areas are applied on a single entity basis. Specifically, the proposed regulations provide that, in applying section 172(h)(3)(E)(ii) to determine the offset of stock issuances against distributions, only stock that is issued to non-members is taken into account. Further, the proposed regulations provide that the value of the group, computed pursuant to section 172(h)(3)(C)(ii)(II), equals the value of the stock of all members other than stock that is owned directly or indirectly by another member.

F. Reverse Acquisitions

These proposed regulations address the application of the MSA rules to reverse acquisitions, as defined in § 1.1502–75(d)(3). The proposed regulations provide that, if a reverse acquisition occurs, the CERT rules will be applied by treating the acquirer in form as the target corporation, and treating the target in form as the acquiring corporation. They also provide special rules regarding the computation of the CERT costs in a reverse acquisition.

G. Life-Nonlife Groups

These proposed regulations provide rules for applying the CERT rules to a group that elects under section 1504(c)(2) to file a consolidated return (life-nonlife group). As with consolidated groups generally, the fungibility of money and the ease of moving cash and debt within a life-nonlife group may provide an unwarranted ability to manipulate the application of the CERT rules. Accordingly, these proposed regulations generally apply the CERT rules and the consolidated return CERT rules to a life-nonlife group on a single entity basis, and not on a subgroup basis. Under the proposed regulations, a single CERIL is computed with regard to any loss limitation year of a life-nonlife group, which includes all life-nonlife group members' CERT costs, debt, and interest paid or accrued for that year. However, for purposes of determining the CERIL of a life-nonlife group under section 172(h)(1) for any loss limitation year, the sum of the nonlife consolidated net operating loss (nonlife CNOL) (if any) and the life consolidated loss from operations (LO) (if any) for that year is treated as a notional ''NOL'' of the group. For this purpose, nonlife consolidated taxable income does not offset any LO, and consolidated partial life insurance company taxable income (as used in § 1.1502–47(g)) does not offset any nonlife CNOL.

If a CERIL exists for a loss limitation year of a life-nonlife group, that CERIL is allocated on a pro rata basis between the nonlife CNOL and the LO of the group, based on the relative sizes of the two attributes.

3. Specialized CNOL Carryback Rules

These proposed regulations provide rules regarding the apportionment of CNOLs that contain a component portion of special status loss, such as a CERIL or a specified liability loss. See section 172(h)(1) and (f)(1). Under these rules, a special status loss is apportioned to each group member, separately from the remainder of the CNOL, under the method provided in § 1.1502–21(b)(2)(iv). This apportionment occurs without separate entity inquiry into whether a particular member incurred the specific expenses or engaged in the particular activities required by the provisions governing the special status loss.

The proposed regulations also amend and expand the current election under § 1.1502–21(b)(3)(ii)(B), informally referred to as the ''split-waiver'' election. That election is currently available to any group that acquires one or more members from another group. By making the election, the acquiring group relinquishes, with respect to all CNOLs attributable to the newly-acquired corporation, the portion of the carryback period during which that corporation was a member of another group. The current rule does not allow a group to waive the portion of the carryback period for which a newly-acquired corporation was not a member of a consolidated group. The current election is a one-time election and must be made with the acquiring group's timely-filed original return for the year of the acquisition.

The proposed regulations amend the split waiver election to make the election available to any group that acquires a corporation, regardless of whether such corporation was acquired from another group. An election results in the waiver of the entire carryback period with regard to CNOLs allocable to the acquired corporation, not only the period during which the corporation was a member of another group. Further, any election that is made with regard to a newly-acquired member that had been a member of another group at the time of its acquisition must include all members acquired from the same group during the taxable year of the acquiring group.

In addition, the proposed regulations give the electing group a choice of making the one-time election or making the split-waiver election on an annual basis with regard to the CNOL of a particular consolidated return year. Any annual split-waiver election must be filed with the group's timely filed original return for the year of the CNOL. The one-time election and the annual split-waiver election that are available under proposed § 1.1502–21(b)(3)(ii)(B) apply generally with respect to losses attributable to the acquired corporation. These split-waiver elections are in addition to the one-time election available under the CERT rules to elect out of the general rule of apportionment for CERT costs and interest history to a deconsolidating member, which also results in the waiver of all carrybacks of losses allocable to the deconsolidating member to any prior taxable years. As a result, under these proposed regulations, corporations may have three, mutually exclusive, irrevocable elections to waive carryback of CNOLs to separate return years: An annual election, a one-time election, and a special CERT election.

Proposed Effective Date

Sections 1.172(h)–1 through 1.172(h)–5 and § 1.1502–72 (except § 1.1502–72(e)) are effective for CERTs occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**, except that they do not apply to any CERTs occurring pursuant to a written agreement that is binding prior to the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**. The amendments to § 1.1502–21(b)(2) are effective for taxable years for which the due date of the original return (without extensions) is on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**. Section 1.1502–72(e) and the amendments to § 1.1502–21(b)(3) are effective for acquisitions or deconsolidations, as appropriate, occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**, except that they do not apply to any acquisition or deconsolidations, as appropriate, occurring pursuant to a written agreement that is binding before the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that these proposed regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these proposed regulations will primarily affect C corporations and members of consolidated groups, which tend to be large corporations. Accordingly, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The Department of Treasury and the IRS request comments on all aspects of the proposed regulations. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal authors of these proposed regulations are Rebecca J. Holtje and Marie C. Milnes-Vasquez of the Office of Associate Chief Counsel (Corporate). However, other personnel from the Department of Treasury and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be 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 * * *

Sections 1.172(h)–1 through –5 are also issued under 26 U.S.C. 172. * * *

Section 1.1502–21(b)(2)(iv)(C) is also issued under 26 U.S.C. 1502. * * *

Section 1.1502–72 is also issued under 26 U.S.C. 1502. * * *

Par. 2. Sections 1.172(h)–0 through 1.172(h)–5 are added to read as follows:

§ 1.172(h)–0 Table of Contents.

This section lists the paragraphs contained in §§ 1.172(h)–1 through 1.172(h)–5.

§ 1.172(h)–1 Existence of CERT and loss limitation years.

(a) *In general.* If there is a corporate equity reduction transaction (CERT) and an applicable corporation has a corporate equity reduction interest loss (CERIL) for any loss limitation year, section 172(b)(1)(E) and (h), this section, §§ 1.172(h)–2 through 1.172(h)–5, and § 1.1502–72 (collectively, the *CERT rules*) limit the amount of net operating loss that can be carried back to any taxable year preceding the taxable year in which the CERT occurs. This section provides rules regarding the determination of whether a CERT has occurred and whether a taxable year constitutes a loss limitation year. See § 1.172(h)–2 for rules regarding the computation of a CERIL.

(b) *Applicable corporation*—(1) *In general.* The CERT rules apply only to applicable corporations. The term *applicable corporation* means a C corporation that acquires stock, or the stock of which is acquired, in a major stock acquisition (MSA), a C corporation making distributions with respect to, or redeeming, its stock in connection with an excess distribution (ED), or a C corporation that is a successor of any corporation described in this paragraph (b)(1). For special rules regarding the definition of an applicable corporation with regard to members that join and leave a consolidated group, see § 1.1502–72(a) and (b).

(2) *Predecessor and successor.* For purposes of the CERT rules, the term *predecessor* means a transferor or distributor of assets to a transferee or distributee (the successor) in a transaction to which section 381(a) applies. A corporation is a successor to its predecessor, and to all predecessors of that predecessor. If an applicable corporation transfers or distributes its assets to a successor, the successor is treated as an applicable corporation in the successor's taxable year during which the transfer or distribution occurs and any subsequent years.

(c) *CERT defined*—(1) *In general.* A CERT can be an MSA or an ED.

(2) *MSA defined.* An *MSA* is the acquisition by a corporation pursuant to a plan of such corporation (or any group of persons acting in concert with such corporation) of stock in another corporation representing 50 percent or more (by vote or value) of the stock in such other corporation.

(3) *ED defined.* An *ED* is any excess of the aggregate distributions made during a taxable year by a corporation with respect to its stock, over the greater of—

(i) 150 percent of the average of such distributions (the three-year distribution average) during the three taxable years immediately preceding such taxable year (the distribution lookback period); or

(ii) 10 percent of the fair market value of the stock of such corporation as of the beginning of such taxable year. For purposes of testing a potential ED, distributions include redemptions.

(d) *Transactions tested as CERTs*—(1) *Tax-free transactions.* A transaction may constitute a CERT and must be tested under the CERT rules regardless of whether gain or loss is recognized by any party. For example, a distribution that qualifies for tax-free treatment under section 355 is tested as a potential ED (or part of a potential ED). Likewise, the acquisition by a corporation of 50 percent or more of the stock of another corporation in a transaction meeting the requirements of section 351, section 368(a)(1)(A) and (a)(2)(E), or section 368(a)(1)(B) constitutes an MSA.

(2) *Multiple step plan of acquisition.* Solely for purposes of determining whether an MSA has occurred and determining the consequences of an MSA, all steps of an integrated plan (including redemptions and other distributions) are tested as a single potential MSA. If an integrated plan qualifies as an MSA and includes one or more distributions, then, for purposes of applying the CERT rules, the distributions are treated solely as a part of the MSA, regardless of whether such distributions would otherwise constitute an ED (or would so qualify in conjunction with other distributions). Any distributions during the year that are not part of the integrated plan qualifying as an MSA are tested as a potential ED.

(3) *Examples.* The following examples illustrate the rules of this paragraph (d). For purposes of these examples, unless otherwise stated, assume that all entities are domestic C corporations that do not join in the filing of a consolidated return and that the entities have no history of paying dividends or otherwise making distributions:

Example 1. Spin-off. Distributing corporation (D) distributes stock of controlled corporation (C) to its shareholders in a transaction that satisfies the requirements of section 355. There is no taxable ''boot'' associated with the distribution. Pursuant to paragraph (d)(1) of this section, D's distribution of C stock is tested as a potential ED (in conjunction with any other distributions by D during the same taxable year). The same result would obtain if D distributes boot to its shareholders in addition to C stock.

Example 2. Bootstrap acquisition. (i) *Facts.* T is a publicly-traded, widely-held corporation with a single class of stock outstanding with a fair market value of $100. The following steps occur as part of an integrated plan. Corporation A acquires 10 percent of the outstanding stock of T for $10. A forms a new corporation, S, with a contribution of $25. S obtains a loan of $65 from an unrelated lender, and then merges with and into T, with T surviving. In the merger, all shareholders of T except A receive cash in exchange for their shares, and as a consequence, A owns all of the outstanding stock of T. As a result of the merger, T becomes liable for S's $65 loan. Assume that the $90 cash payment from T to the T shareholders should be treated as a redemption to the extent of the $65 loan assumed by T, and as a stock acquisition by A to the extent of the remaining $25.

(ii) *Analysis.* A's direct acquisition of 10 percent of T's outstanding stock and the steps culminating with the merger are part of an integrated plan. Therefore, the multiple steps are tested together as a potential MSA. Because the steps of the integrated plan resulted in A's acquisition of 100 percent of T, the transaction is treated as a single MSA. Furthermore, because the $65 redemption is part of an MSA, it is treated solely as part of the MSA and is not tested as a potential ED. See paragraph (d)(2) of this section.

(e) *Loss limitation years.* The taxable year in which a CERT occurs and each of the two succeeding taxable years constitute loss limitation years with regard to the CERT. See § 1.172(h)–4(b) (addressing loss limitation years of successors) and § 1.1502–72(a)(3) (addressing loss limitation years of consolidated groups and former members of consolidated groups).

(f) *Computation of three-year distribution average relevant to a potential ED*—(1) *Integrated plan.* Section 172(h)(3)(C)(ii)(I) and paragraph (c)(3) of this section treat as an ED the excess of distributions in a taxable year over the taxpayer's average distributions (three-year distribution average) made in the three taxable years preceding the taxable year in which a potential ED occurs (distribution lookback period). The computation of a taxpayer's three-year distribution average under this paragraph (f) excludes any distribution during the distribution lookback period that is treated as part of an integrated plan qualifying as an MSA pursuant to paragraph (d)(2) of this section. See § 1.1502–72(f)(2) and (3) for rules relating to distributions (including intercompany distributions) made during a consolidated return year.

(2) *Short taxable year.* For purposes of computing the three-year distribution average under this paragraph (f), if the year of the potential ED is less than a full 12-month year, the distribution history with regard to any year of the taxpayer during a distribution lookback period (distribution lookback period year) equals the amount of distributions made during the distribution lookback period year multiplied by a fraction, the numerator of which equals the number of days in the short taxable year of the potential ED, and the denominator of which equals the number of days in the distribution lookback period year. The value of the fraction may not exceed 100 percent. No distributions are deemed made (in excess of amounts actually distributed) in a distribution lookback period year that is shorter than the year of the potential ED.

(g) *Effective/applicability date.* This section is applicable to CERTs occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**. This section is also applicable to the deconsolidation of a member from, or the acquisition of a corporation by, a consolidated group that occurs on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**. However, in each case, this section does not apply to any CERT, deconsolidation, or acquisition occurring pursuant to a written agreement that is binding before the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

§ 1.172(h)–2 Computation of a CERIL.

(a) *In general*—(1) *Scope.* The portion of a net operating loss (NOL) that is treated as a corporate equity reduction interest loss (CERIL) (as defined in paragraph (a)(2) of this section) cannot be carried back to a taxable year preceding the taxable year in which the corporate equity reduction transaction (CERT) occurs. This section provides rules for computing allocable interest deductions necessary to compute a CERIL for purposes of applying section 172(b)(1)(E) and (h), §§ 1.172(h)–1 through 1.172(h)–5, and § 1.1502–72 (the CERT rules).

(2) *CERIL defined.* A *CERIL* means, with respect to any loss limitation year, the excess (if any) of the NOL for such taxable year over the NOL for such taxable year determined without regard

to any allocable interest deductions otherwise taken into account in computing such loss.

(b) *Computation of allocable interest deductions*—(1) *In general. Allocable interest deductions* are deductions allowed for interest on the portion of indebtedness allocable to a CERT. Except as provided in section 172(h)(2)(E) (relating to adjustments for certain unforeseeable events), indebtedness is allocated to a CERT in the manner prescribed in section 263A(f)(2)(A), without regard to clause (i) thereof (relating to traced debt). Generally, interest deductions are allocable to a CERT if the interest expense could have been avoided if the CERT had not been undertaken (for example, if the amount of CERT costs (as defined in paragraph (b)(3)) had instead been used to pay down debt). See section 263A(f)(2)(A)(ii) and § 1.263A–9(a)(1). For purposes of applying the avoided cost rules of section 263A(f)(2)(A)(ii), all CERT costs are treated as if they were cash expenditures.

(2) *Operating rules.* This section provides a method for identifying the pool of costs to be treated as arising from a CERT (CERT costs). The interest allocable to those CERT costs is then computed under the principles of the avoided cost rules under section 263A(f)(2)(A) (without regard to paragraph (i) thereof) and the regulations thereunder, but substituting ''CERT costs'' or ''accumulated CERT costs'' (as defined in paragraph (b)(4)) for ''production expenditures'' or ''accumulated production expenditures,'' where those terms appear. In addition, for purposes of applying the avoided cost rules to compute interest allocable to a CERT, the ''production period'' is treated as beginning on the first date of the taxable year in which the CERT occurs (year of the CERT) on which there are accumulated CERT costs. Because the principles of section 263A(f)(2)(A)(i) are inapplicable to CERT computations, the principles of § 1.263A–9(b) (relating to traced debt) are also inapplicable. Instead, accumulated CERT costs are treated in their entirety as expenditures allocable to non-traced debt as that term is defined under § 1.263A–9(c)(5), and interest allocable to a CERT is calculated without tracing debt under the provisions of § 1.263A–9(d)(1). Limitations apply to the amount of interest allocable to a CERT. See, for example, section 172(h)(2)(C)(ii) and § 1.172(h)–3 (generally relating to three-year average interest history).

(3) *CERT costs defined*—(i) *Major stock acquisition.* CERT costs with regard to a major stock acquisition (MSA) include the fair market value of the stock acquired, whether that stock is acquired in exchange for cash, for stock of the acquirer, or for other property. In addition, CERT costs include the fair market value of any distributions to shareholders that are treated as part of the MSA under § 1.172(h)–1(d)(2). CERT costs also include the sum of amounts paid or incurred to facilitate any step of the MSA to the extent that those amounts are required to be capitalized under section 263(a), and any amounts disallowed under section 162(k). See also § 1.1502–72(a)(4) for additional rules regarding CERT costs in the case of a reverse acquisition.

(ii) *Excess distribution.* CERT costs with regard to an excess distribution (ED) include the fair market value of any distributions to shareholders during the year of the CERT. CERT costs also include the sum of amounts paid or incurred to facilitate the distributions to the extent that those amounts are required to be capitalized under section 263(a), and any amounts disallowed under section 162(k). To the extent that neither section 263(a) nor section 162(k) applies or if only section 162(k) applies to a distribution included in an ED, additional CERT costs associated with the distribution are determined under the principles of § 1.263(a)–4(e) (relating to the capitalization of certain costs incurred to acquire or create intangibles), applied as if the distribution were a transaction within the scope of § 1.263(a)–4.

(iii) *Borrowing costs included in CERT costs.* For purposes of identifying CERT costs with regard to an MSA or ED under this paragraph (b)(3), the determination of whether costs facilitate an MSA or ED is made without regard to §§ 1.263(a)–5(c)(1) and 1.263(a)–4(e)(1)(iv) (excluding borrowing costs). Therefore, certain costs of debt financing are included in CERT costs.

(4) *Accumulated CERT costs*—(i) *Major stock acquisition.* Except as otherwise provided in this paragraph (b)(4), accumulated CERT costs with regard to an MSA as of a particular date are the total CERT costs described in paragraph (b)(3) of this section that have been taken into account as of that date under the applicable corporation's method of accounting. For example, CERT costs incurred in the taxable year after the year of the CERT are not included in accumulated CERT costs in the year of the CERT, but are included in accumulated CERT costs during the taxable year in which they are incurred and in any succeeding loss limitation year. Similarly, CERT costs include costs incurred after the date on which a CERT occurs if the CERT consists of multiple steps. See § 1.172(h)–5(a).

(ii) *Excess distribution.* Except as provided otherwise in this paragraph (b)(4), accumulated CERT costs as of a particular date with regard to an ED are the total CERT costs described in paragraph (b)(3) of this section that have been taken into account as of that date under the applicable corporation's method of accounting, multiplied by a fraction, the numerator of which equals the amount of distributions constituting an ED during the year of the CERT pursuant to § 1.172(h)–1(c)(3), and the denominator of which equals the total amount of distributions made during the year of the CERT. CERT costs include costs incurred after date on which a CERT occurs if the CERT consists of multiple steps. See § 1.172(h)–5(a).

(iii) *CERT costs incurred in a year prior to a CERT year.* CERT costs incurred in a year prior to the year of the CERT are treated as incurred on the first day of the year of the CERT.

(iv) *Year constitutes loss limitation year with regard to multiple CERTs.* If a single taxable year constitutes a loss limitation year with regard to more than one CERT, the accumulated CERT costs on any particular date during that year include accumulated CERT costs under this paragraph (b)(4) with regard to all such CERTs. See § 1.172(h)–3(d) for rules regarding computation of a CERIL if a year constitutes a loss limitation year with regard to multiple CERTs.

(5) *No netting of interest income and deductions.* Allocable interest deductions under paragraph (b)(1) of this section are the deductions allowed for interest on any indebtedness allocable to a CERT. Allocable interest deductions are not netted against a taxpayer's interest income.

(6) *Certain unforeseeable events.* [Reserved].

(7) *Examples.* The following examples illustrate the rules of this paragraph (b). Unless otherwise provided, assume that all entities are domestic C corporations that do not join in the filing of consolidated returns and are accrual method taxpayers. Assume that all applicable corporations have substantial NOLs in their loss limitation years:

Example 1. CERT costs in MSA. (i) *Facts.* On February 1, Year 5, Corporation A begins investigating the possible acquisition of Corporation T. On March 1, Year 5, A enters into an exclusivity agreement with T. On July 1, Year 5, A engages in an MSA when it acquires all of the stock of T in exchange for cash. A incurs costs for services rendered by its outside counsel and an investment banker. A's outside counsel and the investment banker conduct due diligence on T, determine the value of T, negotiate and structure the transaction with T, draft the purchase agreement, secure shareholder approval, and prepare SEC filings. In addition, the investment banker arranges borrowings to fund both the stock acquisition and A's operations. A also pays a bonus to one of its corporate officers, who negotiated the acquisition of T. Before and after the acquisition is consummated, A incurs costs to relocate personnel and equipment, and to integrate records and information systems.

(ii) *Analysis.* The CERT costs taken into account by A in computing interest allocable to the CERT include the fair market value of the T stock. See paragraph (b)(3)(i) of this section. The costs incurred on or after the date of the exclusivity agreement, March 1, Year 5, (but not before) to conduct due diligence are also included in A's CERT costs. See paragraph (b)(3)(i) of this section and § 1.263(a)–5(e)(1). A's CERT costs also include all amounts incurred to determine the value of T, negotiate and structure the transaction with T, draft the purchase agreement, secure shareholder approval, and prepare SEC filings. See § 1.263(a)–5(e)(2). In addition, A's CERT costs include borrowing costs that facilitate the CERT. See paragraph (b)(3)(iii) of this section. A's CERT costs do not include any portion of the bonus paid to the corporate officer or the costs incurred to relocate personnel and equipment, and to integrate records and information systems. See § 1.263(a)–5(c)(6) and (d).

Example 2. CERT costs in ED. (i) *Facts.* X corporation is a calendar-year taxpayer. On July 1, Year 5, X makes a distribution of $80,000 to its shareholders, $60,000 of which constitutes an ED. X makes no other distributions during Year 5. At previous regular quarterly board of directors meetings, the directors discussed the July 1, Year 5 distribution. On March 30, Year 5, X incurs $2,500 in borrowing costs that constitute CERT costs under paragraph (b)(3)(iii) of this section. In addition, on March 30 and April 15, Year 5, X incurs $500 and $3,000, respectively, for work performed by its outside counsel which facilitates the ED under the principles of § 1.263(a)–4(e). During Year 5, X pays its directors for attendance at the regular quarterly board of directors meetings. No additional CERT costs are incurred in Years 6 and 7.

(ii) *CERT costs.* X's CERT costs include the fair market value of all distributions made during the year of the CERT ($80,000), as well as the $2,500 of borrowing costs. See paragraph (b)(3)(ii) and (iii) of this section. In addition, under the principles of section § 1.263(a)–4(e), X's CERT costs include the costs incurred for work performed by A's outside counsel related to the ED. See paragraph (b)(3)(ii) of this section and § 1.263(a)–4(e)(1)(i). X's CERT costs do not include amounts paid to X's board of directors to attend the regular board of directors meetings. See § 1.263(a)–4(e)(4)(ii)(B).

(iii) *Accumulated CERT costs.* Under paragraph (b)(4)(ii) of this section, X's accumulated CERT costs as of a particular date with regard to its ED are the total CERT costs that have been taken into account as of that date multiplied by a fraction the numerator of which equals the amount of distributions constituting ED during the year of the CERT, and the denominator of which equals the total amount of distributions made during the year of the CERT. Here $60,000 is divided by $80,000, which equals ¾. The CERT occurs during X's Year 5, and that year is a loss limitation year with regard to the CERT. X's accumulated CERT costs on March 30, Year 5 are $2,250 (3,000 x ¾). X's accumulated CERT costs are $4,500 (6,000 × ¾) on April 15, Year 5 and $64,500 (86,000 × ¾) on July 1, Year 5. X's Years 6 and 7 are also loss limitation years. Because no additional CERT costs are incurred in Years 6 and 7, throughout those years, X's accumulated CERT costs are $64,500.

Example 3. Accumulated CERT costs in an MSA. (i) *All CERT costs incurred in year of CERT.* X corporation is a calendar-year taxpayer. On March 1, Year 5, X acquires all of the stock of unrelated corporation T in an MSA. X's loss limitation years are calendar Years 5, 6, and 7. During Year 5, X incurs the following CERT costs: $4,000 on January 30; $50,000 on March 1; and $9,000 on March 15. During Year 5, X's accumulated CERT costs are: $4,000 as of January 30; $54,000 as of March 1; and $63,000 as of March 15. See paragraph (b)(4)(i) of this section. No additional CERT costs are incurred in Years 6 and 7. As a result, throughout Years 6 and 7, X's accumulated CERT costs are $63,000.

(ii) *Portion of CERT costs incurred prior to year of CERT.* The facts are the same as in paragraph (i) of this *Example 3,* except during Year 4, X incurs $2,000 of CERT costs. During Year 5, X's accumulated CERT costs are: $2,000 as of January 1 (reflecting costs incurred during Year 4); $6,000 as of January 30; $56,000 as of March 1; and $65,000 as of March 15. See paragraph (b)(4)(i) and (iii) of this section. X is treated as having no accumulated CERT costs during Year 4.

(c) *Effective/applicability date.* This section is applicable to CERTs occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**. This section is also applicable to the deconsolidation of a member from, or the acquisition of a corporation by, a consolidated group that occurs on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**. However, in each case, this section does not apply to any CERT, deconsolidation, or acquisition occurring pursuant to a written agreement that is binding before the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

§ 1.172(h)–3 Limitation on allocable interest deductions.

(a) *General rule.* The amount of allocable interest deductions (determined under § 1.172(h)–2(b)) for any loss limitation year is limited to the excess (if any) of the amount allowable as a deduction for interest paid or accrued by the taxpayer during the loss limitation year, over the average of interest paid or accrued by the taxpayer (the three-year average) for the three taxable years preceding the taxable year in which the corporate equity reduction transaction (CERT) occurred (the lookback period). This section provides additional rules for computing the three-year average relevant to any loss limitation year for purposes of applying section 172(b)(1)(E) and (h), §§ 1.172(h)–1 through 1.172(h)–5, and § 1.1502–72 (the CERT rules*).*

(b) *Three-year average for a short loss limitation year*—(1) *General rule.* For purposes of computing the three-year average if the relevant loss limitation year is less than a full 12-month year, the interest paid or accrued with regard to any year of the taxpayer during a lookback period (lookback period year) equals the amount of interest treated as paid or accrued multiplied by a fraction, the numerator of which equals the number of days in the short loss limitation year, and the denominator of which equals the number of days in the lookback period year. The value of the fraction may not exceed 100 percent. Zero interest is deemed paid or accrued (in excess of amounts actually paid or accrued) in a lookback period year that is shorter than the loss limitation year.

(2) *Example.* The following example illustrates the short loss limitation year rule of this paragraph (b):

Example. (i) *Facts.* T, a domestic C corporation, was organized on July 1, Year 1. T's first taxable year is a short taxable year, which includes July 1 through December 31, Year 1 (184 days). T's next two taxable years are full calendar years: Calendar Year 2 and Calendar Year 3. T's Year 4 ends on September 30 as a result of a change in accounting period. T engages in a CERT during its taxable Year 4, which includes January 1, Year 4, through September 30, Year 4 (273 days). T's next two taxable periods are full 12-month fiscal years ending on September 30, Year 5, and September 30, Year 6.

(ii) *Year 4 analysis.* T's taxable Year 4 is a short loss limitation year. Therefore, in computing its three-year average applicable to loss limitation Year 4, T multiplies its interest treated as paid or accrued during each of the three years of the lookback period by the fraction specified in paragraph (b)(1) of this section. The pertinent fraction with regard to Year 1 of the lookback period is 273/184 (number of days in short loss limitation year divided by the number of days in the lookback period year). However, under paragraph (b)(1) of this section, the value of the fraction cannot exceed 100 percent. As a result, T includes in the computation of its three-year average its actual interest paid or accrued in Year 1. As to Years 2 and 3, T includes in the computation of its three-year average its actual interest paid or accrued in each of those years, multiplied by a fraction equal to 273/365.

(iii) *Year 5 and 6 analysis.* Because T's taxable Years 5 and 6 are full 12-month loss limitation years, T includes in the computation of its three-year average applicable to those loss limitation years its actual interest paid or accrued in each year of the lookback period, without adjustment.

(c) *Computation of interest paid or accrued by corporation with incomplete lookback period*—(1) *Lookback period for corporation not in existence.* If an applicable corporation was not in existence for three taxable years preceding the taxable year in which the CERT occurred (the lookback period), for purposes of determining the limitation on allocable interest deductions under section 172(h)(2)(C) and paragraph (a) of this section, the applicable corporation's lookback period is deemed to have additional 12-month periods that end on the calendar date that is one day prior to the date of the corporation's organization. See § 1.172(h)–4(c)(2)(i)(B) (regarding determination of lookback period for successor applicable corporations not in existence on date of CERT) and § 1.1502–72(d)(4)(ii) (regarding consolidated groups not in existence during the entire lookback period).

(2) *Interest history of corporation not in existence.* If an applicable corporation was not in existence for the entire lookback period, it is treated as having paid or accrued zero interest during periods deemed to exist under paragraph (c)(1) of this section in computing any three-year average. However, if the applicable corporation is a successor corporation pursuant to § 1.172(h)–1(b)(2), the computation of any three-year average for the successor includes interest paid or accrued by any predecessor during the lookback period. See § 1.172(h)–4(c)(2)(ii)(A).

(3) *Example.* The following example illustrates the rules of this paragraph (c):

Example. Corporation not in existence for entire lookback period. C is a domestic C corporation that does not join in the filing of a consolidated return and maintains a calendar taxable year. C is formed on October 1, Year 3, and engages in a CERT during Year 5. For purposes of computing any CERIL related to the CERT, paragraph (a) of this section requires that C must measure its interest deductions for the lookback period. However, C was not in existence for three taxable years preceding the year in which the CERT occurred. Rather, C was in existence for one full calendar taxable year (Year 4) and one short taxable year (October 1 through December 31, Year 3). Pursuant to paragraph (c)(1) of this section, C's lookback period is deemed to include an additional taxable period (October 1, Year 2, through September 30, Year 3). Further, in computing any three-year average, C is treated as having paid or accrued zero interest during the deemed additional period. See paragraph (c)(2) of this section.

(d) *Computation of a CERIL if single year constitutes loss limitation year with regard to multiple CERTs*—(1) *Single CERIL computation.* This paragraph (d) applies if a taxable year constitutes a loss limitation year of the taxpayer with regard to more than one CERT. In that case, a single corporate equity reduction interest loss (CERIL) is computed under section 172(h)(1) and § 1.172(h)–2(a)(2) for that year. This computation takes into account accumulated CERT costs for every CERT, determined under § 1.172(h)–2(b)(4)(iv) for the loss limitation year.

(2) *Limitation on allocable interest deductions.* In computing the single CERIL under this paragraph (d), section 172(h)(2)(C) and paragraph (a) of this section are applied a single time to limit the cumulative amount of interest allocable to all of the CERTs to the excess (if any) of the amount allowable as a deduction for interest paid or accrued by the taxpayer during the loss limitation year over the three-year average for the lookback period. The limitation is not applied separately with respect to interest allocable to a particular CERT.

(3) *Computation of three-year average if CERTs have different lookback periods*—(i) *In general.* If the lookback periods (as defined in paragraph (a) of this section or in § 1.1502–72(d)(4)) relevant to all of the CERTs pertinent to a loss limitation year are not identical, a cumulative three-year average is computed by applying the rules of paragraph (d)(3)(ii) of this section. The cumulative three-year average is treated as the three-year average relevant to the loss limitation year, and is applied to determine the limitation on the amount of interest allocable to all of the CERTs under section 172(h)(2)(C) and paragraph (a) of this section.

(ii) *Cumulative three-year average.* The cumulative three-year average applicable to any loss limitation year is computed under this paragraph (d)(3)(ii). With regard to each lookback period relevant to a loss limitation year, a modified three-year average is computed. The modified three-year average is the three-year average relevant to a particular lookback period (determined under section 172(h)(2)(C) and this section) multiplied by a fraction, the numerator of which equals the accumulated CERT costs as of the close of the loss limitation year that are attributable to the particular CERT or CERTs to which the three-year average corresponds, and the denominator of which equals the total accumulated CERT costs as of the close of the loss limitation year that are attributable to all CERTs relevant to the loss limitation year. See § 1.172(h)–2(b)(4) defining accumulated CERT costs. The sum of all modified three-year averages is the cumulative three-year average for that year.

(4) *Allocation of a CERIL among CERTS.* After the computation of the single CERIL for a loss limitation year that is attributable to all CERTs, the total CERIL is allocated to particular CERTs, if CERILs attributable to different CERTs are subject to different limitations on carryback. See section 172(b)(1)(E)(i) and § 1.172(h)–5(b) (regarding prohibition on carrybacks). For purposes of this allocation, the CERT costs attributable to each particular CERT are identified. The total CERIL is then attributed to each CERT by multiplying the total CERIL by a fraction, the numerator of which equals the accumulated CERT costs as of the close of the loss limitation year that are attributable to a particular CERT, and the denominator of which equals the total accumulated CERT costs as of the close of the loss limitation year that are attributable to all CERTs relevant to the loss limitation year. See § 1.172(h)–2(b)(4) defining accumulated CERT costs.

(5) *Examples.* The following examples illustrate the rules of this paragraph (d). Unless otherwise provided, assume that all entities are domestic C corporations that do not join in the filing of consolidated returns and that maintain calendar taxable years. Assume that all applicable corporations have substantial net operating losses in their loss limitation years:

Example 1. Multiple CERTs with identical lookback period. (i) *Facts.* Corporation A maintains a calendar taxable year. A engages in two separate CERTs during its taxable Year 4. The lookback period for both CERTs is January 1, Year 1, through December 31, Year 3. The total amount of interest deductions allocable to CERT 1 and CERT 2 (before application of section 172(h)(2)(C) and paragraph (a) of this section) is $50. A's total interest expense during Year 4 was $150, and its three-year average interest for the lookback period was $120.

(ii) *Analysis.* Year 4 constitutes a loss limitation year with regard to both CERT 1 and CERT 2. A single CERIL is computed with regard to Year 4, and the limitation on allocable interest under section 172(h)(2)(C) and paragraph (a) of this section is applied a single time. See paragraphs (d)(1) and (2) of this section. The limitation under section 172(h)(2)(C) and paragraph (a) of this section is applied to the cumulative amount of interest allocable to the two CERTs ($50). See paragraph (d)(2) of this section. The limitation under section 172(h)(2)(C) and paragraph (a) of this section equals the excess of the amount of interest allowable in Year 4 ($150) over the three-year average ($120), or $30. Therefore, the CERIL is limited to $30.

Example 2. Multiple CERTs with different lookback periods. (i) *Facts.* Corporation A maintains a calendar taxable year. A engages in CERT 1 during its taxable Year 4. The lookback period relevant to CERT 1 is January 1, Year 1, through December 31, Year 3. A also engages in CERT 2 during its taxable Year 5. The lookback period relevant to CERT 2 is January 1, Year 2, through December 31, Year 4. The total amount of interest deductions allocable to CERT 1 and CERT 2 (before application of section 172(h)(2)(C) and paragraph (a) of this section) during taxable Year 5 is $50. A's total interest expense during Year 5 is $126. A's three-year average interest that is relevant to loss limitation Year 5 for the CERT 1 lookback period is $100, and its three-year average interest that is relevant to loss limitation Year 5 for the CERT 2 lookback period is $110. A's accumulated CERT costs attributable to CERT 1 are $400. A's accumulated CERT costs attributable to CERT 2 are $600.

(ii) *Cumulative three-year average.* Year 5 is a loss limitation year with regard to both CERT 1 and CERT 2. A single CERIL is computed with regard to Year 5, and the limitation on allocable interest under section 172(h)(2)(C) and paragraph (a) of this section is applied a single time. See paragraph (d)(1) and (2) of this section. The limitation under section 172(h)(2)(C) and paragraph (a) of this section is applied to the cumulative amount of interest allocable to the two CERTs ($50). See paragraph (d)(2) of this section. Because Year 5 constitutes a loss limitation year with regard to CERTs with different lookback periods, the relevant three-year average applied under section 172(h)(2)(C) and paragraph (a) of this section is the cumulative three-year average, which is the sum of all modified three-year averages. See paragraph (d)(3)(ii) of this section. The modified three-year average with regard to CERT 1 is the three-year average for CERT 1 multiplied by $400/$1,000 (accumulated CERT costs attributable to CERT 1 divided by the total accumulated CERT costs attributable to CERTs 1 and 2), or ⅖. Therefore, the modified three-year average with regard to CERT 1 is $40 (100 × ⅖). The modified three-year average with regard to CERT 2 is the three-year average for CERT 2 multiplied by $600/$1,000 (accumulated CERT costs attributable to CERT 2 divided by the total accumulated CERT costs attributable to CERTs 1 and 2), or ⅗. Therefore, the modified three-year average with regard to CERT 2 is $66 (110 × ⅗). Thus, the cumulative three-year average interest for Year 5 is $106 ($40 + $66). See paragraph (d)(3) of this section. The limitation under section 172(h)(2)(C) and paragraph (a) of this section equals the excess of the amount of interest allowable in Year 5 ($126) over the cumulative three-year average interest ($106), or $20. Therefore, the CERIL for Year 5 is limited to $20.

(iii) *Allocation of a CERIL to different CERTs.* Because Year 5 constitutes a loss limitation year with regard to more than one CERT, and a CERIL associated with each CERT is subject to different limitations on carryback, the total CERIL must be allocated between CERT 1 and CERT 2. See paragraph (d)(4) of this section. The portion of the total CERIL allocated to CERT 1 is the total CERIL multiplied by $400/$1,000 (accumulated CERT costs attributable to CERT 1 divided by the total accumulated CERT costs attributable to CERTs 1 and 2), or ⅖. Therefore, the portion of the total CERIL allocated to CERT 1 is $8 ($20 × ⅖). The portion of the total CERIL allocated to CERT 2 is the total CERIL multiplied by $600/$1,000 (accumulated CERT costs attributable to CERT 2 divided by the total accumulated CERT costs attributable to CERTs 1 and 2), or ⅗. Therefore, the portion of the total CERIL allocated to CERT 2 is $12 ($20 × ⅗). See paragraph (d)(4) of this section. See also section 172(b)(1)(E)(i) and § 1.172(h)–5(b)(1) for rules regarding the prohibition on carryback of a CERIL.

Example 3. CERTs of multiple corporations with identical lookback period. (i) *Facts.* Corporation T maintains a taxable year ending on June 30. On August 31, Year 5, T engages in CERT 1. Unrelated P is the parent of a group that maintains a calendar taxable year. On October 31, Year 5, P acquires all the stock of T in an MSA (CERT 2). T is first included in the P group on November 1, Year 5. For its calendar Year 5, the P group is treated as an applicable corporation with respect to CERT 1 and CERT 2. See § 1.1502–72(a)(2)(iv)(A). The P group's lookback period for both CERTs is January 1, Year 2, through December 31, Year 4. The total CERIL of the group in Year 5 is $80. The P group's accumulated CERT costs attributable to CERT 1 are $500. The P group's accumulated CERT costs attributable to CERT 2 are $1,500. The P group has a consolidated net operating loss (CNOL) in Year 5, a portion of which is allocable to T under § 1.1502–21(b)(2)(iv)(B).

(ii) *Allocation of a CERIL to different CERTs.* Year 5 constitutes a loss limitation year with regard to two CERTs that share a common lookback period. However, the CERIL associated with the different CERTs is subject to different limitations on carryback under § 1.172(h)–5(b)(1) (some CNOL will be carried back to the group's consolidated return years and some will be carried back to T's separate return years). Therefore, the total CERIL must be allocated between CERT 1 and CERT 2. The portion of the total CERIL allocated to CERT 1 is the total CERIL multiplied by $500/$2,000 (accumulated CERT costs attributable to CERT 1 divided by the total accumulated CERT costs attributable to CERTs 1 and 2), or ¼. See paragraph (d)(4) of this section. Therefore, the portion of the total CERIL allocated to CERT 1 is $20 ($80 × ¼). The portion of the total CERIL allocated to CERT 2 is the total CERIL multiplied by $1,500/$2,000 (accumulated CERT costs attributable to CERT 2 divided by the total accumulated CERT costs attributable to CERTs 1 and 2), or ¾. Therefore, the portion of the total CERIL allocated to CERT 2 is $60 ($80 × ¾).

(e) *Effective/applicability date.* This section is applicable to CERTs occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**. This section is also applicable to the deconsolidation of a member from, or the acquisition of a corporation by, a consolidated group that occurs on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**. However, in each case, this section does not apply to any CERT, deconsolidation, or acquisition occurring pursuant to a written agreement that is binding before the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

§ 1.172(h)–4 Special rules for predecessors and successors.

(a) *Scope.* This section provides guidance with regard to the application of section 172(b)(1)(E) and (h), §§ 1.172(h)–1 through 1.172(h)–5, and § 1.1502–72 (the CERT rules) to predecessors and successors (as defined in § 1.172(h)–1(b)(2)).

(b) *Loss limitation years*—(1) *In general.* This paragraph (b)(1) applies to identify loss limitation years of a successor. The taxable year in which a corporate equity reduction transaction (CERT) actually occurs is a loss limitation year. See § 1.172(h)–1(e). Any taxable year of a successor (potential loss limitation year) of any applicable corporation is a loss limitation year with regard to the CERT if, under the carryover rules of sections 172(b)(1)(A)(ii) and 381(c)(1), the potential loss limitation year constitutes the first or second taxable year following the taxable year of the corporation that actually engaged in the CERT which includes the date on which the CERT occurred. See § 1.172(h)–5(a) (defining date on which CERT occurs in multiple-step transaction); but see § 1.1502–72(a)(3) (defining loss limitation years of consolidated groups and corporations that were previously members of a consolidated group).

(2) *Example.* The following example illustrates the rules of this paragraph (b):

Example. Loss limitation years of successor. T is a domestic C corporation that maintains a calendar taxable year and does not join in the filing of a consolidated return. On March 31, Year 6, T engages in a CERT. On June 30, Year 6, T merges into Corporation A, a calendar-year taxpayer, in a transaction to which section 381(a) applies. T's taxable Year 6 ends on the date of the merger, and A succeeds to T's tax attributes. See section 381(a) and (b)(1). T's only loss limitation year with respect to the Year 6 CERT is its short taxable year ending June 30, Year 6. See section 172(b)(1)(E)(ii) and § 1.172(h)–1(e). Following the merger, A is the successor to T, and A is treated as an applicable corporation with regard to the

Year 6 CERT. See § 1.172(h)–1(b)(2). A's calendar Years 6 and 7 are the second and third loss limitation years with regard to the Year 6 CERT. See section 172(b)(1)(E)(ii) and paragraph (b)(1) of this section.

(c) *Computation of a CERIL*—(1) *CERT costs.* For purposes of computing any corporate equity reduction interest loss (CERIL) under section 172(h)(1) and § 1.172(h)–2(a)(2), any CERT costs incurred (or treated as incurred under this paragraph (c)) by a predecessor are attributed to the successor. However, such costs are treated as having been incurred by the successor only for purposes of applying the avoided cost rules of section 263A(f)(2)(A) to any measurement date (as defined in § 1.263A–9(f)(2)) after the date of the section 381(a) transaction.

(2) *Limitation on allocable interest deductions*—(i) *Lookback period*—(A) *In general.* The *lookback period* with regard to a CERT is the three taxable years preceding the taxable year in which the CERT occurs. See § 1.172(h)–3(a). The lookback period that is relevant to the calculation of any CERIL of a successor (successor's lookback period) is the three years preceding the taxable year of the successor that includes the date on which the CERT occurred. See §§ 1.172(h)–5(a) (defining the date on which a CERT occurs if the CERT consists of multiple steps) and § 1.172(h)–3(c) (regarding corporations with insufficient lookback periods).

(B) *Successor not in existence on date of CERT.* If a successor was not in existence on the date on which the CERT occurred, for purposes of determining the lookback period, the successor is deemed to have additional 12-month periods that end on the calendar date that is one day prior to the date of the corporation's organization. The successor is deemed to have a sufficient number of such additional periods such that the successor is treated as having a year that includes the date on which the CERT occurred and as having three years (the lookback period) immediately preceding the deemed year that includes the date of the CERT. See § 1.172(h)–3(c)(1) regarding lookback period for corporation lacking three-year history.

(ii) *Computation of three-year average*—(A) *In general.* Except as otherwise provided in this paragraph (c)(2)(ii), for purposes of determining any three-year average of a successor under section 172(h)(2)(C)(ii) and § 1.172(h)–3, the interest paid or accrued by a successor includes interest paid or accrued by all corporations that are its predecessors as of the end of the successor's taxable year. If the dates of any taxable year of a predecessor do not precisely correspond to the dates of a taxable year of the successor, the interest paid or accrued by the predecessor is apportioned equally to each date of the predecessor's taxable year. The successor is treated as having paid or accrued in any year during the lookback period all predecessor interest that is apportioned to a date within that lookback period year.

(B) *Year of successor transaction.* In computing the three-year average that is relevant to the taxable year of a successor that includes the date of the section 381(a) transaction that resulted in successor status, the successor includes only a pro rata portion of the predecessor's amount of interest paid or accrued during the successor's lookback period. The pro rata amount equals the predecessor's interest treated as paid or accrued for the dates of the successor's lookback period, multiplied by a fraction, the numerator of which equals the number of days in the loss limitation year of the successor that follow the date of the transaction that resulted in successor status, and the denominator of which equals the number of days in the successor's loss limitation year. The predecessor's amount of interest treated as paid or accrued that is subject to proration under this paragraph (c)(2)(ii)(B) is the interest history of the predecessor that would otherwise be fully combined with the interest history of the successor under paragraph (c)(2)(ii)(A) of this section.

(3) *Examples.* The following examples illustrate the rules of this paragraph (c). Unless otherwise provided, assume that all entities are domestic C corporations that do not join in the filing of consolidated returns and that maintain calendar taxable years. Assume that all applicable corporations have substantial net operating losses in their loss limitation years:

Example 1. Predecessor corporation engages in CERT. (i) *Facts.* Corporation X is a calendar-year taxpayer. On February 1, Year 5, X engages in a CERT. On August 1, Year 5, X merges into unrelated corporation Y in a transaction to which section 381(a) applies. Y is a calendar-year taxpayer and all of its taxable years are full calendar years. All of X's taxable years prior to the year of the merger are full calendar years.

(ii) *Analysis.* X's only loss limitation year is its short year ending August 1, Year 5. X's lookback period relevant to the Year 5 CERT includes X's calendar Years 2, 3, and 4. See paragraph (c)(2)(i)(A) of this section; see also § 1.172(h)–3(b)(1) (computation of three-year average for a short loss limitation year). Following the merger, Y is the successor to X, and Y is treated as an applicable corporation with regard to the Year 5 CERT. See § 1.172(h)–1(b)(2). Because Y's calendar Year 5 follows a single loss limitation year of X with regard to the same CERT, Y's calendar Years 5 and 6 are loss limitation years with regard to the Year 5 CERT. See paragraph (b)(1) of this section and § 1.381(c)(1)–1(e)(3). Y's lookback period for the Year 5 CERT is its calendar Years 2, 3, and 4. See paragraph (c)(2)(i)(A) of this section. The computations of Y's three-year averages relevant to its loss limitation Years 5 and 6 include interest paid or accrued by Y and by all of Y's predecessors, including X, during the lookback period. See paragraph (c)(2)(ii)(A) of this section. However, because Year 5 is Y's taxable year that includes the date of the section 381(a) transaction that resulted in Y's successor status, for purposes of computing Y's three-year average for Y's loss limitation Year 5, Y includes only a pro rata portion of X's amount of interest paid or accrued. In the proration, X's amount of interest paid or accrued during the 3 year lookback period is multiplied by 151/365 (the number of days in Y's loss limitation Year 5 that follow the date of the section 381(a) transaction that resulted in Y's successor status, divided by the number of days in Y's loss limitation Year 5). See paragraph (c)(2)(ii)(B) of this section.

(iii) *Predecessor and successor have different taxable years.* The facts are the same as in paragraph (i) of this *Example 1,* except that X maintained a taxable year ending June 30 before its merger into Y. X's full taxable year ending June 30, Year 5, and its short year ending August 1, Year 5, are its loss limitation years with regard to its February 1, Year 5 CERT. See section 172(b)(1)(E)(ii) and § 1.172(h)–1(e). Following the merger of X into Y, Y is a successor to X and is treated as an applicable corporation with regard to the Year 5 CERT. Y's calendar Year 5 is the third loss limitation year with regard to the CERT. See paragraph (b)(1) of this section. Y's lookback period is Y's three taxable years preceding Y's taxable year that includes the date of the CERT, which are Years 2, 3, and 4. Further, because the dates of X's taxable years do not precisely correspond to the dates of Y's taxable years, X's interest paid or accrued is apportioned equally to each date within each of X's taxable years. Y is treated as having paid or accrued in any year during the lookback period all of X's interest that is so apportioned. See paragraph (c)(2)(ii)(A) of this section. However, because Y's taxable Year 5 includes the date of the section 381(a) transaction that resulted in Y's successor status, for purposes of computing Y's three-year average for loss limitation Year 5, Y includes only a pro rata portion of X's interest history. See paragraphs (c)(2)(ii)(B) of this section.

Example 2. Successor corporation not in existence for entire lookback period. (i) *Facts.* Corporation A is formed on October 1, Year 3, and thereafter maintains a calendar taxable year. Immediately after A is formed in Year 3, a second corporation, T, merges into A in a transaction that meets the requirements of section 368(a)(1)(A). During Year 5, A engages in a CERT.

(ii) *Analysis.* A's loss limitation years are its calendar Years 5, 6, and 7. See section 172(b)(1)(E)(ii). For purposes of computing any CERIL related to the Year 5 CERT, section 172(h)(2)(C)(ii) and § 1.172(h)–3 require that A measure its interest deductions for the three years preceding the taxable year of the CERT (three-year average). However, A is in existence for only two taxable years before the year in which the CERT occurs. Therefore, pursuant to § 1.172(h)–3(c)(1), A is deemed to have an additional taxable period (October 1, Year 2, through September 30, Year 3). Further, in computing the three-year average, A is treated as having paid or accrued zero interest during the deemed year. See § 1.172(h)–3(c)(2). However, because T is the predecessor of A, the computation of A's three-year average relevant to its loss limitation Year 5 includes interest paid or accrued by T during the lookback period (October 1,Year 2, through December 31, Year 4). See paragraph (c)(2)(ii)(A) of this section and § 1.172(h)–3(c)(2). Because T merges into A in a year prior to any loss limitation year, there is no proration of T's interest history under paragraph (c)(2)(ii)(B) of this section.

(d) *Three-year distribution average.* For purposes of determining any three-year distribution average of a successor under section 172(h)(3)(C)(ii)(I) and § 1.172(h)–1(c)(3), the distributions made by a successor include distributions made by all corporations that are its predecessors as of the end of the successor's taxable year. If the dates of any taxable year of a predecessor do not correspond to the dates of a taxable year of the successor, the distributions made by the predecessor are apportioned equally to each date of the predecessor's taxable year. The successor is treated as having made in its taxable years all predecessor distributions that are apportioned to a date within those taxable years.

(e) *Effective/applicability date.* This section is applicable to CERTs occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**. This section is also applicable to the deconsolidation of a member from, or the acquisition of a corporation by, a consolidated group that occurs on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**. However, in each case, this section does not apply to any CERT, deconsolidation, or acquisition occurring pursuant to a written agreement that is binding before the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

§ 1.172(h)–5 Operating rules.

(a) *Date on which CERT occurs in a multi-step transaction.* For purposes of applying section 172(b)(1)(E) and (h), §§ 1.172(h)–1 through 1.172(h)–4, and this section, and § 1.1502–72 (the CERT rules), if a corporate equity reduction transaction (CERT) consists of multiple steps, the date on which the CERT occurs is the earliest date on which the requirements for CERT status are satisfied. For example, if multiple distributions are made in a single year, an excess distribution (ED) is treated as occurring on the earliest date on which the amount of distributions satisfies the greater of the two thresholds contained in section 172(h)(3)(C)(ii) and § 1.172(h)–1(c)(3). A major stock acquisition (MSA) is treated as occurring on the earliest date on which at least 50 percent of the stock of a corporation is acquired, subject to the provisions of section 172(h)(3)(B) and § 1.172(h)–1(c)(2).

(b) *Prohibition on carryback*—(1) *In general.* No corporate equity reduction interest loss (CERIL) attributable to a CERT may be carried back under section 172 or § 1.1502–21(b) to any taxable year (including a consolidated return year) that includes solely dates that precede the date on which the CERT occurred. In addition, if a corporation becomes a member of a consolidated group as a result of a CERT, no CERIL allocable to that CERT may be carried back under section 172 or § 1.1502–21(b) to the taxable year of the acquired corporation that includes the date on which the CERT occurred, or to any preceding taxable year. See § 1.172(h)–3(d)(4) regarding allocation of a CERIL among CERTs, and § 1.1502–21(b)(2)(iv)(C)(1) for the apportionment of a CERIL among consolidated group members.

(2) *Example.* The following example illustrates the rules of this paragraph (b):

Example. Prohibition on carryback. (i) *Facts.* T corporation maintains a taxable year ending June 30. X corporation is the parent of a group that maintains a calendar taxable year. On March 31, Year 5, the X group acquires all of the T stock in a CERT, and T is first included in the X group on April 1, Year 5. During its consolidated return Year 5, the X group has a consolidated net operating loss (CNOL), a portion of which constitutes a CERIL, pursuant to section 172(h)(1) and § 1.172(h)–2(a)(2). Part of the CERIL is apportioned to T, pursuant to § 1.1502–21(b)(2)(iv)(C)(1).

(ii) *Analysis.* On the date of the acquisition, both the X group and T constitute applicable corporations with regard to the Year 5 CERT. See section 172(b)(1)(E)(iii)(I) and § 1.172(h)–1(b). T's short taxable year ending on March 31, Year 5, was T's taxable year in which the CERT occurred. The X group's year in which the CERT occurred was its consolidated return Year 5. Section 172(b)(1)(E)(i) and paragraph (b) of this section prohibit the carryback of a CERIL to years preceding the taxable year in which the CERT occurs. Pursuant to paragraph (b)(1) of this section, no portion of a CERIL relating to the X group CNOL can be carried back to any taxable year that includes solely dates that precede the date on which the CERT occurred. As a result, no portion of the CERIL can be carried back to the X group's Year 4, or any preceding year. Moreover, because T becomes a member of the X group as a result of the CERT, no portion of the CERIL can be carried back to T's short taxable year ending March 31, Year 5, or any preceding taxable year. See paragraph (b)(1) of this section.

(c) *Stock issuances and computation of three-year distribution average*—(1) *In general.* In determining whether an ED has occurred, aggregate distributions made during a taxable year are reduced by the aggregate amount of stock issued by the applicable corporation during the year in which the potential ED occurred in exchange for money or property other than stock of the applicable corporation. Similarly, the computation of any three-year distribution average under section 172(h)(3)(C)(ii)(I) and § 1.172(h)–1(f) is reduced by the average of the stock issuances described in section 172(h)(3)(E)(ii) and this paragraph (c)(1) during the three years of the distribution lookback period (three-year stock issuance average).

(2) *Example.* The following example illustrates the rules of this paragraph (c):

Example. (i) *Facts.* C is a corporation that maintains a calendar taxable year. During Year 5, C makes a large distribution to its shareholders. During taxable Years 2, 3, and 4, C distributes an average of $100,000 per year. In addition, during taxable Year 2, C issued stock in exchange for $90,000 cash. During taxable Year 3, C issued stock in exchange for $15,000 cash. C issued no stock during taxable Year 4.

(ii) *Analysis.* C must test its Year 5 distribution as a potential ED. C's three-year distribution average without respect to any stock issued during the distribution lookback period is $100,000. C's three-year distribution average is reduced by the average of the stock issued by the corporation in exchange for money or property other than stock in C during the years of the distribution lookback period (three-year stock issuance average). See paragraph (c)(1) of this section. C's three-year stock issuance average is $35,000 [($90,000 + $15,000 + 0)/3]. Therefore, T's three-year distribution average is $65,000 ($100,000 − $35,000).

(d) *Computation of the alternative minimum tax net operating loss deduction.* The CERT rules governing the carryback of net operating losses following a CERT also apply to the carryback of an alternative minimum tax net operating loss.

(e) *Effective/applicability date.* This section is applicable to CERTs occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**. This section is also applicable to the deconsolidation of a member from, or the acquisition of a corporation by, a consolidated group that occurs on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**. However, in each case, this section does not apply to any CERT, deconsolidation, or acquisition occurring pursuant to a written agreement that is binding before the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

Par. 3. Section 1.1502–21 is amended by adding paragraphs (b)(2)(iv)(C) and (h)(1)(iv) and revising paragraphs (b)(3)(ii)(B) and (h)(5) to read as follows:

§ 1.1502–21 Net operating losses.

* * * * *

(b) * * *

(2) * * *

(iv) * * *

(C) *Apportionment of special status losses—(1) In general.* The amount of the group's CNOL that is determined to constitute a corporate equity reduction interest loss (CERIL) (as defined in section 172(h)(1) and § 1.172(h)–2(a)(2)), specified liability loss (as defined in section 172(f)(1)), or any other net operating loss (NOL) that is subject to special carryback or carryover rules (special status loss), is apportioned to each member separately from the remainder of the CNOL, based on the percentage of CNOL attributable to the member as determined under paragraph (b)(2)(iv)(B) of this section. This apportionment is made without regard to whether a particular member actually incurred specific expenses or engaged in specific activities required by the special status loss provisions. If a consolidated group must apply § 1.172(h)–3(d)(4) to allocate its CERIL for a loss limitation year between multiple corporate equity reduction transactions (CERTs), then the portion of the CERIL allocable to each CERT is treated as a separate CERIL for purposes of applying this paragraph (b)(2)(iv)(C) to apportion special status losses among members of the group.

(*2*) *Example.* The following example illustrates the rules of this paragraph (b)(2)(iv)(C):

Example. (i) *Facts.* P is the parent of a group that includes S and that maintains a calendar taxable year. S has been a member of the group for all relevant years. In Year 3, the P group engages in a CERT. T is included in the P group beginning on January 1, Year 4, as a result of a transaction that does not constitute a CERT. In Year 4, the P group has a CNOL of $1,200. Under the CERT rules (in section 172(b)(1)(E) and (h), §§ 1.172(h)–1 through 1.172(h)–5, and § 1.1502–72), $300 of the CNOL (25%) constitutes a CERIL. Assume that, absent application of this paragraph (b)(2)(iv)(C), under paragraph (b)(2)(iv)(B) of this section, ⅔ of the CNOL ($800) is attributable to T and the remaining ⅓ of the CNOL ($400) is attributable to S.

(ii) *Analysis.* Under this paragraph (b)(2)(iv)(C), the CNOL is divided into its special status (CERIL) component, and its non-special status component. Because T has separate return year carryback years, each component of the CNOL (the non-special status CNOL and the CERIL) is apportioned under paragraph (b)(2)(iv)(B) of this section. Under that apportionment rule, ⅔ of each amount is apportioned to T, and the remainder of the CNOL is attributable to S and can be carried back to prior P group years, subject to any applicable limitations. Therefore, $200 of the $300 CERIL is apportioned to T, and $600 of the $900 non-special status CNOL is also apportioned to T. The $200 CERIL cannot be carried back to certain taxable years of T under the CERT rules. Likewise, $100 of the $300 CERIL is apportioned to S, and $300 of the $900 non-special status CNOL is also apportioned to S. Under the CERT rules, the $100 CERIL cannot be carried back to certain taxable years.

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(3) * * *

(ii) * * *

(B) *Election on acquisition to waive carryback to separate return years*—(*1*) *In general.* A corporation may make one of three mutually exclusive, irrevocable elections to waive carryback of CNOLs to separate return years of acquired members. Any election that is made with regard to an acquired corporation that was a member of a consolidated group (the former group) immediately before becoming a member of an acquiring group must include all other corporations that were members of the former group and that joined the acquiring group during the same consolidated return year of the acquiring group.

(*2*) *Annual election.* If a corporation becomes a member of an acquiring group, the acquiring group may make an irrevocable election to relinquish, with respect to the part of any CNOL attributable to the member, the portion of the carryback period for which the member filed a separate return. This is an annual election, applicable to the CNOL of a single year. The election is made in a separate statement entitled, ''THIS IS AN ELECTION UNDER § 1.1502–21(b)(3)(ii)(B)(*2*) TO WAIVE THE PRE- [insert the first taxable year in which the member(s) joined the group] CARRYBACK PERIOD FOR THE PORTION OF THE [insert taxable year] CNOL ATTRIBUTABLE TO [insert the name(s) and EIN(s) of the corporation(s)].'' The statement must be filed with the acquiring group's timely filed original return for the consolidated return year of the particular CNOL.

(*3*) *Single election.* If a corporation becomes a member of an acquiring group, the acquiring group may make an irrevocable election to relinquish, with respect to all CNOLs attributable to the member, the portion of the carryback period for which the member filed a separate return. The election is not an annual election and applies to all losses that would otherwise be subject to a carryback to separate return years under section 172 or paragraph (b) of this section. The election is made in a separate statement entitled, ''THIS IS AN ELECTION UNDER § 1.1502–21(b)(3)(ii)(B)*(3)* TO WAIVE THE PRE- [insert the first taxable year in which the member(s) joined the group] CARRYBACK PERIOD FOR THE PORTION FOR ALL NOLs (and ALL CNOLs) ATTRIBUTABLE TO [insert the name(s) and EIN of the corporation(s)].'' The statement must be filed with the acquiring group's timely filed original income tax return for the consolidated return year the corporation (or corporations) became a member.

(*4*) *Special one-time election for deconsolidating member.* Section 1.1502–72(e)(1) makes available an election by a deconsolidating member (or its new common parent immediately following deconsolidation) to relinquish in whole the carryback of all NOLs to taxable years of the former group and any preceding taxable year. An election under § 1.1502–72(e)(1) will control whether the deconsolidating corporation is treated as an applicable corporation under section 172(b)(1)(E)(iii) and § 1.172(h)–1(b)(1) following the deconsolidation with regard to a CERT of the former group. See § 1.1502–72(b). Further, an election under § 1.1502–72(e)(1) may affect the computation of the CERIL under section 172(h)(1) and § 1.172(h)–2(a)(2) with regard to any CERT for which the deconsolidating corporation (or any group of which the deconsolidating corporation is a member) is an applicable corporation under section 172(b)(1)(E)(iii) and § 1.172(h)–1(b)(1) following the deconsolidation. See § 1.1502–72(c)(4) and (d)(3)(ii).

* * * * *

(h) * * *

(1) * * *

(iv) Paragraph (b)(2)(iv)(C) of this section applies to taxable years for which the due date of the original return (without extensions) is on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

* * * * *

(5) *Waiver of carrybacks.* Paragraph (b)(3)(ii)(B) of this section (relating to the waiver of carrybacks to separate return years) applies to acquisitions

occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**, except that it does not apply to any acquisition occurring pursuant to a written agreement that is binding before the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**. For original consolidated Federal income tax returns due (without extensions) before the date of the publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**, see paragraph (b)(3)(ii)(B) of this section as contained in 26 CFR part 1 in effect on April 1, 1999.

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Par. 4. Section 1.1502–72 is added to read as follows:

§ 1.1502–72 Corporate equity reduction transactions.

(a) *In general*—(1) *Scope.* Section 172(b)(1)(E) and (h), §§ 1.172(h)–1 through 1.172(h)–5, and the rules of this section (the CERT rules) apply to determine whether a corporate equity reduction transaction (CERT) has occurred and to determine the consequences of the CERT, including rules governing the carryback of losses following a CERT, with respect to corporations that become, are, or cease to be members of a consolidated group.

(2) *Single entity treatment*—(i) *In general.* All members of a group are treated as a single taxpayer for purposes of the CERT rules. For example, if multiple members of a group acquire in total 50 percent or more (by vote or value) of the stock of another corporation, the group has engaged in a major stock acquisition (MSA) as defined in section 172(h)(3)(B) and § 1.172(h)–1(c)(2). The transactions and expenditures undertaken by a particular group member are generally not separately tracked; instead, the entire group is treated as a single applicable corporation.

(ii) *Debt and interest of group members*—(A) *In general.* The computation of a group's corporate equity reduction interest loss (CERIL) under section 172(h)(1) and § 1.172(h)–2(a)(2) for any loss limitation year (as defined in paragraph (a)(3) of this section) that is a consolidated return year includes the debt of all members and all interest deductions that are allowed on the group's consolidated return for that year. This rule applies regardless of whether any particular debt or interest expense is directly related to the CERT, whether any particular member was included in the group on the date of the CERT, or whether any particular debt would not exist in the group if the group had not engaged in the CERT. But see paragraph (a)(2)(iii) of this section (providing that intercompany transactions are generally disregarded).

(B) *Debt of acquired corporation.* With respect to a corporation that joins a consolidated group (acquired corporation), in applying the CERT rules to consolidated return years that are loss limitation years, any debt of the acquired corporation is treated as debt of the acquiring group for purposes of applying the avoided cost rules of section 263A(f)(2)(A) on any measurement date after the inclusion of the corporation in the group. See section 172(h)(2) and § 1.172(h)–2(b) (applying the principles of section 263A(f)(2)(A)(ii)); see also § 1.263A–9(f)(2) (defining measurement dates).

(iii) *Intercompany transactions.* In applying the CERT rules, intercompany transactions as defined in § 1.1502–13 are generally disregarded. For example, interest expense attributable to an intercompany obligation is not taken into account in computing the CERIL or three-year average of a group. However, a transaction between group members is not disregarded if a party to the transaction becomes a non-member pursuant to the same plan or arrangement. In such case, any transaction between group members, including a potential excess distribution (ED) as defined in section 172(h)(3)(C), § 1.172(h)–1(c)(3), and paragraph (f)(1) of this section, is tested on a separate entity basis under the CERT rules. It may also be tested as part of a larger, multi-step MSA. See § 1.172(h)–1(d)(2).

(iv) *Applicable corporation status following inclusion of member with pre-existing CERT*—(A) *Acquiring group treated as applicable corporation.* If a corporation that is an applicable corporation (including by application of paragraph (b) of this section) with regard to a CERT occurring in a separate return year (pre-existing CERT member) joins a consolidated group, the group is treated as a single applicable corporation with regard to that CERT in the consolidated return year of the acquisition and any succeeding year. A corporation is a pre-existing CERT member regardless of whether the transaction at issue is an MSA that constitutes a CERT with respect to both a consolidated return year of the acquiring group and a separate return year of the acquired corporation.

(B) *End of separate tracking of target.* Beginning on the first day on which a pre-existing CERT member is included in a consolidated group, the member ceases to be separately tracked as an applicable corporation. See paragraph (a)(2)(i) of this section. The CERT rules thereafter apply to the group, rather than to the member, with regard to any CERT for which the member had been an applicable corporation, including an MSA in which the member was acquired by the group. Therefore, beginning on the day on which the pre-existing CERT member is included in the group, no CERIL is computed with regard to the member, independent of the CERIL computed for the group. But see § 1.1502–21(b)(2)(iv)(C) (providing for allocation and apportionment of a group's CERIL to specific group members) and § 1.172(h)–5(b)(1) (relating to prohibition on carryback of a CERIL).

(3) *Loss limitation years*—(i) *In general.* This paragraph applies to identify loss limitation years of a consolidated group and corporations that have been members of a consolidated group. The taxable year in which a CERT actually occurs is a loss limitation year. Any other taxable year (potential loss limitation year) of any applicable corporation (including a consolidated group) constitutes a loss limitation year with regard to the CERT only if, under the carryforward rules of sections 172(b)(1)(A)(ii) and 381(c)(1), the potential loss limitation year would constitute the first or second taxable year following the taxable year of the corporation or consolidated group that actually engaged in the CERT that includes the date on which the CERT occurred. Except as otherwise provided in paragraph (a)(3)(ii) of this section, for purposes of this paragraph (a)(3), sections 172 and 381 are applied as if the inclusion of any corporation in a consolidated group or the deconsolidation of any member from a group were a transaction listed in section 381(a).

(ii) *Corporation joins group in an MSA.* If a corporation joins a group in an MSA, no separate return year of the acquired corporation ending on or before it joined the acquiring group is treated as a loss limitation year for the purpose of determining the loss limitation years of the acquiring group or any corporation that deconsolidates from that group that relate to the MSA.

(iii) *Deconsolidating members.* Under this paragraph (a)(3)(iii), a corporation that deconsolidates (deconsolidating member) from a group (former group) that is an applicable corporation may have loss limitation years with regard to a CERT of its former group. See paragraphs (b) (relating to post-deconsolidation status as applicable corporation) and (e)(1) of this section (providing for an irrevocable waiver of carrybacks such that a deconsolidating member is not treated as an applicable corporation). If the consolidated return year during which the deconsolidation occurs (year of deconsolidation) is a first or second loss limitation year with regard to the CERT, then certain separate return years of a deconsolidating member that is treated as an applicable corporation will constitute loss limitation years. If the year of deconsolidation is a first loss limitation year with regard to the CERT, the following two separate return years will constitute loss limitation years. If the year of deconsolidation is a second loss limitation year with regard to the CERT, the separate return year that immediately follows the year of deconsolidation will constitute a loss limitation year. If the deconsolidating member joins another consolidated group, the consolidated return years of that group may also constitute loss limitation years with regard to the CERT of the former group. See paragraph (a)(2)(iv) of this section (relating to inclusion of member with pre-existing CERT).

(4) *Application of rules to reverse acquisitions.* In the case of any acquisition to which § 1.1502–75(d)(3) applies (a reverse acquisition), for purposes of applying the CERT rules, the first corporation (as defined in § 1.1502–75(d)(3)(i)) is treated as the corporation the stock of which is acquired, and the second corporation (as defined in § 1.1502–75(d)(3)(i)) is treated as the corporation that acquires stock. In addition, for purposes of § 1.172(h)–2(b)(3)(i) (identifying CERT costs of an MSA) in the case of a reverse acquisition, the fair market value of the stock acquired equals the fair market value of the stock of the first corporation that the stockholders (immediately before the acquisition) of the first corporation own immediately after the acquisition, rather than the fair market value of the stock of the second corporation.

(b) *Applicable corporation status following deconsolidation*—(1) *In general.* If a corporation deconsolidates in a loss limitation year from a group that is treated as an applicable corporation with regard to a CERT, the deconsolidating corporation and the former group are both treated as applicable corporations following the deconsolidation. If the corporation joins another consolidated group (acquiring group) following the deconsolidation, the rules of this section apply to the acquiring group, and this paragraph (b) applies with regard to the deconsolidation of any member from the acquiring group during a loss limitation year associated with the CERT. See paragraph (a)(2)(iv) of this section regarding treatment of a group as a single applicable corporation following an acquisition; see also paragraph (a)(3)(ii) of this section for identification of loss limitation years following a deconsolidation. This paragraph (b) applies without regard to whether any particular corporation would on a separate entity basis have constituted an applicable corporation with regard to the CERT under section 172(b)(1)(E)(iii) and § 1.172(h)–1(b), with or without the application of section 172(h)(4)(C) and paragraph (a)(2) of this section, or whether the CERT occurred in a consolidated return year. However, under this paragraph (b), the deconsolidating corporation may be treated as an applicable corporation with regard to a CERT of a former group only if the group engages in the CERT on or before the date of the deconsolidation, or if a pre-existing CERT member, as described in paragraph (a)(2)(iv)(A) of this section, joins the group on or before the date of the deconsolidation.

(2) *Exception if waiver filed.* In general, a corporation that deconsolidates from a group (or the parent of a group acquiring the deconsolidating member), may, pursuant to paragraph (e)(1) of this section, make an irrevocable election to relinquish the carryback of all net operating losses (NOLs) (and attributable portions of consolidated net operating losses (CNOLs)) to taxable years of the former group and any preceding years. If such an election is made, the deconsolidating member is not treated as an applicable corporation with regard to any CERT of the former group after the deconsolidation. Any group that acquires the deconsolidating member is not treated as an applicable corporation with regard to any CERT of the former group solely as a result of the acquisition of that member. The former group will continue to be treated as an applicable corporation with regard to the CERT.

(3) *Examples.* The following examples illustrate the rules of paragraph (a) of this section and this paragraph (b). For purposes of these examples, assume that all entities are domestic C corporations unless otherwise stated. Assume that all applicable corporations have substantial NOLs in their loss limitation years:

Example 1. Single entity treatment of acquisition indebtedness. (i) *Facts.* Corporation T is a calendar-year taxpayer that has significant debt outstanding, which was incurred to fund operations. Unrelated P is the common parent of a calendar-year consolidated group. The following steps occur pursuant to an integrated plan. On May 1, Year 5, P acquires 10 percent of the T stock for $100. On June 30, Year 5, T borrows $700 and immediately thereafter uses the money to redeem some of its shares from its shareholders. On the same day, the P group acquires all of the remaining T stock in exchange for $200. Assume that the $700 cash payment from T to the T shareholders is treated as a redemption. T is first included in the P group on July 1, Year 5. Under § 1.172(h)–1(d)(2), the steps of the integrated plan (including the redemption of the former T shareholders) constitute a single MSA.

(ii) *Analysis.* T's short taxable year ending June 30, Year 5 is T's year of the CERT. The P group's consolidated return Year 5 is the taxable year of the CERT for the group. For purposes of allocating to the single MSA interest paid or accrued during the P group's loss limitation years (Years 5, 6, and 7) under § 1.172(h)–2(b), the P group takes into account the debt of all members, including the $700 loan and all of T's other debt. See paragraph (a)(2)(ii)(B) of this section. The allocation of interest also takes into account all deductions for interest paid or accrued that are included in the consolidated return for the relevant loss limitation year. See paragraph (a)(2)(ii)(A) of this section.

Example 2. Loss limitation years if a corporation joins group in an MSA. Corporation T maintains a taxable year ending June 30. Unrelated X is the common parent of a calendar-year consolidated group. On March 31, Year 5, the X group acquires all of the T stock in a CERT, and T is first included in the X group on April 1, Year 5. On the date of the acquisition, both the X group and T constitute applicable corporations with regard to the Year 5 CERT. See § 1.172(h)–1(b) and paragraph (a)(2) of this section. T's short taxable year ending on March 31, Year 5, was T's taxable year in which the CERT occurred. T's only loss limitation year with respect to the Year 5 CERT is its short taxable year ending on March 31, Year 5. See § 1.172(h)–1(e) and paragraph (a)(3) of this section. Beginning on April 1, Year 5, T ceases to be separately tracked as an applicable corporation. See paragraph (a)(2)(i) and (iv)(B) of this section. The X group's year in which the CERT occurred is its consolidated return Year 5. The X group's loss limitation years with respect to the Year 5 CERT are its full taxable calendar Years 5, 6, and 7. See paragraph (a)(3)(i) and (ii) of this section.

Example 3. Loss limitation years of a group and deconsolidating member. (i) *Facts.* P is the common parent of a calendar-year consolidated group that includes S. On June 30, Year 6, a member of the P group engages in an acquisition that constitutes a CERT. S is not a party to the acquisition. On September 30, Year 6, S deconsolidates from the P group. No election under paragraph (e)(1) of this section is made with respect to the deconsolidation of S. Following its deconsolidation, S does not join in the filing of a consolidated return with another group, and it maintains a calendar taxable year.

(ii) *Analysis.* Because no election is made under paragraph (e)(1) of this section, following the deconsolidation, both the P group and S are treated as applicable corporations with regard to the Year 6 CERT. See paragraph (b)(1) of this section. The P group's loss limitation years with regard to the CERT are its consolidated return Years 6, 7, and 8. See section 172(b)(1)(E)(ii) and paragraph (a)(3)(i) of this section. S deconsolidates from the P group during consolidated return Year 6, which is the first loss limitation year with regard to the CERT. See paragraph (a)(3)(i) of this section. For purposes of applying paragraph (a)(3) of this section to identify loss limitation years, S is treated as deconsolidating from the P group in a transaction to which section 381(a) applies. Therefore, S's two taxable years that follow the deconsolidation, the short year ending December 31, Year 6, and the full taxable calendar Year 7, are its additional loss limitation years with regard to the Year 6 CERT. See paragraph (a)(3)(iii) of this section. See section 172(b)(1)(E)(i) and § 1.172(h)–5(b)(1) for rules regarding the prohibition on carryback of a CERIL.

Example 4. Loss limitation years if a pre-existing CERT member joins the group. (i) *Acquiring group has loss limitation years.* Corporation T maintains a calendar taxable year and does not join in the filing of a consolidated return. On July 1, Year 5, T engages in a CERT (Year 5 CERT). Unrelated X is the common parent of a calendar-year consolidated group that includes S. On December 31, Year 5, the X group acquires all of the outstanding T stock. T is first included in the X group on January 1, Year 6. The first loss limitation year with respect to the Year 5 CERT is T's calendar Year 5. See § 1.172(h)–1(e). As a result of the X group's acquisition of T, the X group is treated as a single applicable corporation with respect to the Year 5 CERT. See paragraph (a)(2)(iv) of this section. For purposes of applying paragraph (a)(3) of this section to identify loss limitation years, T is treated as joining the X group in a transaction to which section 381(a) applies. Because T has one loss limitation year with regard to the CERT before it joins the X group, the X group has two loss limitation years with respect to the Year 5 CERT: Its calendar Years 6 and 7. See paragraph (a)(3)(i) of this section. However, the X group must test its acquisition of T under the CERT rules.

(ii) *Acquiring group has no loss limitation years.* The facts are the same as in paragraph (i) of this *Example 4,* except that the X group acquires T on January 31, Year 7. Because T has three loss limitation years before it is included in the X group (calendar Years 5 and 6, and a short taxable year ending on January 31, Year 7), none of the X group's consolidated return years are loss limitation years with regard to the Year 5 CERT. See section 172(b)(1)(E)(ii) and paragraph (a)(3)(i) of this section.

(iii) *Member deconsolidates from acquiring group.* The facts are the same as in paragraph (i) of this *Example 4,* except that S deconsolidates from the X group on June 30, Year 6. No election under paragraph (e)(1) of this section is made on the deconsolidation of S. Following its deconsolidation from the X group, S does not join in the filing of a consolidated return. T and the X group's loss limitation years remain the same as in paragraph (i) of this *Example 4.* Because no election is made under paragraph (e)(1) of this section with respect to S's deconsolidation, following the deconsolidation, S and the X group are both treated as applicable corporations with regard to T's Year 5 CERT. See paragraph (b)(1) of this section. S deconsolidates from the P group during consolidated return Year 6, which is the second loss limitation year with regard to the CERT. See paragraph (a)(3)(i) of this section. Therefore, following its deconsolidation, S's only loss limitation year with respect to the Year 5 CERT is its short taxable year July 1, Year 6 through December 31, Year 6. See paragraph (a)(3)(iii) of this section.

Example 5. Deconsolidation before group engages in CERT. Corporation T is a member of the P group, which maintains a calendar taxable year. On February 28, Year 4, T deconsolidates from the P group due to T's acquisition by the X group, which also maintains a calendar taxable year. T is included in the X group as of March 1, Year 4. No election under paragraph (e)(1) of this section is made on the deconsolidation of T from the P group. On March 31, Year 4, the P group engages in a CERT. Because the P group engages in the CERT after the date of the deconsolidation, T is not treated as an applicable corporation following the deconsolidation. See paragraph (b)(1) of this section. However, the X group must apply the CERT rules to the X group's acquisition of T.

Example 6. Member that engages in CERT deconsolidates with a waiver election. (i) *Facts.* P is the common parent of a calendar-year consolidated group. On March 31, Year 4, the P group engages in an MSA, when member T acquires all of the stock of T1. On June 30, Year 4, T and its subsidiaries (including T1) deconsolidate from the P group due to the acquisition of T by the X group. T and its subsidiaries are first included in the X group as of July 1, Year 4. The X group makes an election under paragraph (e)(1) of this section on the deconsolidation.

(ii) *Analysis.* Because an election under paragraph (e)(1) of this section is made on the deconsolidation of T and its subsidiaries from the P group, following the deconsolidation, only the P group is treated as an applicable corporation with regard to the March 31, Year 4 CERT. Neither T, T1, nor the X group is treated as an applicable corporation with regard to the March 31, Year 4 CERT, even though T directly engaged in the MSA, and T1 was the acquired corporation in that MSA. See paragraph (b)(2) of this section. However, the X group must apply the CERT rules to the X group's acquisition of T.

(c) *Identification and allocation of CERT costs*—(1) *In general.* The portion of an NOL that is treated as a CERIL is subject to limitation on carryback. See section 172(b)(1)(E)(i) and § 1.172(h)–5(b)(1). A CERIL is computed in part by identifying the deductions allowed for interest allocable to the CERT. The computation of interest allocable to a CERT under section 172(h)(2) and § 1.172(h)–2(b) takes into account all CERT costs as defined in § 1.172(h)–2(b)(3). This paragraph (c) contains rules applicable to the identification and allocation of CERT costs of a consolidated group.

(2) *Single entity treatment of CERT costs.* The computation of interest allocable to a CERT in any particular loss limitation year of a consolidated group includes CERT costs incurred (including costs deemed incurred under this paragraph (c)) with regard to the CERT by all corporations that are members of a group during the loss limitation year.

(3) *CERT costs of acquired corporation.* With respect to a corporation that joins a consolidated group (acquired corporation), for purposes of applying the CERT rules, any CERT costs incurred (or treated as incurred under this paragraph (c)) by the acquired corporation during separate return years prior to the acquired corporation's inclusion in the group are attributed to the acquiring group. Such costs are treated as having been incurred by the acquiring group for purposes of applying the avoided cost rules of section 263A(f)(2)(A) to any measurement date after the acquisition of the corporation. Those CERT costs are no longer separately identified as CERT costs incurred by the acquired corporation.

(4) *Allocation of CERT costs on deconsolidation*—(i) *In general.* This paragraph (c)(4) applies to determine the CERT costs allocable to a corporation that deconsolidates in a loss limitation year from a group that is treated as an applicable corporation with regard to a CERT. Under this paragraph (c)(4), CERT costs may be allocated to a deconsolidating corporation only if the group engages in the relevant CERT on or before the date of the deconsolidation, or if a pre-existing CERT member, as described in paragraph (a)(2)(iv)(A) of this section, joins the group on or before the date of the deconsolidation. This paragraph (c)(4) applies regardless of whether any particular corporation would have constituted an applicable corporation under section 172(b)(1)(E)(iii) and § 1.172(h)–1(b) without the application of section 172(h)(4)(C) and paragraph (a)(2) of this section, whether the CERT occurred in a consolidated return year, or whether any particular corporation actually incurred CERT costs.

(ii) *No waiver election made.* If no election under paragraph (e)(1) of this section is made with regard to the deconsolidation, CERT costs incurred by the group (including costs treated as incurred by the group under this paragraph (c)) are allocated between the deconsolidating corporation and the former group, solely for purposes of computing allocable interest deductions of the deconsolidating corporation and the continuing group with regard to the CERT under section 172(h)(2) and § 1.172(h)–2(b). For purposes of computing interest allocable to the CERT under section 172(h)(2) and § 1.172(h)–2(b) during the loss limitation year of the former group that is the year of the deconsolidation, the CERT costs allocated to the deconsolidating member are included in the group's accumulated CERT costs on those measurement dates on which the deconsolidating corporation was included in the group. The portion of the group's total CERT costs that is allocated to a deconsolidating member equals the group's total CERT costs multiplied by a fraction, the numerator of which equals the value of the deconsolidating corporation immediately after its deconsolidation, and the denominator of which equals the value of the entire group immediately prior to the deconsolidation.

(iii) *Waiver election made.* If an election under paragraph (e)(1) of this section is made with regard to a deconsolidation, no CERT costs are allocated to the deconsolidating corporation. All CERT costs remain with the former group for purposes of identifying its allocable interest deductions under section 172(h)(2) and § 1.172(h)–2(b) with regard to the CERT.

(5) *Examples.* The following examples illustrate the rules of this paragraph (c). For purposes of the examples in this paragraph (c)(5), assume that all entities are domestic C corporations unless otherwise stated. Assume that all applicable corporations have substantial NOLs in their loss limitation years:

Example 1. Aggregation of CERT costs of consolidated group and target. (i) *Facts.* P is the common parent of a calendar-year consolidated group that includes S1 and S2. On June 30, Year 5, S1 acquires all of the stock of T for $10 million. P incurs CERT costs of $100,000 and $250,000 for work performed by its outside counsel and an investment banker, respectively, that facilitates the acquisition. In addition, T incurs CERT costs of $175,000 for work performed by its outside counsel that facilitates the acquisition. All of these costs are incurred on or before the date of the acquisition. In all relevant years preceding its acquisition, T does not join in the filing of a consolidated return.

(ii) *Analysis.* For purposes of computing the P group's allocable interest deductions under section 172(h)(2) and § 1.172(h)–2(b), the P group's CERT costs include CERT costs incurred by all members of the P group. See paragraph (c)(2) of this section. In addition, when T joins the P group, the CERT costs incurred by T prior to its inclusion in the P group are attributed to the P group and are treated as having been incurred by the P group for purposes of applying the avoided cost rules of section 263A(f)(2)(A) to any measurement date after the acquisition of T. See paragraph (c)(3) of this section. As a result, the P group's accumulated CERT costs on July 1, Year 5, are $10,525,000 [$10,000,000 + $100,000 + 250,000 + 175,000]. See § 1.172(h)–2(b)(3) for rules defining CERT costs.

Example 2. Acquiring group treated as incurring CERT costs associated with unrelated CERT of target. T is a calendar-year taxpayer that does not join in the filing of a consolidated return. P is the common parent of a calendar-year consolidated group. P also owns 70 percent of the only class of T stock. During Year 4, T engages in a CERT. On June 30, Year 5, P acquires the remainder of the stock of T, and T is first included in the P group on July 1, Year 5. Following the acquisition, the P group is treated as an applicable corporation with regard to T's Year 4 CERT. See paragraph (a)(2)(iv) of this section. The P group's consolidated return Year 5 is the third and final loss limitation year with regard to the Year 4 CERT. See paragraph (a)(3)(i) of this section. The P group is treated as having incurred all of T's expenses allocable to the CERT for purposes of computing any CERIL for consolidated return Year 5. Because T was a member of the P group for less than the entire calendar taxable Year 5, T's CERT costs are included in the P group's accumulated CERT costs only on those measurement dates on which T is included in the group (that is, measurement dates on or after July 1, Year 5). See paragraph (c)(3) of this section and § 1.172(h)–2(b)(4). See also paragraph (d)(3)(iii) for rules relating to the interest history of a partial-year member.

Example 3. Allocation of CERT costs to deconsolidating member. (i) *Facts.* P is the common parent of a calendar-year consolidated group. P owns 60 percent of the sole class of stock of T, a calendar-year taxpayer. On January 31, Year 5, the P group engages in a CERT. On March 31, Year 5, P acquires the remainder of the stock of T, and T is first included in the P group on April 1, Year 5. On June 30, Year 6, T deconsolidates from the P group, with no election made under paragraph (e)(1) of this section.

(ii) *Analysis.* T is not a member of the P group at the time of the CERT. However, following its deconsolidation, T is treated as an applicable corporation with regard to the Year 5 CERT because the P group engages in the CERT before T deconsolidates, and no election is made under paragraph (e)(1) of this section on the deconsolidation. See paragraph (b)(1) of this section. Further, a portion of the P group's CERT costs is allocated to T for purposes of computing any CERIL of T (or of any group of which T becomes a member following its deconsolidation from the P group) with regard to the Year 5 CERT. See paragraphs (b)(1) and (c)(4)(ii) of this section. However, the CERT costs of the group otherwise allocated to T are included in the P group's accumulated CERT costs on those measurement dates during which T is included in the group (that is, measurement dates before July 1, Year 6). See paragraph (c)(4)(ii) of this section and § 1.172(h)–2(b)(4).

(d) *Determining the three-year average of a group*—(1) *In general.* Section 172(h)(2)(C) and § 1.172(h)–3(a) limit the amount of allocable interest deductions to the excess (if any) of the amount allowable as a deduction for interest paid or accrued by the taxpayer during the loss limitation year, over the average of interest paid or accrued by the taxpayer (the three-year average) for the three taxable years preceding the taxable year in which the CERT occurred (the lookback period). The computation under section 172(h)(2)(C)(ii) and § 1.172(h)–3(b) of a group's three-year average for the lookback period that is relevant to any loss limitation year includes interest paid or accrued (or treated as paid or accrued under this paragraph (d)) during the lookback period by all corporations that are members of the consolidated group during the loss limitation year.

(2) *Varying group membership.* If group membership varies from one loss limitation year to another, a different three-year average is computed with regard to each loss limitation year of the group.

(3) *Interest history*—(i) *Combination of interest history of acquired member with group history.* With respect to a corporation that joins a consolidated group (acquired corporation), for purposes of applying the CERT rules, the interest paid or accrued (or treated as paid or accrued under this paragraph (d)) by the acquired corporation during each separate return year prior to its inclusion in the group is apportioned equally to each day within each of its separate return years. The interest apportioned to dates within the lookback period is then combined with the interest paid or accrued by the acquiring group and is treated as interest paid or accrued by the acquiring group during the lookback period for purposes of computing the three-year average that is relevant to any loss limitation year beginning with the consolidated return year during which the acquired corporation is first included in the group. For purposes of the CERT rules, the interest from the separate return years is no longer separately traced as interest paid or accrued by the acquired corporation. But see paragraph (d)(3)(iii) of this section for rules requiring proration of interest history attributable to corporations that are members of a group for less than an entire loss

limitation year. The interest paid or accrued by a predecessor (as defined in § 1.172(h)–(1)(b)(2)) of a member of the group is similarly combined with the interest paid or accrued by the group. See § 1.172(h)–4(c)(2)(ii)(A).

(ii) *Interest treated as paid or accrued by a corporation that deconsolidates*—(A) *In general.* This paragraph (d)(3)(ii) provides rules that apply for purposes of determining any three-year average of a corporation that deconsolidates from a group (or a three-year average of any other group of which it becomes a member) and any three-year average of the group from which the corporation deconsolidates (former group). These rules apply to the computation of any three-year average with regard to a CERT of the former group or any other CERT.

(B) *Waiver election made.* If an election under paragraph (e)(1) of this section is made with respect to the deconsolidation of a corporation from a group, then, following the deconsolidation, the deconsolidating member is treated as having paid or accrued zero interest during the period of its inclusion in the former group and preceding years. The group retains the interest history that would otherwise be allocated and apportioned to the deconsolidating member under this paragraph (d)(3)(ii).

(C) *No waiver election made.* If no election under paragraph (e)(1) of this section is made with respect to the deconsolidation of a corporation, a portion of the group's amount of interest treated as paid or accrued during the period of the corporation's consolidation and any preceding years is allocated and apportioned to the deconsolidating corporation. The allocated and apportioned interest is subtracted from the group's interest history and is unavailable to the group (or any other group member) for purposes of computing a three-year average with regard to any loss limitation year of the group (or any other group member) after the year of deconsolidation. But see paragraph (d)(3)(iii) of this section for rules requiring proration of interest history attributable to corporations that are members of a group for less than an entire loss limitation year.

(D) *Method of allocation.* If no election under paragraph (e)(1) of this section is made when a corporation deconsolidates, solely for purposes of the CERT rules, the corporation is treated as having paid or accrued interest equal to the amount of interest paid or accrued by the group in each consolidated return year through the date of the deconsolidation (including any combination of interest history pursuant to paragraph (d)(3)(i) of this section), multiplied by a fraction, the numerator of which equals the value of the deconsolidating corporation immediately after its deconsolidation, and the denominator of which equals the value of the entire group immediately prior to the deconsolidation.

(iii) *Proration of lookback period interest for members that are part of a group for less than the entire loss limitation year.* If any member is included in the group for less than an entire consolidated return year that is a loss limitation year (partial-year member), then the group takes into account a pro rata portion of the partial-year member's amount of interest paid or accrued during the lookback period for purposes of determining a group's three-year average relevant to that loss limitation year. The amount of interest treated as paid or accrued that is subject to proration under this paragraph (d)(3)(iii) is the interest of the partial-year member that would otherwise be fully combined with the interest history of the acquiring group under paragraph (d)(3)(i) of this section (with regard to corporations acquired during the loss limitation year) or the interest that is otherwise allocated to a deconsolidating member under paragraph (d)(3)(ii) of this section. The pro rata amount equals the partial-year member's interest treated as paid or accrued for the dates of the lookback period, multiplied by a fraction, the numerator of which equals the number of days of the loss limitation year during which the partial-year member was a member of the group, and the denominator of which equals the number of days in the loss limitation year. This proration applies to interest paid or accrued during the entire lookback period, including portions of the lookback period during which the partial-year member was a member of the group.

(4) *Lookback period*—(i) *In general.* The lookback period with regard to a CERT is the three taxable years preceding the taxable year in which the CERT occurs. See section 172(h)(2)(C)(ii) and § 1.172(h)–3(a). The lookback period that is relevant to any CERIL of a consolidated group is the three taxable years preceding the taxable year of the group that includes the date on which the CERT occurred. See § 1.172(h)–5(a) (defining the date on which a CERT occurs if the CERT consists of multiple steps). This rule applies whether the group actually engaged in the CERT or is treated as an applicable corporation with regard to a CERT solely by application of paragraph (a)(2)(iv) of this section.

(ii) *Group not in existence for entire lookback period.* If a group was not in existence for three taxable years prior to the consolidated return year that includes the date of the CERT, the lookback period includes the group's taxable years preceding the year of the CERT plus the preceding taxable years of the corporation that was the common parent of the group on the first day of the group's first consolidated return year (original common parent). If the group and the original common parent together have fewer than three taxable years that precede the consolidated return year that includes the date of the CERT, the lookback period will be deemed to include full 12-month periods that end on the calendar date that is one day prior to the date of organization of the original common parent.

(iii) *Group not in existence on date of CERT.* If a group was not in existence on the date on which the CERT occurred, for purposes of determining the lookback period, the group's taxable years will be deemed to include the taxable years of the group's original common parent. If the original common parent was not in existence on the date of the CERT, or it does not have three taxable years that precede its taxable year that includes the date of the CERT, the group will be deemed to have additional 12-month taxable periods that end on the calendar date that is one day prior to the date of the original common parent's organization. From these deemed taxable periods, the group will identify the deemed period that includes the date on which the CERT occurred and the three immediately preceding deemed periods that constitute the lookback period. See § 1.172(h)–5(a) regarding date on which CERT occurred in multi-step transaction.

(iv) *Interest history of corporations not in existence.* If any member of a group is not in existence for the entire lookback period, for purposes of the CERT rules, that member is treated as having paid or accrued zero interest before its organization. But see § 1.172(h)–4(c)(2)(ii) (regarding interest history of successors).

(5) *Examples.* The following examples illustrate the rules of this paragraph (d). Unless otherwise stated, assume that all entities are domestic C corporations that have full, 12-month taxable years. Assume that all applicable corporations have substantial NOLs in their loss limitation years:

Example 1. Acquired member's interest history combined with interest history of group. (i) *Facts.* P is the common parent of a calendar-year consolidated group that includes S on all relevant dates. On December 31, Year 5, S acquires the stock of T in a CERT, and T is first included in the P group on January 1, Year 6. Membership in the P group is otherwise stable for all relevant years. Prior to joining the P group, T does not join in the filing of a consolidated return and maintains a calendar taxable year. T's amounts of interest paid or accrued in Years 2, 3, and 4, respectively, are $600, $200, and $400. The P group's amounts of interest paid or accrued in Years 2, 3, and 4, respectively, are $1,400, $1,000, and $1,200.

(ii) *Analysis.* The P group's loss limitation years are calendar Years 5, 6, and 7. See paragraph (a)(3)(i) of this section. Year 5 is also a loss limitation year for T. The P group's lookback period with regard to the CERT is calendar Years 2, 3, and 4. See paragraph (d)(4)(i) of this section. For purposes of computing any three-year average of the P group for its lookback period, on the acquisition of T, the interest history of T is generally combined with the interest history of the P group. See paragraph (d)(3)(i) of this section. However, because T is not a member of the P group on any date during consolidated return Year 5, the computation of the P group's three-year average relevant to Year 5 will not include any of T's interest paid or accrued during the lookback period. See paragraph (d)(3)(iii) of this section. Thus, the P group's three-year average for loss limitation Year 5 is $1,200 ([$1,400 + $1,000 + 1,200]/3). Because T is a member of the P group during each day of loss limitation Years 6 and 7, T's history of interest paid or accrued during the lookback period is fully included in the P group's computation of its three-year average relevant to loss limitation Years 6 and 7. See paragraph (d)(3)(i) and (iii) of this section. Thus, the P group's three-year average for loss limitation Years 6 and 7 is $1,600 ([$1,400 + $1,000 + 1,200 + $600 + $200 + $400]/3).

(iii) *Interest combination if acquired member included in group for part of loss limitation year.* The facts are the same as in paragraph (i) of this *Example 1,* except that S acquires the stock of T on March 31, Year 5, and T is included in the P group for 275 days. Because T is a partial-year member of the P group during loss limitation Year 5, the computation of the three-year average relevant to loss limitation Year 5 includes the interest of T for the lookback period, prorated as required under paragraph (d)(3)(iii) of this section. Because T is in the P group for 275 days during Year 5, the computation of the P group's three-year average relevant to Year 5 takes into account an amount of T's interest history equal to T's actual amount of interest paid or accrued for each year of the lookback period, multiplied by a fraction equal to 275/365 (number of days of the loss limitation year during which T is a member of the P group divided by the number of days in the loss limitation year), or $452 ($600 × [275/365]), $151 ($200 × [275/365]), and $301 ($400 × [275/365]) for Years 2, 3, and 4, respectively.

Example 2. Lookback period if corporation with CERT history joins group. (i) *Facts.* P is the common parent of a calendar-year consolidated group. P also owns 55 percent of the sole class of stock of Corporation T, which maintains a taxable year ending June 30. On September 30, Year 4, T engages in a CERT. On December 31, Year 5, P acquires the remainder of the stock of T, and T is first included in the P group on January 1, Year 6.

(ii) *Analysis.* T's full taxable year ending June 30, Year 5, and its short year ending December 31, Year 5 are loss limitation years with regard to the September Year 4 CERT. The lookback period for the CERT relevant to these two loss limitation years is T's three taxable years ending on June 30, Years 2, 3, and 4. See section 172(h)(2)(C)(ii) and § 1.172(h)–3(a). The P group's calendar Year 6 is its sole loss limitation year with regard to T's September Year 4 CERT. See paragraph (a)(3)(i) of this section. In determining any CERIL with regard to the P group's calendar Year 6, the lookback period is the three taxable years prior to the taxable year of the group that includes the date on which the CERT occurred. See paragraph (d)(4)(i) of this section. Therefore, the lookback period with regard to the P group's loss limitation Year 6 is calendar consolidated return Years 1, 2, and 3.

Example 3. Interest history if no waiver election made on member deconsolidation. (i) *Facts.* P is the common parent of a calendar-year consolidated group that includes S. The P group engaged in a CERT on December 27, Year 5. S deconsolidates from the P group on December 31, Year 5. No election under paragraph (e)(1) of this section is made on the deconsolidation of S. S's value immediately after its deconsolidation is $4,000. The P group's value immediately before S's deconsolidation is $10,000. The P group and its members engaged in no prior CERTs.

(ii) *Analysis.* Because the CERT occurs during the P group's calendar consolidated return Year 5, Years 5, 6, and 7 are the P group's loss limitation years. Because no election is made under paragraph (e)(1) of this section with regard to the deconsolidation of S, S is treated as an applicable corporation with regard to the Year 5 CERT under paragraph (b)(1) of this section and the interest history of the P group during the period of S's consolidation and any preceding years is allocated to S and the remaining members of the P group. See paragraph (d)(3)(ii)(C) of this section. The amount of the P group's interest for each year that is allocated to S is the amount of interest paid or accrued by the P group in the relevant consolidated return year multiplied by a fraction equal to 4,000 divided by 10,000 (the value of the deconsolidating corporation immediately after its deconsolidation divided by the value of the entire group immediately prior to the deconsolidation), or ⅖. See paragraph (d)(3)(ii)(D) of this section. The interest allocated to S is subtracted from the interest history of the group and is unavailable to the P group for purposes of computing a three-year average with regard to any loss limitation year of the P group after the year of the deconsolidation, including Years 6 and 7. The interest history allocated to S will be maintained by S to be used in the computation of any CERIL of S, or any CERIL of any group of which S is later a member. See paragraph (d)(3)(ii)(C) of this section.

(iii) *Waiver election filed.* The facts are the same as in paragraph (i) of this *Example 3,* except that an election under paragraph (e)(1) of this section is filed on the deconsolidation of S. As a result of that election, S is not treated as an applicable corporation with regard to the Year 5 CERT under paragraph (b)(2) of this section and none of the interest history of the P group is allocated to S under paragraph (d)(3)(ii)(B) of this section. Therefore, in any post-deconsolidation year, for purposes of computing a CERIL in connection with any CERT with regard to which S (or of any group of which S is later a member) is an applicable corporation, S is treated as having paid or accrued zero interest for the period of its inclusion in the P group and preceding years. The P group will retain the interest history that would otherwise be allocated to S. See paragraph (d)(3)(ii)(B) of this section.

Example 4. Interest history if no waiver election made for member that deconsolidates prior to CERT. (i) *Facts.* P is the parent of a calendar-year consolidated group that includes S. On December 31, Year 4, S deconsolidates from the P group. No election is made under paragraph (e)(1) of this section with regard to the deconsolidation. On July 1, Year 5, the P group engages in a CERT. The P group and its members engaged in no prior CERTs.

(ii) *Analysis.* Because no election is made under paragraph (e)(1) of this section with regard to the deconsolidation of S, the interest history of the P group is allocated between S and the remaining members of the P group. See paragraph (d)(3)(ii)(C) of this section. This allocation occurs despite the fact that, at the time of the deconsolidation, the P group has not engaged in a CERT. Therefore, for purposes of computing any three-year average for the P group relevant to the Year 5 CERT, the portion of the interest history allocated to S is unavailable to the P group for purposes of computing a three-year average with regard to any loss limitation year of the P group after the year of the deconsolidation. See paragraph (d)(3)(ii)(C) of this section.

Example 5. Interest history if waiver election made for member that deconsolidates and then engages in a CERT. (i) *Facts.* P is the parent of a calendar-year consolidated group that includes X. On December 31, Year 5, X deconsolidates from the P group and makes an election under paragraph (e)(1) of this section. After its deconsolidation, X maintains a calendar taxable year. During Year 7, X engages in a CERT.

(ii) *Analysis.* X's loss limitation years with regard to the Year 7 CERT are Years 7, 8, and 9. X's lookback period with regard to the CERT is comprised of its Years 4 and 5 in the P consolidated group, and X's separate return Year 6. See section 172(h)(2)(C)(ii) and paragraph (d)(4)(i) of this section. As a result of the filing of the election under paragraph (e)(1) of this section, none of the interest history of the P group is allocated to X. Therefore, for purposes of computing X's three-year average for loss limitation Years 7, 8, and 9, X is treated as having paid or accrued zero interest during Years 4 and 5 of the lookback period. See paragraph (d)(3)(ii)(B) of this section.

Example 6. Interest history if member deconsolidates mid-year. (i) *Facts.* P is the common parent of a calendar-year consolidated group that includes S. S deconsolidates from the P group on June 30, Year 5. No election under paragraph (e)(1) of this section is made on the deconsolidation of S. During Year 5, but prior to the deconsolidation, the P group engages in a CERT. S is not a party to the CERT, and, throughout its history in the group, S paid or accrued only nominal interest.

(ii) *Analysis.* The P group's lookback period is calendar Years 2, 3, and 4. Consolidated return Years 5, 6, and 7 are the P group's loss limitation years. Because no election is made under paragraph (e)(1) of this section with regard to the deconsolidation of S, the interest history of the P group is allocated between S and the remaining members of the P group. See paragraph (d)(3)(ii)(C) of this section. This is true although S played no part in the CERT, and it actually paid or accrued only nominal interest. In the consolidated return year of the deconsolidation (here, the P group's Year 5), S was a member for 181 days. Therefore, the P group includes in the computation of its three-year average relevant to Year 5 a pro rata portion of the interest history allocated to S. See paragraph (d)(3)(ii)(C) and (iii) of this section. The pro rata portion equals the group's interest history allocated to S under paragraph (d)(3)(ii)(C) and (D) of this section, multiplied by a fraction equal to 181/365 (number of days of the loss limitation year during which S is a member divided by the number of days in the loss limitation year). See paragraph (d)(3)(iii) of this section. The portion of the interest history allocated to S is excluded in its entirety from the computation of the group's three-year average relevant to Years 6 and 7. The interest history allocated to S will be used in the computation of any CERIL of S, and any CERIL of any group of which S is later a member. See paragraph (d)(3)(ii)(C) of this section.

Example 7. Group not in existence for the entire lookback period. (i) *Facts.* Corporation P is formed on October 1, Year 3, and maintains a calendar taxable year. On January 1, Year 4, P forms S in a transaction meeting the requirements of section 351. Beginning in Year 4, P files consolidated returns with S, its only subsidiary. The P group maintains a calendar taxable year. During Year 5, the P group engages in an ED.

(ii) *Analysis.* For purposes of limiting any CERIL related to the Year 5 CERT, the P group must measure its interest deductions for the three years preceding the taxable year in which the CERT occurs (three-year average). See section 172(h)(2)(C)(ii) and § 1.172(h)–3(a). However, the P group was not in existence for three taxable years before the year that includes the date of the CERT (calendar Year 5). Rather, the P group was in existence for one full calendar taxable year (Year 4). Because the group does not have a three-year history, the lookback period includes the common parent's (P's) short taxable year (October 1 through December 31, Year 3), and is also deemed to include an additional taxable period (October 1, Year 2 through September 30, Year 3). See paragraph (d)(4)(ii) of this section. Further, in computing the three-year average, the P group members are treated as having paid or accrued zero interest for dates on which they did not exist. However, the P group is treated as having paid any interest paid by P during its short taxable year (October 1 through December 31, Year 3). See paragraph (d)(4)(iv) of this section.

Example 8. Group not in existence prior to year of the CERT but target in existence. (i) *Facts.* Corporation P is formed on January 1, Year 4. On the same day, P organizes wholly-owned, special-purpose corporation S. T is an unrelated, calendar-year corporation with a significant tax history. On February 1, Year 4, S merges into T, with T surviving. In the merger, all of T's historic shareholders receive cash in exchange for their shares. Following the merger, P owns all of the outstanding stock of T, and P is treated as acquiring all the stock of T in an MSA. The P group files consolidated returns beginning in Year 4 and maintains a calendar taxable year. T is first included in the P group on February 2, Year 4.

(ii) *Analysis.* Neither P (the original common parent) nor the P group is in existence before the year that includes the date of the CERT (calendar Year 4). Therefore, for purposes of applying the interest allocation limitation of section 172(h)(2)(C) and § 1.172(h)–3(a), the P group's lookback period is deemed to include three additional taxable periods (January 1 through December 31 for Years 1, 2, and 3). See paragraph (d)(4)(ii) of this section. Further in computing the three-year average, P is treated as having paid or accrued zero interest during the deemed years (January 1, Year 1 through December 30, Year 3). See paragraph (d)(4)(iv) of this section. However, with respect to the group's acquisition of T, the interest history of T is combined with the interest history of the P group. Because T is not a member of the P group for each day of loss limitation Year 4, the computation of the three-year average applicable to loss limitation Year 4 will include only a pro rata portion of the interest of T for the lookback period. See paragraph (d)(3)(i), (d)(3)(iii), and paragraph (iii) of Example 1 of paragraph (d)(5) of this section.

(e) *Election to waive carryback from all separate return years*—(1) *In general.* In addition to any other elections available under section 172(b)(3) and § 1.1502–21(b)(3), if a member becomes a non-member of a group (former group), the former member may make an irrevocable election to relinquish the carryback of all NOLs (and attributable portions of CNOLs) to taxable years of the former group and any preceding years. If the former member becomes a member of another group (acquiring group) immediately after its deconsolidation from the former group, the election described in this paragraph (e)(1) is available only to the common parent of the acquiring group. The election is not an annual election and applies to all losses that would otherwise be subject to carryback to years of the former group (or preceding years) under section 172 or § 1.1502–21(b). The election is binding on the deconsolidating corporation and any group of which it may become a member. Further, the election is available without regard to whether the former group is treated as an applicable corporation with regard to any CERT at the time of the deconsolidation. Any election under this paragraph (e)(1) by the common parent of an acquiring group must include all deconsolidating corporations that were members of the former group and that joined the acquiring group during the same consolidated return year of the acquiring group. The election is made in a separate statement entitled, ''THIS IS AN ELECTION UNDER § 1.1502–72(e)(1) TO WAIVE THE PRE- [insert the first taxable year following the deconsolidation of the former member(s) from the former group] CARRYBACK PERIOD FOR ALL NOLs AND ALL CNOLs ATTRIBUTABLE TO [insert the name(s) and EIN(s) of the corporation(s)].'' The statement must be filed with the timely filed original return of the former member or the acquiring group for the first taxable year following the deconsolidation of the former member from the former group. See paragraphs (b)(2), (c)(4)(iii), and (d)(3)(ii)(B) of this section relating to treatment of a deconsolidating member making an election under this paragraph (e)(1).

(2) *Example.* The following example illustrates the rules of this paragraph (e):

Example. P, a publicly-held corporation, is the common parent of a calendar-year consolidated group that includes T. On July 30, Year 5, the P group engages in a CERT. On December 31, Year 5, T deconsolidates from the P group, and it continues to maintain a calendar taxable year. With respect to its deconsolidation, T makes an election under paragraph (e)(1) of this section. As a result of such election, T is not treated as an applicable corporation with regard to the P group's Year 5 CERT and none of the CERT costs or interest history of the P group are allocated to T. See paragraphs (b)(2), (c)(4)(iii), and (d)(3)(ii)(B) of this section. On March 30, Year 6, the X group acquires all of the stock of T. The X group maintains a calendar taxable year. A portion of the X group's Year 6 CNOL is attributable to T under § 1.1502–21(b)(2)(iv)(B). Because T filed an election under paragraph (e)(1) of this section with respect to its deconsolidation from the P group, no portion of the X group's Year 6 CNOL attributable to

T can be carried back to any taxable years of T, of the P group, or any preceding years.

(f) *Excess distribution*—(1) *Defined.* Section 172(h)(3)(C) and § 1.172(h)–1(c)(3) provide that an ED means the excess (if any) of the aggregate distributions (including redemptions) made during a taxable year by a corporation with respect to its stock, over the greater of 150 percent of the average of such distributions (three-year distribution average) for the three taxable years immediately preceding such taxable year (distribution lookback period), or 10 percent of the fair market value of the stock of such corporation as of the beginning of such taxable year.

(2) *Determination of an ED by a group*—(i) *Aggregation of distributions to non-members.* For purposes of determining whether a group has made an ED during any consolidated return year (potential ED year), distributions by all members of the group to non-members during the potential ED year are aggregated and tested under section 172(h)(3)(C), § 1.172(h)–1(c)(3), and paragraph (f)(1) of this section.

(ii) *Distributions between members of the same group.* Distributions between members of the same group are generally disregarded for purposes of applying the CERT rules. However, the preceding sentence does not apply if a party to the transaction is deconsolidated pursuant to the same plan or arrangement. See paragraph (a)(2)(iii) of this section.

(3) *Computation of three-year distribution average*—(i) *In general.* The computation under section 172(h)(3)(C)(ii)(I) and § 1.172(h)–1(f) of the group's three-year distribution average includes distributions made during the distribution lookback period to non-members by each corporation that is a member of the consolidated group during the potential ED year. Distributions made during the distribution lookback period by predecessors of those members are also included. See § 1.172(h)–4(d). The computation includes distributions made by corporations during separate return years, subject to additional rules of this paragraph (f) and paragraph (a)(2)(iii) of this section. If a corporation was a member of a prior group during a portion of a distribution lookback period, the distribution history of that corporation during taxable years of the prior group includes only distributions made by that corporation to non-members of the prior group.

(ii) *Corporation deconsolidated from a group.* If a corporation deconsolidates from a group (former group), the corporation's actual distribution history is subtracted from the group's distribution history and is available to the deconsolidating corporation (or any group of which it becomes a member) for purposes of computing any three-year distribution average following the deconsolidation. The deconsolidating member's distribution history will be unavailable to the former group for purposes of computing its three-year distribution average with regard to any potential ED year of the former group after the year of deconsolidation. See § 1.172(h)–1(f)(1) (excluding from three-year distribution average those distributions treated as part of an MSA).

(iii) *Members included in group for less than entire loss limitation year.* If any member is included in the group for less than an entire potential ED year (partial-year member), then a pro rata portion of the partial-year member's distribution history is computed under the principles of paragraph (d)(3)(iii) of this section and is included for purposes of determining the group's three-year distribution average relevant to that potential ED year.

(4) *Stock value and stock issuances of a group*—(i) *Stock issuances taken into account in computing distributions.* Stock issued by a member of a group is taken into account in applying section 172(h)(3)(E)(ii) and § 1.172(h)–5(c)(1) only if the stock is issued to a non-member. Intercompany stock issuances are disregarded. This rule is applicable whether the stock issuance occurred in the current group or a previous group.

(ii) *Value of stock of group.* For purposes of applying section 172(h)(3)(C)(ii)(II), § 1.172(h)–1(c)(3), and paragraph (f)(1) of this section (relating to the fair market value of the stock of a distributing corporation), the value of the stock of the group is the value of the stock of all members, other than stock that is owned directly or indirectly by another member. But see section 172(h)(3)(E)(i) for rules regarding the exclusion of certain preferred stock for purposes of applying sections 172(h)(3)(C), § 1.172(h)–1(c)(3) and (f), and this paragraph (f). See also paragraphs (a)(2)(iii) and (f)(2)(ii) of this section, requiring separate entity analysis of certain transactions between members of a consolidated group.

(5) *Examples.* The following examples illustrate the rules of this paragraph (f). For purposes of these examples, assume that all entities are domestic C corporations:

Example 1. Corporation deconsolidates from group. (i) *Facts.* P is the common parent of a calendar-year consolidated group that includes T. P owns 90 percent of the outstanding stock of T, and A (an unrelated party) owns the remaining 10 percent of the outstanding stock of T. T regularly makes distributions to its shareholders, P and A. On December 31, Year 4, X, the common parent of another calendar-year consolidated group, acquires all of the outstanding stock of T, and T deconsolidates from the P group. T is first included in the X group on January 1, Year 5. On March 31, Year 5, X makes a large distribution to its non-member shareholders. X makes no further distributions during its taxable year.

(ii) *Analysis.* The X group's distribution to its non-member shareholders on March 31, Year 5, is tested as a potential ED under section 172(h)(3)(C), § 1.172(h)–1(c)(3) and (f), and paragraph (f) of this section. The X group's distribution lookback period with regard to the potential ED is January 1 through December 31, for each of Years 2, 3, and 4. For purposes of computing the X group's three-year distribution average, the computation includes any distributions made by T to A, its former non-member shareholder, during the distribution lookback period, because T is a member of the X group during the year of the potential ED. See paragraph (f)(3) of this section. Distributions between members of the X group and between members of the P group are disregarded. See paragraph (f)(2)(ii) of this section.

Example 2. Integrated plan to deconsolidate. T is a wholly-owned subsidiary of P, and is a member of the P group. As part of a plan that includes the deconsolidation of T from the P group, T makes a distribution to P. Because T's distribution to P is part of an integrated plan that results in the deconsolidation of T, T's distribution to P is tested on a separate entity basis as a potential ED under section 172(h)(3)(C) § 1.172(h)–1(c)(3) and (f), and paragraph (f) of this section. See paragraphs (a)(2)(iii) and (f)(2)(ii) of this section. Therefore, the rules of section 172(h)(3)(C), § 1.172(h)–1(c)(3) and (f), and paragraph (f) of this section are applied based on the separate entity value and distribution history of T. See § 1.172(h)–1(d)(2) regarding testing of the distribution as part of a plan of major stock acquisition.

(g) *Life-nonlife groups*—(1) *Scope.* This paragraph (g) provides rules for applying the CERT rules to a group that elects under section 1504(c)(2) to file a consolidated return (life-nonlife group). See § 1.1502–47 (rules regarding life-nonlife groups).

(2) *Single entity treatment*—(i) *In general.* All members of a life-nonlife group are generally treated as a single taxpayer for purposes of the CERT rules. Accordingly, the rules of paragraphs (a) through (f) and (h) of this section and the rules of §§ 1.172(h)–1 through 1.172(h)–5 are applied by treating the life-nonlife group as a single taxpayer, and are not applied on a subgroup basis. For example, all members of a life-nonlife group are treated as a single entity for purposes of determining whether a CERT has occurred under sections 172(h)(3)(B) and (C) and

§ 1.172(h)–1. See paragraph (a)(2)(i) of this section. Furthermore, all intercompany transactions between and within subgroups are generally disregarded. In addition, if a pre-existing CERT member becomes a member of a life-nonlife group, the life-nonlife group is treated as a single applicable corporation with regard to that CERT in the consolidated return year of the acquisition and any succeeding year. See paragraph (a)(2)(iv) of this section. If it is determined that a CERT exists, the amount of the CERIL is determined for the entire life-nonlife consolidated group as described in paragraph (g)(2)(ii)(A) of this section, and the CERIL is allocated to each subgroup as described in paragraph (g)(3) of this section.

(ii) *CERIL*—(A) *Single CERIL computation.* For any loss limitation year, a single CERIL is computed under section 172(h)(1) and § 1.172(h)–2(a)(2) for the life-nonlife group. The computation of the life-nonlife group's CERIL for any loss limitation year includes all life-nonlife group members' CERT costs, debt, and interest paid or accrued for that year.

(B) *Net operating loss.* For purposes of determining the CERIL of a life-nonlife group under section 172(h)(1) and § 1.172(h)–2(a)(2), the *net operating loss* of the group in any loss limitation year is the sum of the nonlife consolidated net operating loss (nonlife CNOL) (if any) and the consolidated loss from operations (consolidated LO) (if any) for that year. For this purpose, nonlife consolidated taxable income does not offset any LO, and consolidated partial life insurance company taxable income (as used in § 1.1502–47(g)) does not offset any nonlife CNOL.

(iii) *Carryover to separate return years.* If any nonlife CNOL or consolidated LO that is attributable to a member of a subgroup may be carried to a separate return year (as defined in § 1.1502–47(d)(10)), the CERIL that is associated with the nonlife CNOL or consolidated LO is apportioned to each member, as relevant, under the method provided by § 1.1502–21(b)(2)(iv)(C)(1).

(iv) *Deconsolidation.* If a member deconsolidates from a life-nonlife group without an election under paragraph (e)(1) of this section, then paragraphs (b)(1), (c)(4)(i) and (ii), and (d)(3)(ii)(A) and (C) of this section (relating to treatment of a deconsolidating member) apply to allocate CERT status, CERT costs, and interest history from the entire life-nonlife group to the deconsolidating member, and not from a specific subgroup.

(3) *Allocation of a CERIL.* If a CERIL exists under paragraph (g)(2)(ii)(A) of this section, that CERIL is allocated to each subgroup that has a nonlife CNOL or consolidated LO. The amount of the nonlife CNOL and consolidated LO in a loss limitation year that constitutes a CERIL is equal to the total amount of the CERIL for the loss limitation year multiplied by a fraction, the numerator of which equals the nonlife CNOL or consolidated LO (as relevant), and the denominator of which equals the nonlife CNOL plus the consolidated LO.

(h) *Effective/applicability date*—(1) *In general.* Other than paragraph (e) of this section, the rules of this section apply to CERTs occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**. The rules of this section also apply to the deconsolidation of a member from, or the acquisition of a corporation by, a consolidated group that occurs on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**. However, in each case, this section does not apply to any CERT, deconsolidation, or acquisition occurring pursuant to a written agreement that is binding before the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

(2) *Waiver election.* Paragraph (e) of this section applies to the deconsolidation of a member from a consolidated group that occurs on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**, except that it does not apply to any deconsolidation occurring pursuant to a written agreement that is binding before the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

Steven T. Miller,

Deputy Commissioner for Services and Enforcement.

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