The Unified Loss Rules: An Overview

Todd Way
(214) 220-7942 / (713) 758-7942
tway@velaw.com

Laura Gieseke
(713) 758-2053
lgieseke@velaw.com
Set forth herein is a summary of the “unified loss rules,” and in particular the “attribute reduction rules” contained in Treas. Reg. § 1.1502-36(d), which are designed to prevent taxpayers from recognizing more than one tax loss with respect to a single economic loss. The attribute reduction rules can lead to surprising results and should be carefully analyzed to determine their potential application in connection with the purchase and sale of a corporation out of a consolidated group. Given the current natural resource commodity price environment, these rules will likely become increasingly relevant for certain M&A transactions within the energy space.
Introduction

• Background:
  – They are the culmination of 20 years of notices, proposed, temporary and final regulations, court cases, and legislation, including:
    • Notice 87-14, 1987 C.B. 445.
    • Numerous proposed, temporary, and final regulations.
    • Section 646 of American Jobs Creation Act of 2004.
Definitions

• For simplicity, assume the following unless otherwise indicated:
  – “Seller” is the common parent of an affiliated group of corporations that have elected to file consolidated federal income tax returns (the “Seller Group”).
  – “Target” is a member of the Seller Group and is 100% directly owned by Seller.
  – “Buyer” is a corporation that is not affiliated with the Seller Group.
The Unified Loss Rules have two primary purposes:

• Preventing the consolidated return provisions from reducing Seller Group’s consolidated taxable income through the creation and recognition of noneconomic loss on Target’s stock (Treas. Reg. 1.1502-36(a)(2)); and

• Preventing members (including former members) of a Seller Group from collectively obtaining more than one tax benefit from a single economic loss (Id.).
• The Unified Loss Rules Contain Three Principal Rules:
• Each of the three rules, to the extent applicable, apply in the order set forth above.
1. The Basis Redetermination Rule: Treas. Reg. § 1.1502-36(b)

The Basis Redetermination Rule is designed to prevent prior adjustments made under Treas. Reg. § 1.1502-32 from creating non-economic or duplicated losses where Seller (or other Seller Group members) hold Target shares with disparate bases.

- The rule reallocates previously applied investment adjustments to reduce basis disparity among different classes or blocks of Target stock.
  - Doesn’t apply if there is no disparity among bases in Target’s common shares and no member of the Seller Group owns preferred shares with an unrecognized gain or loss.
  - Doesn’t apply where all of Target’s shares are sold to a non-member in a fully taxable transaction.
2. The Stock Basis Reduction Rule: Treas. Reg. § 1.1502-36(c)

The Stock Basis Reduction Rule is primarily designed to prevent the “son of mirrors” and similar transactions that the IRS thinks result in noneconomic losses.

- Son of Mirror Example: Seller purchases Target for $400 and files a consolidated return. Target has two assets (X and Y), each of which has a $200 value and $100 basis. Seller only wants Asset X. Target distributes Asset X to Seller and then Seller sells Target’s stock for $200. The distribution of Asset X results in $100 deferred intercompany gain (a “DIG”) to Target and a $200 reduction Seller’s basis in its Target stock. The DIG is triggered in connection with the stock sale, resulting in a $100 increase in Seller’s stock basis under the investment adjustment rules. As a result, Seller recognizes a $100 loss on the stock sale, which offsets the gain recognized on the distribution of Asset X.

- The stock basis reduction rule prevents this result by reducing Seller’s basis in the Target stock by the $100 positive investment adjustment.
3. The Attribute Reduction Rule: Treas. Reg. § 1.1502-36(d)

The Attributed Reduction Rule is primarily intended to prevent recognition of more than one loss with respect to a single economic loss.

- Unlike the prior temporary regulations, the final regulations do not trace losses.

- Basic Example of Problem: Seller buys Target’s stock for $200, at which time Target’s assets have a $200 basis and value. A year later, Target’s assets have declined in value to $100. Before Target recognizes a loss on the assets for tax purposes, Seller sells Target’s stock for $100.
  - Absent the attribute reduction rule, Seller would recognize a $100 loss on its Target stock and Target would continue to have a $100 built-in loss that it could later recognize. Thus, there could be $200 of losses recognized even though the economic loss was only $100.
Default Attribution Reduction Mechanics

• If any transferred share remains a loss share after the application of the stock basis redetermination and reduction rules, Target’s tax attributes are reduced by the “attribution reduction amount.” Treas. Reg. § 1.1502-36(d)(2)(i).

• Attribute Reduction Amount = the lesser of (i) the net stock loss and (ii) the aggregate inside loss. § 1.1502-36(d)(3).
  – Net stock loss = the excess, if any, of the aggregate basis of all Target shares transferred over the aggregate value of those shares.
  – Aggregate Inside Loss = the excess, if any, of Target’s net inside attribute amount (loss carryovers, plus deferred deductions, plus money, plus basis in assets other than money, minus liabilities) over the value of all outstanding Target shares. Complicated further if Target owns subsidiaries – See Treas. Reg. 1.1502-36(d)(5).

• Exception if the attribution reduction amount < 5% of the value of the shares transferred (unless Seller elects otherwise). Treas. Reg. § 1.1502-36(d)(2)(ii).
Default Attribution Reduction Mechanics, Continued

• Default Application of Attribution Reduction.
  1. Category A: Capital loss carryovers (oldest to newest);
  2. Category B: NOL carryovers (oldest to newest);
  3. Category C: Deferred deductions (proportionately); and
    – Seller can specify the allocation of the attribution reduction amount among attributes in Categories A, B, and C. *Id.*
    – Asset basis cannot be reduced until all of the attributes in Categories A, B, and C are reduced in full. *Id.*
• Reduction of Target’s Asset Basis.
  – After reducing the attributes in Categories A, B, and C, any excess attribution reduction amount is applied to reduce the basis of Target’s Category D assets.
  • The basis reduction is allocated between any stock of Target’s subsidiaries, if any, and Target’s other assets based on relative basis. Special rules apply to determine the “deemed basis” of Target’s subsidiary stock. See Treas. Reg. § 1.1502-36(d)(5).
  • The attribution reduction amount allocated to non-stock Category D assets are allocated to Target’s Class VII, VI, V, IV, III, and II assets in reverse sequential order. Treas. Reg. § 1.1502-36(4)(ii)(B)(2). Basis of assets within a class are reduced proportionately.
Default Attribution Reduction Mechanics, Continued

- Reduction of Target’s Asset Basis Cont.
  - If the attribution reduction amount exceeds Target’s attributes and Target has contingent liabilities, the excess is suspended and applied to any future attributes attributable to those liabilities. Otherwise, the excess attribution reduction amount has no further effect. Treas. Reg. § 1.1502-36(d)(4)(iii).
  - Attribute reductions are effective immediately before the transfer of Target’s stock. Id.
  - Any reduction of attributes are NOT noncapital, nondeductible expenses described in Treas. Reg. § 1.1502-32(b)(2)(iii). The point here is to prevent duplicative stock basis reductions under the investment adjustment rules.
In lieu of the default attribute reduction rules described above, Seller can elect to:

1. Reduce all or any portion of its basis in Target’s shares (i.e., reduce its capital loss on the sale of Target);
2. Reattribute all or any portion of Target’s Category A, B, and C attributes to the extent they would otherwise be reduced; or
3. Any combination of the above.

Seller may specify the amount of attributes in Category A, B, and C (up to the extent such attributes would otherwise be subject to reduction).

Seller can make a protective election to reduce stock basis or reattribute attributes.
• Seller is treated as succeeding to any attributes that are reattributed to it as though such attributes were acquired in a Section 381 transaction. Treas. Reg. § 1.1502-36(d)(6)(iv)(A).

• The reattribution of Target’s assets is a noncapital, nondeductible expense of Target described in Treas. Reg. § 1.1502-32(b)(2)(iii).

• In general, any stock basis reduction and reattribution of attributes is deemed to occur immediately before the application of the default loss attribution reduction rules (which in turn is deemed to occur immediately before the stock sale).

• Stock basis reduction is deemed elected if the stock loss would be permanently disallowed (e.g., under Section 311(a)). Treas. Reg. § 1.1502-36(d)(6)(iv)(C).

• An election is made by Seller in a statement titled “Section 1.1502-36 Statement,” which must be attached to the Seller Group’s return for the taxable year of the transaction. See Treas. Reg. § 1.1502-36(e)(5) for election filing details.
• Facts:
  – Seller owns all 100 outstanding shares of Target with a basis of $2.10/share ($210).
  – Seller sells all of its Target shares to X for $1/share ($100).
  – At the time of the sale, Target has no liabilities, a $10 capital loss carryover (Category A), $90 NOL carryover (Category B), and $40 deferred deduction (Category C), and land with a basis of $70 (Category D) (total attributes = $210).
• Computation of Attribute Reduction Amount
  – Attribution reduction amount = lesser of the $110 net stock loss ($210 basis over $100 purchase price) and Target’s $110 aggregate inside loss ($210 total attributes over the $100 purchase price).

• Allocation of Attribute Reduction Amount of $110
  – Absent a specific allocation, Target’s $10 capital loss carryover and $90 NOL carryover would be reduced to $0, and its $40 deferred deduction would be reduced by $10 to $30.
  – Alternatively, Seller could specifically state how it wants to apply the $110 attribute reduction amount among the capital loss carryover, NOL carryover, and deferred deduction.
  – Seller recognizes a $110 capital loss on the stock sale.
• Election to Reduce Stock Basis.
  – Instead of the attribution reduction described above, Seller Group could elect pursuant to Treas. Reg. § 1.1502-36(d)(6) to reduce Seller’s basis in the Target shares by the full attribute reduction amount of $110. It could also elect to reduce its basis by only part of the attribute reduction amount.
  – After giving effect to the election, the Target shares are not loss shares and therefore Target’s attributes are not subject to reduction.
• Election to Reattribute Losses.
  – Instead of the attribution reduction described above, Seller Group could elect pursuant to Treas. Reg. § 1.1502-36(d)(6) to reattribute Target’s attributes up to the attribute reduction amount.
  – For example, Seller Group could elect to reattribute the $10 capital loss carryover, $90 NOL, and $10 of the deferred deduction to the Seller Group.
• As a result, Target’s remaining attributes would be a $30 deferred deduction and land with a basis of $70.
• The reattribution is treated as a noncapital, nondeductible expense of Target that is deemed to occur immediately before the application of Treas. Reg. § 1.1502-36(d) (and therefore before the stock sale), which reduces Seller’s basis in its Target shares by $110 under the investment adjustment rules.
• Seller Group succeeds to the reattributed attributes.
A Few Strategic Considerations

• Buyers need to be careful anytime the purchase price is less than the basis in Target’s shares and the net attributes of Target.

• Buyer should consider requiring Seller to make a protective Treas. Reg. § 1.1502-36(d)(6) election to reduce stock basis at the time of sale.
  – The existence or amount of the attribution reduction amount may not be known at closing (e.g., there may be a purchase price adjustment or audit that affects the calculation post-closing).
  – If Seller is unwilling to make the election (e.g., because it is expecting to have capital gain income from another source), Buyer could ask for a representation regarding the attributes that Target will take with it.

• In certain circumstances, it may make sense for Seller to reattribute Target net operating losses (“NOLs”) and other attributes because the NOLs will not be subject to a 382 limitation resulting from the sale of Target to Buyer.
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