

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

(ii) *Gain stock.* If a member, M, would otherwise recognize gain on a qualified disposition of P stock, then immediately before the qualified disposition, M is treated as purchasing the P stock from P for fair market value with cash contributed to M by P (or, if necessary, through any intermediate members). A disposition is a qualified disposition only if—

(A) The member acquires the P stock directly from the common parent (P) through a contribution to capital or a transaction qualifying under section 351(a) (or, if necessary, through a series of such transactions involving only members);

(B) Pursuant to a plan, the member transfers the stock immediately to a nonmember that is not related, within the meaning of section 267(b) or 707(b), to any member of the group;

(C) No nonmember receives a substituted basis in the stock within the meaning of section 7701(a)(42);

(D) The P stock is not exchanged for P stock;

(E) P neither becomes nor ceases to be the common parent as part of, or in contemplation of, the plan or disposition; and

(F) M neither becomes nor ceases to be a member as part of, or in contemplation of, the plan or disposition.

(iii) *Options, warrants and other rights.* Paragraph (f)(6)(i) of this section applies to options, warrants, forward contracts, or other positions with respect to P stock (including, for example, cash-settled positions). For example, if S purchases (from any party) a warrant on P stock and the warrant lapses, any loss recognized by S is permanently disallowed. Similarly, if S purchases a warrant on P stock and S becomes a nonmember at a time when the value of the warrant is less than S's

basis in the warrant, S's basis in the warrant is reduced to its fair market value immediately before S becomes a nonmember.

(iv) *Effective date.* This paragraph (f)(6) applies to transactions on or after July 12, 1995 (notwithstanding whether the intercompany transaction, if any, occurred prior to that date).

Michael P. Dolan,

Acting Commissioner of Internal Revenue.

Approved: June 29, 1995.

Leslie Samuels,

Assistant Secretary of the Treasury.

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## 26 CFR Parts 1 and 602

[TD 8597] 95-11-91

RIN 1545-AT58

### Consolidated Groups and Controlled Groups—Intercompany Transactions and Related Rules

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

**ACTION:** Final regulations

**SUMMARY:** This document contains final regulations amending the intercompany transaction system of the consolidated return regulations. The final regulations also revise the regulations under section 267(f), limiting losses and deductions from transactions between members of a controlled group. Amendments to other related regulations are also included in this document.

**DATES:** These regulations are effective July 18, 1995.

For dates of applicability, see the **EFFECTIVE DATES** section under the **SUPPLEMENTARY INFORMATION** portion of the preamble and the effective date provisions of the new or revised regulations.

**FOR FURTHER INFORMATION CONTACT:** Concerning the regulations relating to consolidated groups generally, Roy Hirschhorn of the Office of Assistant Chief Counsel (Corporate), (202) 622-7770; concerning stock and obligations of members of consolidated groups, Victor Pentco of the Office of Assistant Chief Counsel (Corporate), (202) 622-7750; concerning insurance issues, Gary Geisler of the Office of Assistant Chief Counsel (Financial Institutions and Products), (202) 622-3970; concerning international issues, Philip Tretiak of the Office of Associate Chief Counsel (International), (202) 622-3860; and concerning controlled groups, Martin Scully, Jr. of the Office of Assistant Chief Counsel (Income Tax and

Accounting), (202) 622-4960. (These numbers are not toll-free numbers.)

#### SUPPLEMENTARY INFORMATION

##### A. Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the requirements of the Paperwork Reduction Act (44 U.S.C. 3504(b)) under control number 1545-1433. The estimated average annual burden per respondent is .5 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, PC:FP, Washington, DC 20224, and 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.

##### B. Background

This document contains final regulations under section 1502 of the Internal Revenue Code of 1986 (Code) that comprehensively revise the intercompany transaction system of the consolidated return regulations. Amendments are also made to related regulations, including the regulations under section 267(f), which apply to transactions between members of a controlled group.

The proposed regulations were published in the *Federal Register* on April 15, 1994 (59 FR 18011). The notice of hearing on the proposed regulations, Notice 94-49, 1994-1 C.B. 358, 59 FR 18048, contains an extensive discussion of the issues considered in developing the proposed regulations. The IRS received many comments on the proposed regulations and held public hearings on May 4, 1994 and August 8, 1994.

After consideration of the comments and the statements made at the hearings, the proposed regulations are adopted as revised by this Treasury decision. The principal comments and revisions are discussed below. However, a number of other changes have been made to the proposed regulations. References in the preamble to P, S, and B are references to the common parent, the selling member, and the buying member, respectively. No inference is intended as to the operation of the prior regulations or other rules.

### C. Principal Issues Considered in Adopting the Final Regulations

#### 1. Retention and modification of the deferred sale approach

The proposed regulations generally retain the deferred sale approach of prior law but comprehensively revise the manner in which deferral is achieved to eliminate many of the inconsistent combinations of single and separate entity treatment under prior law. Notwithstanding these revisions, the results for most common intercompany transactions remain unchanged.

Commentators uniformly supported the retention of the deferred sale approach. Some comments, however, suggested that the rules of prior law should be retained, with modifications only where necessary to address a specific problem. Since the adoption of the prior regulations in 1966, however, developments in business practice and the tax law have greatly increased the problems of accounting for intercompany transactions. Although additional amendments could have been made to the prior regulations, further amendments would risk raising additional inconsistencies or uncertainties without providing a unified regime. By comprehensively revising the intercompany transaction system, the proposed regulations provide a unified regime and eliminate many of the inconsistencies of prior law, without changing the results of most common transactions. The final regulations therefore generally retain the approach of the proposed regulations.

#### 2. General v Mechanical Rules

The prior intercompany transaction regulations were generally mechanical in operation. The proposed regulations rely less on mechanical rules and, instead, provide broad rules of general application based on the underlying principles of the regulations. To supplement the broad rules, the proposed regulations provide examples illustrating the application of the rules to many common intercompany transactions.

Some commentators supported the proposed regulations' use of broad rules based on principles. Others suggested that the final regulations should retain the mechanical rules of prior law. Mechanical rules provide more certainty for transactions clearly covered by those rules. For transactions that are not clearly covered, however, mechanical rules provide much less guidance.

The final regulations retain the approach of the proposed regulations. This approach is flexible enough to

apply to the wide range of transactions that can be intercompany transactions. For example, the final regulations do not require special rules to coordinate with the depreciation rules under section 168, the installment reporting rules under sections 453 through 453B, and the limitations under sections 267, 382, and 469. Flexible rules adapt to changes in the tax law and reduce the need for continuous updating of the regulations.

#### 3. Timing Rules of § 1.1502-13 as a Method of Accounting

The proposed regulations provide that "the timing rules of this section are a method of accounting that overrides otherwise applicable accounting methods." A group's ability to change the manner of applying the intercompany transaction regulations is therefore subject to the generally applicable rules for accounting method changes. Several comments objected to this treatment.

Commentators pointed out that treating the timing provisions of these regulations as a group's method of accounting may increase the burden and complexity of correcting improper applications of the regulations (for example, necessitating requests for accounting method changes for the treatment of intercompany transactions). This treatment also raises questions about members coming into a group and leaving a group (for example, whether requests to change a method of accounting are required when a taxpayer becomes, or ceases to be, a member). Various technical points were also raised as to the effect of a shared accounting method on each member of a group, the propriety of applying accounting method rules only to certain transactions or classes of transactions, the interaction of the intercompany transaction rules with separate entity accounting methods of members, and the linkage of the selling member's method of accounting for its intercompany items with the buying member's method of accounting for its corresponding items.

The intercompany transaction regulations provide guidance on the appropriate time for taking into account items of income, deduction, gain, and loss from intercompany transactions to clearly reflect the consolidated taxable income of the group. Clear reflection of income is the central principle of section 446. Under section 446, any treatment that does or could change the taxable year in which taxable income is reported is a method of accounting. See Rev. Proc. 92-20, 1992-1 C.B. 685. The timing rules of the intercompany

transaction regulations affect the taxable year in which items from intercompany transactions are taken into account in the computation of consolidated taxable income. Accordingly, the timing rules of these regulations are properly viewed as a method of accounting. Moreover, treating the timing rules as a method of accounting assures that the provisions will be applied consistently from year to year under the principles of section 446.

The final regulations retain the general approach of the proposed regulations, treating the timing rules of § 1.1502-13 as a method of accounting under section 446. The regulations also contain several provisions intended to reduce the administrative burden that commentators believe might result from this treatment. The final regulations treat the timing rules as an accounting method for intercompany transactions, to be applied by each member, and not as an accounting method of the group as a whole. However, an application of the timing rules of this section to an intercompany transaction will be considered to clearly reflect income only if the effect of the transaction on consolidated taxable income is clearly reflected. This treatment more closely conforms to the general practice of separate taxpayers having their own methods of accounting, thereby alleviating technical and administrative issues that were raised with respect to characterization of the method as the method of the group as a whole, rather than as the method of each member.

To reduce potential administrative burdens further, the final regulations generally provide automatic consent under section 446(e) to the extent changes in method are required when a member enters or leaves a group. In addition, for the first taxable year of the group to which the final regulations apply, consent is granted for any changes in method that are necessary to comply with the final regulations. For other years, members must obtain the Commissioner's consent to change their methods of accounting for intercompany transactions under applicable administrative procedures of section 446(e), currently Rev. Proc. 92-20. The regulations provide that changes will generally be effected on a cut-off basis (that is, the new method will apply to intercompany transactions occurring on or after the first day of the consolidated return year for which the change is effective). Changes in methods of accounting for intercompany transactions generally will otherwise be subject to the terms and conditions of applicable administrative procedures. The IRS may determine, however, that other terms and conditions are

appropriate in the interest of sound tax administration (for example, if a taxpayer misapplies the regulations to avoid matching S's intercompany item with B's corresponding item). See section 10 of Rev. Proc. 92-20.

Paragraph (e)(3) of the final regulations continues the procedure whereby the common parent may request consent from the IRS to report intercompany transactions on a separate entity basis. Rev. Proc. 82-36 (1982-1 C.B. 490), which provides procedures for obtaining consent under the prior regulations, will be updated and revised. Until new procedures are provided, taxpayers may rely on the principles of Rev. Proc. 82-36 in making applications under these final regulations.

If consent under paragraph (e)(3) of these regulations is obtained or revoked, the final regulations provide the Commissioner's consent under section 445(e) for each member to make any changes in methods of accounting necessary to conform members' methods of accounting to the consent or revocation. Any change in method under this provision must be made as of the beginning of the first year for which the consent (or revocation of consent) under paragraph (e)(3) is effective.

A group that has received consent under the prior intercompany transaction regulations not to defer items from deferred intercompany transactions will be considered to have obtained the consent of the Commissioner to take items from the same class (or classes) of intercompany transactions into account on a separate entity basis under these regulations.

#### 4. Single Entity Treatment of Attributes

##### a. In General

The prior intercompany transaction system used a deferred sale approach that treated the members of a consolidated group as separate entities for some purposes and as a single entity for other purposes. In general, the amount, location, character, and source of items from an intercompany transaction were given separate entity treatment, but the timing of items was determined under rules that produced a single entity effect.

The matching rule of the proposed regulations expands single entity treatment by requiring the redetermination of the attributes (such as character and source) of items to produce a single entity effect. Several comments supported the broader single entity approach taken by the proposed regulations. Other comments asked that

separate entity treatment of attributes be retained.

The commentators arguing for retention of separate entity treatment claimed that single entity treatment does not always result in more rational tax treatment, and may not reflect the economic results of a group's activities as accurately as separate entity treatment. They also argued that taxpayers should have the ability to avoid arbitrary results or administrative burdens by separately incorporating business operations. The Treasury and the IRS believe that single entity treatment of both timing and attributes generally results in a clear reflection of consolidated taxable income. In particular, single entity treatment minimizes the effect of an intercompany transaction on consolidated taxable income. In addition, single entity treatment minimizes the tax differences between a business structured divisionally and one structured with separate subsidiaries. The final regulations therefore retain the approach of the proposed regulations and generally adopt single entity treatment of attributes.

Nevertheless, in certain situations it may be appropriate to provide separate entity treatment. The Treasury and the IRS believe that these situations are relatively rare, and that any exceptions from single entity treatment should be specifically provided in regulations. For example, a separate entity election is permitted under Prop. Reg. § 1.1221-2(d) (published in the Federal Register on July 18, 1994, 59 FR 36394) in the case of certain hedging transactions. See also § 1.263A-9(g)(5). The Treasury and the IRS welcome comments on other situations in which this type of relief might be appropriate.

##### b. Conflict or Allocation of Attributes

The proposed regulations provide specific rules for certain cases in which separate entity attributes are redetermined under the matching rule. Some commentators believe that the proposed regulations do not provide sufficient guidance as to the manner in which these rules are to be applied. In response to these comments, the attribute redetermination provisions of the matching rule have been revised.

For example, the regulations have been revised to clarify that the separate entity attributes of S's intercompany item and B's corresponding item are redetermined under the matching rule only to the extent necessary to produce the same effect on consolidated taxable income as if the intercompany transaction had been between divisions. Thus, the redetermination is required

only to the extent the separate entity attributes differ from the single entity attributes.

The final regulations generally retain the rule of the proposed regulations under which the attributes of B's corresponding item control the attributes of S's intercompany items to the extent the corresponding and intercompany items offset in amount. However, the final regulations provide an exception to this rule to the extent its application would lead to a result that is inconsistent with treating S and B as divisions of a single corporation. To the extent B's corresponding item on a separate entity basis is excluded from gross income or is a noncapital, nondeductible amount (such as a deduction disallowed under section 265), however, the attribute of B's item will always control. This assures the proper operation of attribute limitation provisions contained elsewhere in the regulations.

To the extent B's corresponding item and S's intercompany item do not offset in amount, the final regulations provide that redetermined attributes are allocated to S's intercompany item and B's corresponding item using a method that is reasonable in light of all of the facts and circumstances, including the purposes of these regulations and any other rule affected by the attributes of S's items or B's items. This rule provides taxpayers considerable flexibility to allocate attributes, but the regulations also provide that an allocation method will be treated as unreasonable if it is not used consistently by all members of the group from year to year.

##### c. Source of Income

Several commentators opposed single entity treatment for determining the source of income or loss from an intercompany transaction, arguing that the separate entity treatment under prior law more accurately measures the source of income of the members of the group. The final regulations, however, retain the single entity treatment of source for the same reasons that the single entity treatment of other attributes is retained. The final regulations modify the example in the proposed regulations to reflect the changes made to the attribute allocation rules.

Some comments suggested that a single entity approach would inappropriately reduce the foreign source income of consolidated groups that produce a natural resource abroad and sell it to customers within the United States. For example, assume that one member extracts a commodity

abroad and sells it to a second member, with title passing within a foreign country. The second member sells the commodity to unrelated customers with title passing in the United States. Assume that the first member's income is 80 percent of the group's income and would be treated solely as foreign source income under a separate entity approach. Under a single entity approach, the intercompany transaction is treated as occurring between divisions of a single corporation. If the special sourcing rule for production and sale of natural resources under the section 863 regulations does not apply because of "peculiar circumstances," the income of the group will be subject to the so-called 50/50 rule of the section 863 regulations, and a portion of the group's foreign source income could be recharacterized as domestic source. Revisions to the section 863 regulations are being considered to address these issues. The Treasury and the IRS welcome comments regarding possible revisions to the section 863 regulations.

Another commentator noted that under the single entity approach, a pro rata allocation of the group's foreign and U.S. source income (as illustrated in Example 17 of paragraph (c) of the proposed regulations) could cause a member that qualified as an "80/20" company under section 861(a)(1)(A) to lose that status. As a result, the member could be required to withhold Federal income tax on interest payments to a foreign lender. As indicated above, the final regulations revise the attribute rules to clarify that a redetermination is made only to the extent it is necessary to achieve the effect of treating S and B as divisions of a single corporation and to provide that redetermined attributes are allocated to S and B using a method that is reasonable in light of the purposes of § 1.1502-13 and any other affected rule. Thus, the group is not required to allocate U.S. and foreign source income on a pro rata basis, and a member that qualifies as an 80/20 company under current law generally need not lose that status solely as the result of the allocation from a transaction similar to that described in the example.

Commentators also suggested that the pro rata allocation methodology of the proposed regulations could be inconsistent with U.S. income tax treaties that require the United States to treat income that may be taxed by the treaty partner as derived from sources within the treaty partner. As revised, the attribute rules do not require the group to allocate U.S. and foreign source income on a pro rata basis. Thus, the regulations will generally be consistent

with any source rules contained in U.S. income tax treaties. To the extent, however, that a U.S. income tax treaty provides benefits to a taxpayer, these regulations do not prevent a taxpayer from claiming those benefits.

The final regulations expand the example to illustrate the determination of source if an independent factory or production price exists, and also for a sale of mixed source property within the group that is subsequently sold outside the group if, incident to the sale, services are performed by one member for another member or intangibles are licensed from one member to another member. Example 18 of paragraph (c) of the proposed regulations (Example 15 of the final regulations) addresses the application of section 1248 to intercompany transactions and has been revised to reflect the changes made to the attribute allocation provisions. Issue 3 of Rev. Rul. 87-96 (1987-2 C.B. 709) will no longer be applicable to the extent it is inconsistent with Example 15 and these regulations.

#### d. Limitation on attribute redetermination

The proposed regulations contain a provision limiting the treatment of S's intercompany income or gain as excluded from gross income under the matching rule to situations in which B's corresponding item is a deduction or loss that is permanently disallowed directly under other provisions of the Code or regulations. The final regulations clarify that the Code or regulations must explicitly provide for the disallowance of B's deduction or loss. Thus, B's amount that is realized but not recognized under any provision of the Code or regulations, such as in a liquidation under section 332, is not permanently and explicitly disallowed, notwithstanding that the amount may be considered a corresponding item because it is a "disallowed or eliminated amount."

#### 5. Deemed Items

The proposed regulations provide rules under which certain basis adjustments are deemed to be items, and certain amounts are deemed not to be items. Under the proposed regulations an adjustment reflected in S's basis that is a substitute for an intercompany item is generally treated as an intercompany item (the "deemed intercompany item rule"). An adjustment reflected in B's basis that is a substitute for a corresponding item is generally treated as a corresponding item (the "deemed corresponding item rule"). In addition, a deduction or loss is not treated as an intercompany item or a corresponding

item to the extent it does not reduce basis (the "amounts not deemed to be items rule"). Commentators found these rules to be confusing. In addition, the rules generally overlap with other rules of the proposed regulations.

For example, the deemed intercompany item rule overlaps with the rule of the proposed regulations under which S's items must be taken into account even if they have not yet been taken into account under S's separate entity accounting method. If, under its method of accounting, S's income from an intercompany transaction is treated as a basis reduction, both rules could apply.

Similarly, the deemed corresponding item rule overlaps with the acceleration rule. S's intercompany item is taken into account under the acceleration rule to the extent it will not be taken into account under the matching rule. Thus, an adjustment to B's basis may result in accelerating S's intercompany item to the extent the intercompany item is not reflected in B's basis following the adjustment. Because this is the same result that would occur under the deemed corresponding item rule, it is not necessary to treat the basis adjustment as a corresponding item under the matching rule. For example, B's reduction in the basis of property acquired from S under section 108(b) will cause S's intercompany gain to be accelerated to the extent the basis reduction exceeds S's basis in the property prior to the intercompany transaction.

The amounts deemed not to be items rule treats certain amounts that are within the definition of intercompany items as not being intercompany items to achieve a result consistent with these regulations and other Code provisions. Commentators indicated that this rule has limited application, does not achieve its desired effect in all cases, and is confusing to readers.

For these reasons, the deemed item rules and the amounts deemed not to be items rule have been eliminated in the final regulations. Because the deemed item rules overlap with other provisions, their effects have been retained in the final regulations. In addition, to achieve the intended effect of the amounts deemed not to be items rule, the attribute provisions of the final regulations have been modified to permit the Commissioner to treat intercompany gain as excluded from gross income when that treatment is consistent with these regulations and other applicable provisions of the Code.

#### 6. The Acceleration Rule

The acceleration rule requires S and B to take into account their items from an intercompany transaction to the extent the items cannot be taken into account to produce the effect of treating S and B as divisions of a single corporation. The acceleration rule applies, for example, when either S or B leaves the group. Under the proposed regulations, the attributes of S's items from intercompany property transactions are determined under the principles of the matching rule "as if B resold the property to a nonmember affiliate." Under this rule, S's gain from the sale of depreciable property is always treated as ordinary income under section 1239. This treatment is appropriate if the property remains in the group, as it would, for example, if the acceleration rule applies because S leaves the group. Many commentators objected to this treatment of S's attributes in other situations, arguing, for example, that if B leaves the group while it still owns the property, the rules should treat the property as sold to a person whose relationship to the group is the same as B's relationship to the group after it becomes a nonmember. The commentators argued that section 1239 should not apply if B is unrelated.

In response to these comments, the final regulations revise the acceleration rule to provide that if the property is owned by a nonmember immediately after the event causing acceleration occurs, S's attributes are determined under the principles of the matching rule as if B had sold the property to that nonmember. In applying this rule, if the nonmember is related for purposes of any provision of the Code or regulations to any party to the intercompany transaction (or any related transaction) or to P, the nonmember is treated as related to B for purposes of that provision. Accordingly, that relationship may affect the attributes of S's intercompany item.

Under both the prior regulations and the proposed regulations, if S sells an asset to B at a gain and B then transfers the asset to a partnership, S's gain is taken into account under the acceleration rule. Some commentators argued that gain should not be taken into account, at least to the extent of the member's share of the asset owned through the partnership, treating the partnership, in effect, as an aggregate of its partners, rather than as an entity. One commentator argued that continued deferral would be similar to the treatment currently available under the remedial allocation method under

§ 1.704-3 if appreciated property is transferred to the partnership without a prior intercompany transfer.

The final regulations retain the rule of the proposed regulations. One of the purposes of the acceleration rule is to prevent basis created in an intercompany transaction from affecting nonmembers prior to the time the group takes into account the transaction that created the basis. Allowing property that B purchased from S at a gain to be contributed to a partnership without acceleration would allow the basis created in the intercompany transaction to be reflected by the partnership prior to the group taking into account the gain. While rules could be developed to prevent this basis from affecting nonmembers in most circumstances, the rules would be unduly complex. For example, the rules would have to take into account the allocation of liabilities under section 752 and basis adjustments under section 755. Moreover, these rules would not resemble the remedial allocation method under § 1.704-3 but instead would more closely resemble the deferred sale method under the proposed regulations under section 704(c). However, this method was explicitly rejected when final regulations were issued. See § 1.704-3(a)(1).

#### 7. Transactions Involving Stock of Members

##### a. Single Entity Treatment of Stock

In contrast to their predominantly single entity approach, the proposed regulations generally retain separate entity treatment of stock of members. For example, section 1032, which enables a member to sell its own stock without recognition of gain or loss, is not extended to sales of the stock of other members. Notice 94-49 (1994-1 C.B. 358) discusses the difficulties of extending single entity treatment to stock.

Several comments recommended greater single entity treatment of stock. Some recommended a limited approach under which single entity treatment would apply only to stock of the common parent. Under this approach section-1032 treatment would be expanded so that any member could sell stock of the common parent without recognizing any gain or loss. As a corollary, gain or loss would be recognized when a corporation owning stock of the common parent joined the group, treating the stock, in effect, as redeemed.

This suggestion was generally not adopted in the final regulations, because single entity treatment of P stock would

significantly increase the complexity of the regulations and would require significant additional guidance dealing with the effect of this treatment on other provisions of the Code. For example, the regulations would have to coordinate single entity treatment of P stock with the reorganization provisions of the Code and applicable case law. Similarly, the regulations would have to address situations in which the common parent of the group changes, as well as a variety of collateral consequences.

Nevertheless, the Treasury and the IRS believe that limited single entity treatment of stock is needed to prevent disparities caused by separate entity treatment. Therefore, temporary regulations published elsewhere in this issue of the *Federal Register* provide a limited single entity approach to P stock that generally limits the ability of a group to create loss with respect to P stock and eliminates gain in certain circumstances. The feasibility of expanding single entity treatment for stock of members will continue to be studied. Comments and suggestions on this subject are welcome.

##### b. Liquidations

The proposed regulations provide that if S sells stock of a corporation (T) to B and T later liquidates into B in a transaction to which section 332 applies, S's intercompany gain is taken into account under the matching rule, even though the T stock is never held by a nonmember after the intercompany transaction. This treatment is similar to the treatment under prior regulations and has applied to liquidations under section 332 since 1966 and to deemed liquidations under 338(h)(10) since 1986, although the proposed regulations provide relief not previously available for these transactions.

Some commentators suggested that this rule should be eliminated because it could lead to two layers of tax inside the consolidated group. The final regulations, however, retain the rule (with the elective relief as described below). As more fully explained in Notice 94-49, the location of items within a group is a core principle underlying the operation of these regulations, which like the prior regulations, adopt a deferred sale approach, not a carryover basis approach. Taking intercompany gain into account in the event of a subsequent nonrecognition transaction is necessary to prevent the transfer and liquidation of subsidiaries from being used to affect consolidated taxable income or tax liability by changing the location of items within a group (a result that would be equivalent to a

carryover basis system). For example, assume that S has an asset with a zero basis and a \$100 value. The group would like to shift this built-in gain to B. To do so, S could transfer the asset to T, a newly formed subsidiary. After the transfer, S has a zero basis in the T stock under section 358, and T has a zero basis in the asset under section 362. S then sells the T stock to B for \$100 and realizes a \$100 gain, which is not taken into account. T later liquidates into B, which receives the asset with a zero basis under section 334. If the transaction is not recharacterized as a direct transfer of assets or is not subject to adjustment under section 482, and S's gain on the sale of the T stock is treated as tax-exempt (or if it is indefinitely deferred), the series of transactions has the effect of a transfer of the asset by S to B in a carryover basis transaction.

The Treasury and the IRS rejected a carryover basis system for the reasons detailed in Notice 94-49. While a carryover basis system might be feasible in limited circumstances, extensive rules to prevent avoidance transactions would be required. The result would be to burden the consolidated return regulations with an unworkable combination of rules for both a deferred sale approach and a carryover basis approach. Accordingly, the rule of the proposed regulations has been retained. The regulations have been modified, however, to permit S to determine the amount of its taxable gain by offsetting intercompany gain with intercompany loss on shares of stock having the same material terms.

#### c. Liquidation Relief

The proposed regulations provide elective relief that, in certain circumstances, eliminates or offsets gain taken into account under the matching rule as a result of a section 332 liquidation (or a comparable nonrecognition transaction, such as a downstream merger). In response to comments, the final regulations broaden the circumstances under which this relief is available by eliminating the requirements that T have no minority shareholders and that T not have made substantial noncash distributions during the previous 12-month period.

The available relief depends on the form of the transaction that causes S's intercompany gain to be taken into account. In the case of a liquidation of T under section 332, relief is provided by treating the formation by B of a new subsidiary (new T) as if it were pursuant to the same plan or arrangement as the liquidation (thus allowing treatment as a reorganization if other applicable requirements are met). The final

regulations expand the scope of this relief over that provided in the proposed regulations by allowing the transfer of assets to new T to be completed up to 12 months after the timely filing (including extensions) of the group's return for the year of T's liquidation, so long as the transaction occurs pursuant to a written plan, a copy of which is attached to the return. In the case of a deemed liquidation of T as the result of an election under section 338(h)(10) in connection with B's sale of the T stock to a nonmember, relief is provided by treating the deemed liquidation as if it were governed by section 331 instead of section 332. The amount of loss taken into account on the deemed liquidation is limited to the amount of the intercompany gain with respect to the T stock that is taken into account as a result of the deemed liquidation.

Some commentators requested that the relief applicable for a deemed liquidation resulting from a section 338(h)(10) election be extended to actual liquidations under section 332—that is, the liquidation would be a taxable event both to T and to B (with T's gain or loss not deferred, and B's basis in the T stock adjusted under § 1.1502-32 to reflect T's gain or loss from the taxable liquidation). This suggestion was not adopted. The suggestion would result in the group currently taking into account gain from, and increasing the basis of, property that continues to be held within the group. Adopting the commentators' suggestion could give groups the ability to selectively avoid the deferral of gain on intercompany transactions by instead engaging in stock sales and liquidations. Such selectivity would be contrary to the purpose of these regulations and could create the potential for abusive transactions.

#### d. Effective Date of Relief Provisions

As proposed, the effective date of the relief provisions follows the general effective date of the regulations, applying only if both the intercompany transaction and the triggering event occur in years beginning after the final regulations are filed with the **Federal Register**. Commentators requested retroactive application of the relief provisions to varying degrees. For example, some commentators suggested that the relief should extend to transactions after the date the regulations are finalized. Others suggested that the relief should apply for any open year.

In response to these comments, the final regulations adopt an effective date that allows groups to elect to apply the relief provisions to certain transactions

that occur on or after July 12, 1995, regardless of whether the sale of the T stock from S to B occurred prior to July 12, 1995.

The final regulations neither provide relief for duplicated gains nor preclude losses taken into account under the prior regulations in periods prior to the effective date of the regulations. Broader retroactivity would result in significant additional administrative burdens for the IRS. In addition to an increase in amended returns, taxpayers that made elections to avoid triggering S's gain (for example, under section 338) might seek to revoke these elections. Revocation of these elections could raise difficult valuation issues for assets that were disposed of long ago, as well as questions with respect to other rules that have since been amended. In addition, relief for prior years would be somewhat arbitrary. For example, many taxpayers, such as those whose gain was taken into account from a liquidation of T into B, would be unable to benefit from the relief (because the relief requires T to be reformed within a limited time period). By allowing elective relief only for transactions occurring after the date the regulations are filed, the final regulations provide the most relief possible without creating these problems.

### 8. Obligations of Members

#### a. Deemed Satisfaction and Reissuance

In addition to the general matching provisions, the proposed regulations provide rules applicable to intercompany obligations that generally operate to match an obligor's items with an obligee's items from intercompany obligations. This matching results from a deemed satisfaction and reissuance of an intercompany obligation when either member realizes income or loss with respect to the intercompany obligation from the assignment or extinguishment of all or part of the remaining rights or obligations under the intercompany obligation, or from a comparable transaction, such as marking to market. For example, if one member is a dealer in securities that holds a security issued by another member, the dealer might be required to market the security issued by the other member at year-end under section 475. Under the proposed regulations, to market the other member's security will result in a deemed satisfaction and reissuance of the security, so that the marking member and the issuing member take offsetting gain and loss into account.

Commentators objected to the deemed satisfaction and reissuance provision as requiring significant recordkeeping and



burdensome computations that are not required for financial statement or internal management reporting purposes. Commentators suggested that Prop. Reg. § 1.446-4(e)(9) (published in the *Federal Register* on July 18, 1994, 59 FR 30394), which permits separate entity treatment for certain hedging transactions between members, should be extended beyond hedging transactions to other intercompany obligations, provided one party to the transaction marks its position to market. Separate entity treatment would avoid the deemed satisfaction and reissuance rule if one member is a dealer in securities required to mark its securities to market.

The final regulations do not adopt this suggestion. The rules of § 1.446-4 limit the nonmarking member's ability to selectively recognize gain or loss on its position in the intercompany obligation. Without a limitation of this type, separate entity treatment would allow taxpayers to achieve results that are contrary to the purposes of these regulations (for example, by allowing a member to mark a loss position in an intercompany obligation while the other member defers realization of the associated gain). Accordingly, separate entity treatment is not made available in the final regulations to other types of intercompany obligations.

The Treasury and the IRS recognize that Prop. Reg. § 1.446-4(e)(9) provides an important exception to the general single entity treatment of these final regulations. The Treasury and the IRS anticipate that the proposed section 446 regulations will be finalized shortly.

#### b. Cancellation of Intercompany Indebtedness

The proposed regulations do not affect the application of section 108 to the cancellation of intercompany indebtedness. For example, under the proposed regulations if S loans money to B, a cancellation of the loan subject to section 108(a) may result in: (i) excluded income to B; (ii) a noncapital, nondeductible expense to S (under the matching rule); and (iii) a reduction of B's tax attributes (such as its basis in depreciable property). As a result, B's tax attributes are reduced even though the group has not excluded any income on a net basis. Accordingly, the final regulations provide that section 108(a) does not apply to the cancellation of intercompany indebtedness. As a result of this change, the general principles of the matching rule will prevent transactions to which section 108(a) would otherwise apply from having inappropriate effects on basis and consolidated taxable income. In the

preceding example, S and B will have offsetting ordinary income and ordinary loss, and B's tax attributes will not be reduced. However, no inference is intended as to whether the extinguishment of a loan between S and B would be properly characterized as a transaction giving rise to cancellation of indebtedness income within the meaning of sections 61(a)(12) and 108, or as a contribution to capital, a dividend or other transaction.

#### c. Obligations Becoming Intercompany Obligations

Under the proposed regulations, if an obligation becomes an intercompany obligation, it is treated as satisfied and reissued immediately after the obligation becomes an intercompany obligation. This treatment applies to both the issuer and the holder. The attributes of the issuer's items and the holder's items are separately determined, and thus may not match. Commentators requested that the rules be revised to allow for single entity treatment of attributes, to avoid the mismatch of ordinary income with capital loss.

This suggestion was not adopted. The use of separate return attributes for gain and loss assures that the attributes of gain or loss will be the same whether the obligation is retired immediately before the transaction in which the obligation becomes an intercompany obligation, or is deemed retired as a result of that transaction. Providing for the use of single entity attributes would result in undue selectivity. In addition, the separate entity treatment of attributes in these circumstances best reflects the fact that the income and loss taken into account accrued before the issuer and the holder joined in filing a consolidated return.

Commentators also noted that, under § 1.1502-32, downward stock basis adjustments would be required upon the expiration of any capital losses created by the deemed satisfaction if a member joins the group while holding an obligation of another member. Because the proposed regulations provide that the deemed satisfaction and reissuance is treated as occurring immediately after the obligation becomes an intercompany obligation, these losses could not be waived under § 1.1502-32(b)(4). In response to this comment, the final regulations provide that, solely for purposes of § 1.1502-32(b)(4) and the effect of any elections under that provision, the joining member's loss from the deemed satisfaction and reissuance is treated as a loss carryover from a separate return limitation year. Thus, the group may elect to waive the

capital losses and avoid the downward basis adjustment.

#### d. Warrants and Similar Instruments

The proposed regulations do not provide special rules for the treatment of warrants to acquire a member's stock. The proposed regulations could, however, be read to include warrants within the definition of intercompany obligations.

Under section 1032, warrants and other positions in stock of the issuer are treated like stock. See, for example, Rev. Rul. 88-31, 1988-1 C.B. 302. The treatment of warrants as intercompany obligations subject to a single entity regime is inconsistent with the general separate entity treatment of stock under these regulations. Accordingly, the final regulations provide that warrants and other positions with respect to a member's stock are not treated as obligations of that member. Instead, these instruments are governed by the rules generally applicable to stock of a member. In addition, the final regulations provide that the deemed satisfaction and reissuance rule for intercompany obligations will not apply to the conversion of an intercompany obligation into the stock of the obligor.

#### 9. Anti-avoidance Rule

The purpose of the intercompany transaction regulations is to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability). The proposed regulations provide that transactions which are engaged in or structured with a principal purpose to achieve a contrary result are subject to adjustment under the anti-avoidance rule, notwithstanding compliance with other applicable authorities. Some commentators criticized this rule as being overly broad, unnecessary, and more appropriately placed in other regulations, such as § 1.701-2 (the partnership anti-abuse regulation). Other commentators supported the use of anti-avoidance rules but criticized the particular examples. The Treasury and the IRS continue to believe that the anti-avoidance rule is necessary to prevent transactions that are designed to achieve results inconsistent with the purpose of the regulations and therefore the final regulations retain the rule. Routine intercompany transactions that are undertaken for legitimate business purposes generally will be unaffected by the anti-avoidance rule.

The anti-avoidance provision can apply to transactions that are structured

to avoid treatment as intercompany transactions. For example, if property is indirectly transferred from one member to another using a nonmember intermediary to achieve a result that could not be achieved by a direct transfer within the group, the anti-avoidance rule might apply. Thus, transactions that take place indirectly between members but are not intercompany transactions (including, for example, transactions involving the use of fungible property, trusts, partnerships, and intermediaries) will be analyzed to determine whether they are substantially similar (in whole or in part) to an intercompany transaction, in which case the anti-avoidance rule might apply.

The examples from the proposed regulations have been revised to better illustrate the effect of the anti-avoidance rule. Example 2 of the proposed regulations, which involved a transfer outside of the group to a partnership, has been eliminated. However, the transaction described in that example, as with any other transaction, is subject to challenge under other authorities. See, for example, § 1.701-2.

#### 10. Transitional Anti-avoidance Rule

To prevent manipulation, the proposed regulations provide that if a transaction is engaged in or structured on or after April 8, 1994, with a principal purpose to avoid the final regulations, to duplicate, omit, or eliminate an item in determining taxable income (or tax liability), or to treat items inconsistently, appropriate adjustments must be made in years to which the final regulations apply to prevent the avoidance, duplication, omission, elimination, or inconsistency.

Commentators objected to this rule, arguing that it had the effect of treating the proposed regulation as an immediately effective temporary regulation. These commentators also raised questions as to when the rule applies and what "appropriate adjustments" will be necessary.

Because of the prospective application of the regulations, and particularly because members could otherwise engage in transactions entirely within the group with a principal purpose to avoid the application of the final regulations with almost no transaction costs, this rule is retained in the final regulations, with minor clarifications.

#### 11. Dealers in Securities

If S is a dealer in securities under section 475 and sells securities to B, a nondealer, the proposed regulations require S to treat any gain or loss on the

sale as an intercompany item. Furthermore, under the single entity approach of the matching rule, B must continue to mark to market securities acquired from S.

Several commentators argued that this approach is inconsistent with proposed regulations under section 475, which require S to mark to market the security immediately before the transfer, and take any gain or loss into account immediately (that is, the gain or loss is not subject to deferral under the prior intercompany transaction regulations).

Although the rules applicable to these types of transactions under the proposed regulations and the proposed section 475 regulations differ, the effects of these transactions on consolidated taxable income are generally the same. That is, the dealer's gain or loss is taken into account in the taxable year of the transfer.

The approach of the proposed intercompany transaction regulations is consistent with the general single entity principle, and has been retained in the final regulations. Nevertheless, the Treasury and the IRS will continue to consider the most appropriate treatment of these transactions, in view of the underlying purposes of these regulations and section 475. The Treasury and the IRS anticipate that upcoming regulations under section 475 will address any remaining inconsistencies in the approach, and will provide exceptions to the single entity approach if appropriate. Comments and suggestions on this subject are welcome.

#### 12. Changes to Section 267 Regulations

The proposed regulations under section 267(f) generally provide that losses from sales or exchanges of property between related parties are taken into account in the same manner as is provided in the timing provisions of the regulations under § 1.1502-13. Several technical changes have been incorporated into the final regulations under section 267.

For example, the regulations clarify that to the extent S's loss would have been treated as a noncapital, nondeductible amount under the attribute rules of the regulations under § 1.1502-13, the loss is deferred under section 267(f) until S and B are no longer in a controlled group relationship with each other. Section 267 is intended to prevent a taxpayer from taking a loss into account from the sale or exchange of property when the property continues to be held by a member of the same controlled group. Under § 1.1502-13, S's loss might be taken into account but redetermined to be noncapital or

nondeductible, permanently preventing the loss from being taken into account. It could be argued that this is the result of the attribute provisions of § 1.1502-13, which do not apply under section 267(f), nor a result of the timing provisions of § 1.1502-13, and thus, a controlled group member could take its loss into account. The change made in the final regulations assures that the purpose of section 267 is not defeated as a result of the non-application of the attribute redetermination rules of § 1.1502-13 for purposes of section 267(f).

The proposed regulations also require loss deferral similar to section 267(d) when B transfers property acquired at a loss from S to a nonmember related party. This provision has been modified in the final regulations to include parties described in section 707(b) as related parties to prevent avoidance of the rules of section 267 through the use of related partnerships.

#### 13. Election to Deconsolidate

Section 1.1502-75 authorizes the Commissioner to grant all groups, or groups in a particular class, permission to discontinue filing consolidated returns if any provision of the Code or regulations has been amended and the amendment could have a substantial adverse effect relative to the filing of separate returns. The Commissioner has determined that it is generally appropriate to grant permission to discontinue filing consolidated returns as a result of the amendments made in these regulations. To lessen taxpayer burden and ease administrability, permission will be granted without requiring the group to demonstrate any adverse effect. The Treasury and the IRS intend to issue, prior to January 1, 1996, a revenue procedure pursuant to which groups may receive permission to deconsolidate effective for their first taxable year to which these regulations apply. Permission for a group to deconsolidate will be granted under terms and conditions similar to those prescribed in Rev. Proc. 95-11 (1995-4 I.R.B. 48).

#### D. Effective Dates

The regulations are effective in years beginning on or after July 12, 1995. For dates of applicability, see § 1.1502-13(l).

#### E. Special Analyses

It has been determined that this Treasury Decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations do not have a significant economic impact on



a substantial number of small entities. This certification is based on the fact that these regulations will primarily affect affiliated groups of corporations that have elected to file consolidated returns, which tend to be larger businesses. The regulations also govern certain transactions between members of controlled groups of corporations, but generally produce the same results for such transactions as current law. The regulations do not significantly alter the reporting or recordkeeping duties of small entities. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

**List of Subjects**

**26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

**26 CFR Part 602**

Reporting and recordkeeping requirements.

**Adoption of Amendments to the Regulations**

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

**PART 1—INCOME TAXES**

Paragraph 1. The authority citation for part 1 is amended by revising the entries for §§ 1.1502-13, 1.1502-33, and 1.1502-80, as set forth below; by removing the entries for sections "1.469-1", "1.469-1T", "1.1502-13T", "1.1502-14", and "1.1502-14T"; and adding the remaining entries in numerical order to read as follows:

- Authority: 26 U.S.C. 7805 \* \* \*
- Section 1.108-3 also issued under 26 U.S.C. 108, 267, and 1502. \* \* \*
- Section 1.267(f)-1 also issued under 26 U.S.C. 267 and 1502. \* \* \*
- Section 1.460-4 also issued under 26 U.S.C. 460 and 1502. \* \* \*
- Section 1.469-1 also issued under 26 U.S.C. 469. \* \* \*

- Section 1.469-1T also issued under 26 U.S.C. 469. \* \* \*
- Section 1.1502-13 also issued under 26 U.S.C. 108, 337, 446, 1275, 1502 and 1503. \* \* \*
- Section 1.1502-17 also issued under 26 U.S.C. 446 and 1502.
- Section 1.1502-18 also issued under 26 U.S.C. 1502. \* \* \*
- Section 1.1502-26 also issued under 26 U.S.C. 1502. \* \* \*
- Section 1.1502-33 also issued under 26 U.S.C. 1502. \* \* \*
- Section 1.1502-79 also issued under 26 U.S.C. 1502. \* \* \*
- Section 1.1502-80 also issued under 26 U.S.C. 1502. \* \* \*

**Par. 2.** In the list below, for each location indicated in the left column, remove the language in the middle column from that section, and add the language in the right column.

Affected section	Remove	Add
1.167(a)-(11)(d)(3)(v)(b), 1st sentence	which results in "deferred gain or loss" within the meaning of paragraph (c) of 1.1502-13, 1.1502-13, and 1.1502-14	and 1.1502-13
1.167(c)-1(a)(5)	a deferred intercompany transaction	an intercompany transaction
1.263A-1T(b)(2)(v)(B), 2nd sentence	a deferred intercompany transaction	an intercompany transaction
1.263A-1T(e)(1)(ii), 1st sentence	1.1502-13(c)(2)	1.1502-13
1.263A-1T(e)(1)(ii), 4th sentence	deferred	
1.263A-1T(e)(1)(ii), 7th sentence	"deferred intercompany transaction"	"intercompany transaction"
1.263A-1T(e)(1)(ii), 7th sentence	defined	as used
1.263A-1T(e)(1)(iii)(A) Example, 2nd sentence	1.1502-13(c)	1.1502-13
1.263A-1T(e)(1)(iii)(A) Example, 4th sentence	1.1502-13(c)	1.1502-13
1.279-8(b)(4)	, § 1.1502-13T, § 1.1502-14, or § 1.1502-14T.	
1.337(d)-1(a)(5) Example 8(i), 5th sentence	1.1502-13(c)	1.1502-13
1.337(d)-1(a)(5) Example 8(ii), 1st sentence	1.1502-13(c)	1.1502-13
1.337(d)-1(a)(5) Example 8(ii), 2nd sentence	1.1502-13(f)(1)(i), 1.267(f)-2T(e)(1)	1.1502-13, 1.267(f)-1
1.337(d)-2(g)(1), 2nd sentence	1.1502-13T, 1.1502-14, and 1.1502-14T	and 1.1502-14 (as contained in the 26 CFR part 1 edition revised as of April 1, 1995)
1.338-4(f)(4) Example (2)(a)	1.1502-13(f)	1.1502-13
1.341-7(e)(10)	paragraph (c)(1) of § 1.1502-14 for the deferral.	§ 1.1502-13 for the treatment
1.861-8T(d)(2)(i), concluding text	1.1502-13(c)(2)	1.1502-13
1.861-8T(d)(2)(i), concluding text	deferred.	
1.861-8T(d)(2)(i), concluding text	1.1502-13(a)(2)	1.1502-13
1.861-9T(g)(2)(iv), paragraph heading	deferred.	
1.861-9T(g)(2)(iv), 1st sentence	deferred intercompany transactions	intercompany transactions
1.1502-3(a)(2)	1.1502-13(a)(1)	1.1502-13(b)
1.1502-4(j) Example (1), 8th sentence	Under § 1.1502-13	Under § 1.1502-13 (as contained in the 26 CFR part 1 edition revised as of April 1, 1995)
1.1502-9(f) Example (6)	a restoration event under section 1.1502-13(f) occurs.	the intercompany gain is taken into account under § 1.1502-13
1.1502-12(a)	§§ 1.1502-13 and 1.1502-14	§ 1.1502-13
1.1502-12(g)(2)	a deferred intercompany transaction as defined in § 1.1502-13(a)(2).	an intercompany transaction as defined in § 1.1502-13
1.1502-22(a)(3)	1.1502-14,	
1.1502-22(a)(5) Example (i)	paragraph (d), (e), or (f) of § 1.1502-13	§ 1.1502-13
1.1502-26(b), second sentence	paragraph (a)(1) of § 1.1502-14	§ 1.1502-13
1.1502-47(e)(4)(iii), first sentence	§§ 1.1502-13(f), 1.1502-14,	§§ 1.1502-13,
1.1502-47(e)(4)(iv) Example 4, third sentence	deferred intercompany transactions (see § 1.1502-13(a)(2)).	intercompany transactions (see § 1.1502-13)
1.1502-47(e)(4)(iv) Example 4, fourth sentence	1.1502-13(f)(1)(iv)	1.1502-13
1.1502-47(e)(4)(iv) Example 4, chart header	Deferred intercompany transactions between	Intercompany transactions between

Affected section	Remove	Add
1.1502-47(e)(4)(iv) <i>Example 4</i> , chart header ....	1.1502-13(f)(1)(iv) .....	1.1502-13
1.1502-47(f)(3), first sentence .....	1.1502-14, .....	
1.1502-47(f), second sentence .....	deferred.	
1.1503-2(d)(4) <i>Example 1</i> (iii), fourth sentence	deferred.	
1.1503-2(d)(4) <i>Example 1</i> (iii), fourth sentence	1.1502-13(a)(2) .....	1.1502-13
1.1552-1(a)(2)(ii)(c) .....	1.1502-14 .....	1.1502-13 (f) and (g)

**Par. 3.** Section 1.108-3 is added to read as follows:

**§ 1.108-3 Intercompany losses and deductions.**

(a) *General rule.* This section applies to certain losses and deductions from the sale, exchange, or other transfer of property between corporations that are members of a consolidated group or a controlled group (an intercompany transaction). See section 267(f) (controlled groups) and § 1.1502-13 (consolidated groups) for applicable definitions. For purposes of determining the attributes to which section 108(b) applies, a loss or deduction not yet taken into account under section 267(f) or § 1.1502-13 (an intercompany loss or deduction) is treated as basis described in section 108(b) that the transferor retains in property. To the extent a loss not yet taken into account is reduced under this section, it cannot subsequently be taken into account under section 267(f) or § 1.1502-13. For example, if S and B are corporations filing a consolidated return, and S sells land with a \$100 basis to B for \$90 and the \$10 loss is deferred under section 267(f) and § 1.1502-13, the deferred loss is treated for purposes of section 108(b) as \$10 of basis that S has in land (even though S has no remaining interest in the land sold to B) and is subject to reduction under section 108(b)(2)(E). Similar principles apply, with appropriate adjustments, if S and B are members of a controlled group and S's loss is deferred only under section 267(f).

(b) *Effective date.* This section applies with respect to discharges of indebtedness occurring on or after September 11, 1995.

**§ 1.167(a)-11 [Amended]**

**Par. 4.** Section 1.167(a)-11(d)(3)(v)(e) is amended by removing the second sentence of *Example (3)*.

**Par. 5.** In § 1.263A-1, paragraph (j)(1)(ii)(B), the last sentence is revised to read as follows:

**§ 1.263A-1 Uniform capitalization of costs.**

- \* \* \* \* \*
- (j) \* \* \*
- (1) \* \* \*
- (ii) \* \* \*

(B) \* \* \* See § 1.1502-13.

\* \* \* \* \*

**Par. 6.** Section 1.267(f)-1 is revised to read as follows: *§ 1.267(f)-1 Controlled groups.*

(a) *In general—(1) Purpose.* This section provides rules under section 267(f) to defer losses and deductions from certain transactions between members of a controlled group (intercompany sales). The purpose of this section is to prevent members of a controlled group from taking into account a loss or deduction solely as the result of a transfer of property between a selling member (S) and a buying member (B).

(2) *Application of consolidated return principles.* Under this section, S's loss or deduction from an intercompany sale is taken into account under the *timing* principles of § 1.1502-13 (intercompany transactions between members of a consolidated group), treating the intercompany sale as an intercompany transaction. For this purpose:

(i) The matching and acceleration rules of § 1.1502-13 (c) and (d), the definitions and operating rules of § 1.1502-13 (b) and (j), and the simplifying rules of § 1.1502-13(e)(1) apply with the adjustments in paragraphs (b) and (c) of this section to reflect that this section—

(A) Applies on a controlled group basis rather than consolidated group basis; and

(B) Generally affects only the *timing* of a loss or deduction, and not its *attributes* (e.g., its source and character) or the holding period of property.

(ii) The special rules under § 1.1502-13(f) (stock of members) and (g) (obligations of members) apply under this section only to the extent the transaction is also an intercompany transaction to which § 1.1502-13 applies.

(iii) Any election under § 1.1502-13 to take items into account on a separate entity basis does not apply under this section. See § 1.1502-13(e)(3).

(3) *Other law.* The rules of this section apply in addition to other applicable law (including nonstatutory authorities). For example, to the extent a loss or deduction deferred under this section is from a transaction that is also an intercompany transaction under

§ 1.1502-13(b)(1), attributes of the loss or deduction are also subject to recharacterization under § 1.1502-13. See also, sections 269 (acquisitions to evade or avoid income tax) and 482 (allocations among commonly controlled taxpayers). Any loss or deduction taken into account under this section can be deferred, disallowed, or eliminated under other applicable law. See, for example, section 1091 (loss eliminated on wash sale).

(b) *Definitions and operating rules.* The definitions in § 1.1502-13(b) and the operating rules of § 1.1502-13(j) apply under this section with appropriate adjustments, including the following:

(1) *Intercompany sale.* An intercompany sale is a sale, exchange, or other transfer of property between members of a controlled group, if it would be an intercompany transaction under the principles of § 1.1502-13, determined by treating the references to a consolidated group as references to a controlled group and by disregarding whether any of the members join in filing consolidated returns.

(2) *S's losses or deductions.* Except to the extent the intercompany sale is also an intercompany transaction to which § 1.1502-13 applies, S's losses or deductions subject to this section are determined on a separate entity basis. For example, the principles of § 1.1502-13(b)(2)(iii) (treating certain amounts not yet recognized as items to be taken into account) do not apply. A loss or deduction is from an intercompany sale whether it is directly or indirectly from the intercompany sale.

(3) *Controlled group; member.* For purposes of this section, a controlled group is defined in section 267(f). Thus, a controlled group includes a FSC (as defined in section 922) and excluded members under section 1563(b)(2), but does not include a DISC (as defined in section 992). Corporations remain members of a controlled group as long as they remain in a controlled group relationship with each other. For example, corporations become nonmembers with respect to each other when they cease to be in a controlled group relationship with each other, rather than by having a separate return year (described in § 1.1502-13(j)(7)).

Further, the principles of § 1.1502-13(j)(6) (former common parent treated as continuation of group) apply to any corporation if, immediately before it becomes a nonmember, it is both the selling member and the owner of property with respect to which a loss or deduction is deferred (whether or not it becomes a member of a different controlled group filing consolidated or separate returns). Thus, for example, if S and B merge together in a transaction described in section 368(a)(1)(A), the surviving corporation is treated as the successor to the other corporation, and the controlled group relationship is treated as continuing.

(4) *Consolidated taxable income.* References to consolidated taxable income (and consolidated tax liability) include references to the combined taxable income of the members (and their combined tax liability). For corporations filing separate returns, it ordinarily will not be necessary to actually combine their taxable incomes (and tax liabilities) because the taxable income (and tax liability) of one corporation does not affect the taxable income (or tax liability) of another corporation.

(c) *Matching and acceleration principles of § 1.1502-13—(1) Adjustments to the timing rules.* Under this section, S's losses and deductions are deferred until they are taken into account under the timing principles of the matching and acceleration rules of § 1.1502-13(c) and (d) with appropriate adjustments. For example, if S sells depreciable property to B at a loss, S's loss is deferred and taken into account under the principles of the matching rule of § 1.1502-13(c) to reflect the difference between B's depreciation taken into account with respect to the property and the depreciation that B would take into account if S and B were divisions of a single corporation; if S and B subsequently cease to be in a controlled group relationship with each other, S's remaining loss is taken into account under the principles of the acceleration rule of § 1.1502-13(d). For purposes of this section, the adjustments to § 1.1502-13 (c) and (d) include the following:

(i) *Application on controlled group basis.* The matching and acceleration rules apply on a controlled group basis, rather than a consolidated group basis. Thus if S and B are wholly-owned members of a consolidated group and 21% of the stock of S is sold to an unrelated person, S's loss continues to be deferred under this section because S and B continue to be members of a controlled group even though S is no longer a member of the consolidated

group. Similarly, S's loss would continue to be deferred if S and B remain in a controlled group relationship after both corporations become nonmembers of their former consolidated group.

(ii) *Different taxable years.* If S and B have different taxable years, the taxable years that include a December 31 are treated as the same taxable years. If S or B has a short taxable year that does not include a December 31, the short year is treated as part of the succeeding taxable year that does include a December 31.

(iii) *Transfer to a section 267(b) or 707(b) related person.* To the extent S's loss or deduction from an intercompany sale of property is taken into account under this section as a result of B's transfer of the property to a nonmember that is a person related to any member, immediately after the transfer, under sections 267(b) or 707(b), or as a result of S or B becoming a nonmember that is related to any member under section 267(b) (for example, if S or B becomes an S corporation), the loss or deduction is taken into account but allowed only to the extent of any income or gain taken into account as a result of the transfer. The balance not allowed is treated as a loss referred to in section 267(d) if it is from a sale or exchange by B (rather than from a distribution).

(iv) *B's item is excluded from gross income or noncapital and nondeductible.* To the extent S's loss would be redetermined to be a noncapital, nondeductible amount under the principles of § 1.1502-13 but is not redetermined because of paragraph (c)(2) of this section, then, if paragraph (c)(1)(iii) of this section does not apply, S's loss continues to be deferred and is not taken into account until S and B are no longer in a controlled group relationship. For example, if S sells all of the stock of corporation T to B at a loss and T subsequently liquidates into B in a transaction qualifying under section 332, S's loss is deferred until S and B (including their successors) are no longer in a controlled group relationship. See § 1.1502-13(c)(6)(ii).

(v) *Circularity of references.* References to deferral or elimination under the Internal Revenue Code or regulations do not include references to section 267(f) or this section. See, e.g., § 1.1502-13(a)(4) (applicability of other law).

(2) *Attributes generally not affected.* The matching and acceleration rules are not applied under this section to affect the attributes of S's intercompany item, or cause it to be taken into account before it is taken into account under S's separate entity method of accounting.

However, the attributes of S's intercompany item may be redetermined, or an item may be taken into account earlier than under S's separate entity method of accounting, to the extent the transaction is also an intercompany transaction to which § 1.1502-13 applies. Similarly, except to the extent the transaction is also an intercompany transaction to which § 1.1502-13 applies, the matching and acceleration rules do not apply to affect the timing or attributes of B's corresponding items.

(d) *Intercompany sales of inventory involving foreign persons—(1) General rule.* Section 267(a)(1) and this section do not apply to an intercompany sale of property that is inventory (within the meaning of section 1221(1)) in the hands of both S and B, if—

(i) The intercompany sale is in the ordinary course of S's trade or business;

(ii) S or B is a foreign corporation; and

(iii) Any income or loss realized on the intercompany sale by S or B is not income or loss that is recognized as effectively connected with the conduct of a trade or business within the United States within the meaning of section 864 (unless the income is exempt from taxation pursuant to a treaty obligation of the United States).

(2) *Intercompany sales involving related partnerships.* For purposes of paragraph (d)(1) of this section, a partnership and a foreign corporation described in section 267(b)(10) are treated as members, provided that the income or loss of the foreign corporation is described in paragraph (d)(1)(iii) of this section.

(3) *Intercompany sales in ordinary course.* For purposes of this paragraph (d), whether an intercompany sale is in the ordinary course of business is determined under all the facts and circumstances.

(e) *Treatment of a creditor with respect to a loan in nonfunctional currency.* Sections 267(a)(1) and this section do not apply to an exchange loss realized with respect to a loan of nonfunctional currency if—

(1) The loss is realized by a member with respect to nonfunctional currency loaned to another member;

(2) The loan is described in § 1.988-1(a)(2)(i);

(3) The loan is not in a hyperinflationary currency as defined in § 1.988-1(f); and

(4) The transaction does not have as a significant purpose the avoidance of Federal income tax.

(f) *Receivables.* If S acquires a receivable from the sale of goods or services to a nonmember at a gain, and S sells the receivable at fair market

value to B, any loss or deduction of S from its sale to B is not deferred under this section to the extent it does not exceed S's income or gain from the sale to the nonmember that has been taken into account at the time the receivable is sold to B.

(g) *Earnings and profits.* A loss or deduction deferred under this section is not reflected in S's earnings and profits before it is taken into account under this section. See, e.g., §§ 1.312-6(a), 1.312-7, and 1.1502-33(c)(2).

(h) *Anti-avoidance rule.* If a transaction is engaged in or structured with a principal purpose to avoid the purposes of this section (including, for example, by avoiding treatment as an intercompany sale or by distorting the timing of losses or deductions), adjustments must be made to carry out the purposes of this section.

(i) [Reserved]

(j) *Examples.* For purposes of the examples in this paragraph (j), unless otherwise stated, corporation P owns 75% of the only class of stock of subsidiaries S and B, X is a person unrelated to any member of the P controlled group, the taxable year of all persons is the calendar year, all persons use the accrual method of accounting, tax liabilities are disregarded, the facts set forth the only activity, and no member has a special status. If a member acts as both a selling member and a buying member (e.g., with respect to different aspects of a single transaction, or with respect to related transactions), the member is referred as to M (rather than as S or B). This section is illustrated by the following examples.

*Example 1. Matching and acceleration rules.* (a) *Facts.* S holds land for investment with a basis of \$130. On January 1 of Year 1, S sells the land to B for \$100. On a separate entity basis, S's loss is long-term capital loss. B holds the land for sale to customers in the ordinary course of business. On July 1 of Year 3, B sells the land to X for \$110.

(b) *Matching rule.* Under paragraph (b)(1) of this section, S's sale of land to B is an intercompany sale. Under paragraph (c)(1) of this section, S's \$30 loss is taken into account under the timing principles of the matching rule of § 1.1502-13(c) to reflect the difference for the year between B's corresponding items taken into account and the recomputed corresponding items. If S and B were divisions of a single corporation and the intercompany sale were a transfer between the divisions, B would succeed to S's \$130 basis in the land and would have a \$20 loss from the sale to X in Year 3. Consequently, S takes no loss into account in Years 1 and 2, and takes the entire \$30 loss into account in Year 3 to reflect the \$30 difference in that year between the \$10 gain B takes into account and its \$20 recomputed loss. The attributes of S's intercompany items and B's

corresponding items are determined on a separate entity basis. Thus, S's \$30 loss is long-term capital loss and B's \$10 gain is ordinary income.

(c) *Acceleration resulting from sale of B stock.* The facts are the same as in paragraph (a) of this *Example 1*, except that on July 1 of Year 3 P sells all of its B stock to X (rather than B's selling the land to X). Under paragraph (c)(1) of this section, S's \$30 loss is taken into account under the timing principles of the acceleration rule of § 1.1502-13(d) immediately before the effect of treating S and B as divisions of a single corporation cannot be produced. Because the effect cannot be produced once B becomes a nonmember, S takes its \$30 loss into account in Year 3 immediately before B becomes a nonmember. S's loss is long-term capital loss.

(d) *Subgroup principles applicable to sale of S and B stock.* The facts are the same as in paragraph (a) of this *Example 1*, except that on July 1 of Year 3 P sells all of its S and B stock to X (rather than B's selling the land to X). Under paragraph (b)(3) of this section, S and B are considered to remain members of a controlled group as long as they remain in a controlled group relationship with each other (whether or not in the original controlled group). P's sale of their stock does not affect the controlled group relationship of S and B with each other. Thus, S's loss is not taken into account as a result of P's sale of the stock. Instead, S's loss is taken into account based on subsequent events (e.g., B's sale of the land to a nonmember).

*Example 2. Distribution of loss property.*

(a) *Facts.* S holds land with a basis of \$130 and value of \$100. On January 1 of Year 1, S distributes the land to P in a transaction to which section 311 applies. On July 1 of Year 3, P sells the land to X for \$110.

(b) *No loss taken into account.* Under paragraph (b)(2) of this section, because P and S are not members of a consolidated group, § 1.1502-13(f)(2)(iii) does not apply to cause S to recognize a \$30 loss under the principles of section 311(b). Thus, S has no loss to be taken into account under this section. (If P and S were members of a consolidated group, § 1.1502-13(f)(2)(iii) would apply to S's loss in addition to the rules of this section, and the loss would be taken into account in Year 3 as a result of P's sale to X.)

*Example 3. Loss not yet taken into account under separate entity accounting method.* (a) *Facts.* S holds land with a basis of \$130. On January 1 of Year 1, S sells the land to B at a \$30 loss but does not take into account the loss under its separate entity method of accounting until Year 4. On July 1 of Year 3, B sells the land to X for \$110.

(b) *Timing.* Under paragraph (b)(2) of this section, S's loss is determined on a separate entity basis. Under paragraph (c)(1) of this section, S's loss is not taken into account before it is taken into account under S's separate entity method of accounting. Thus, although B takes its corresponding gain into account in Year 3, S has no loss to take into account until Year 4. Once S's loss is taken into account in Year 4, it is not deferred under this section because B's corresponding gain has already been taken into account. (If

S and B were members of a consolidated group, S would be treated under § 1.1502-13(b)(2)(iii) as taking the loss into account in Year 3.)

*Example 4. Consolidated groups.* (a) *Facts.* P owns all of the stock of S and B, and the P group is a consolidated group. S holds land for investment with a basis of \$130. On January 1 of Year 1, S sells the land to B for \$100. B holds the land for sale to customers in the ordinary course of business. On July 1 of Year 3, P sells 25% of B's stock to X. As a result of P's sale, B becomes a nonmember of the P consolidated group but S and B remain in a controlled group relationship with each other for purposes of section 267(f). Assume that if S and B were divisions of a single corporation, the items of S and B from the land would be ordinary by reason of B's activities.

(b) *Timing and attributes.* Under paragraph (a)(3) of this section, S's sale to B is subject to both § 1.1502-13 and this section. Under § 1.1502-13, S's loss is redetermined to be an ordinary loss by reason of B's activities.

Under paragraph (b)(3) of this section, because S and B remain in a controlled group relationship with each other, the loss is not taken into account under the acceleration rule of § 1.1502-13(d) as modified by paragraph (c) of this section. See § 1.1502-13(a)(4). Nevertheless, S's loss is redetermined by § 1.1502-13 to be an ordinary loss, and the character of the loss is not further redetermined under this section. Thus, the loss continues to be deferred under this section, and will be taken into account as ordinary loss based on subsequent events (e.g., B's sale of the land to a nonmember).

(c) *Resale to controlled group member.* The facts are the same as in paragraph (a) of this *Example 4*, except that P owns 75% of X's stock, and B resells the land to X (rather than P's selling any B stock). The results for S's loss are the same as in paragraph (b) of this *Example 4*. Under paragraph (b) of this section, X is also in a controlled group relationship, and B's sale to X is a second intercompany sale. Thus, S's loss continues to be deferred and is taken into account under this section as ordinary loss based on subsequent events (e.g., X's sale of the land to a nonmember).

*Example 5. Intercompany sale followed by installment sale.* (a) *Facts.* S holds land for investment with a basis of \$130x. On January 1 of Year 1, S sells the land to B for \$100x. B holds the land for investment. On July 1 of Year 3, B sells the land to X in exchange for X's \$110x note. The note bears a market rate of interest in excess of the applicable Federal rate, and provides for principal payments of \$55x in Year 4 and \$55x in Year 5. Section 453A applies to X's note.

(b) *Timing and attributes.* Under paragraph (c) of this section, S's \$30x loss is taken into account under the timing principles of the matching rule of § 1.1502-13(c) to reflect the difference in each year between B's gain taken into account and its recomputed loss. Under section 453, B takes into account \$5x of gain in Year 4 and in Year 5. Therefore, S takes \$20x of its loss into account in Year 3 to reflect the \$20x difference in that year between B's \$0 loss taken into account and its \$20x recomputed loss. In addition, S takes



\$5x of its loss into account in Year 4 and in Year 5 to reflect the \$5x difference in each year between B's \$5x gain taken into account and its \$0 recomputed gain. Although S takes into account a loss and B takes into account a gain, the attributes of B's \$10x gain are determined on a separate entity basis, and therefore the interest charge under section 453A(c) applies to B's \$10x gain on the installment sale beginning in Year 3.

**Example 6. Section 721 transfer to a related nonmember.** (a) *Facts.* S owns land with a basis of \$130. On January 1 of Year 1, S sells the land to B for \$100. On July 1 of Year 3, B transfers the land to a partnership in exchange for a 40% interest in capital and profits in a transaction to which section 721 applies. P also owns a 25% interest in the capital and profits of the partnership.

(b) *Timing.* Under paragraph (c)(1)(iii) of this section, because the partnership is a nonmember that is a related person under sections 267(b) and 707(b), S's \$30 loss is taken into account in Year 3, but only to the extent of any income or gain taken into account as a result of the transfer. Under section 721, no gain or loss is taken into account as a result of the transfer to the partnership, and thus none of S's loss is taken into account. Any subsequent gain recognized by the partnership with respect to the property is limited under section 267(d). (The results would be the same if the P group were a consolidated group, and S's sale to B were also subject to § 1.1502-13.)

**Example 7. Receivables.** (a) *Controlled group.* S owns goods with a \$60 basis. In Year 1, S sells the goods to X for X's \$100 note. The note bears a market rate of interest in excess of the applicable Federal rate, and provides for payment of principal in Year 5. S takes into account \$40 of income in Year 1 under its method of accounting. In Year 2, the fair market value of X's note falls to \$90 due to an increase in prevailing market interest rates, and S sells the note to B for its \$90 fair market value.

(b) *Loss not deferred.* Under paragraph (f) of this section, S takes its \$10 loss into account in Year 2. (If the sale were not at fair market value, paragraph (f) of this section would not apply and none of S's \$10 loss would be taken into account in Year 2.)

(c) *Consolidated group.* Assume instead that P owns all of the stock of S and B, and the P group is a consolidated group. In Year 1, S sells to X goods having a basis of \$90 for X's \$100 note (bearing a market rate of interest in excess of the applicable Federal rate, and providing for payment of principal in Year 5), and S takes into account \$10 of income in Year 1. In Year 2, S sells the receivable to B for its \$85 fair market value. In Year 3, P sells 25% of B's stock to X. Although paragraph (f) of this section provides that \$10 of S's loss (i.e., the extent to which S's \$15 loss does not exceed its \$10 of income) is not deferred under this section, S's entire \$15 loss is subject to § 1.1502-13 and none of the loss is taken into account in Year 2 under the matching rule of § 1.1502-13(c). See paragraph (a)(3) of this section (continued deferral under § 1.1502-13). P's sale of B stock results in B becoming a nonmember of the P consolidated group in

Year 3. Thus, S's \$15 loss is taken into account in Year 3 under the acceleration rule of § 1.1502-13(d). Nevertheless, B remains in a controlled group relationship with S and paragraph (f) of this section permits only \$10 of S's loss to be taken into account in Year 3. See § 1.1502-13(a)(4) (continued deferral under section 267). The remaining \$5 of S's loss continues to be deferred under this section and taken into account under this section based on subsequent events (e.g., B's collection of the note or P's sale of the remaining B stock to a nonmember).

**Example 8. Selling member ceases to be a member.** (a) *Facts.* P owns all of the stock of S and B, and the P group is a consolidated group. S has several historic assets, including land with a basis of \$130 and value of \$100. The land is not essential to the operation of S's business. On January 1 of Year 1, S sells the land to B for \$100. On July 1 of Year 3, P transfers all of S's stock to newly formed X in exchange for a 20% interest in X stock as part of a transaction to which section 351 applies. Although X holds many other assets, a principal purpose for P's transfer is to accelerate taking S's \$30 loss into account. P has no plan or intention to dispose of the X stock.

(b) *Timing.* Under paragraph (c) of this section, S's \$30 loss ordinarily is taken into account immediately before P's transfer of the S stock, under the timing principles of the acceleration rule of § 1.1502-13(d). Although taking S's loss into account results in a \$30 negative stock basis adjustment under § 1.1502-32, because P has no plan or intention to dispose of its X stock, the negative adjustment will not immediately affect taxable income. P's transfer accelerates a loss that otherwise would be deferred, and an adjustment under paragraph (h) of this section is required. Thus, S's loss is never taken into account, and S's stock basis and earnings and profits are reduced by \$30 under §§ 1.1502-32 and 1.1502-33 immediately before P's transfer of the S stock.

(c) *Nonhistoric assets.* Assume instead that, with a principal purpose to accelerate taking into account any further loss that may accrue in the value of the land without disposing of the land outside of the controlled group, P forms M with a \$100 contribution on January 1 of Year 1 and S sells the land to M for \$100. On December 1 of Year 1, when the value of the land has decreased to \$90, M sells the land to B for \$90. On July 1 of Year 3, while B still owns the land, P sells all of M's stock to X and M becomes a nonmember. Under paragraph (c) of this section, M's \$10 loss ordinarily is taken into account under the timing principles of the acceleration rule of § 1.1502-13(d) immediately before M becomes a nonmember. (S's \$30 loss is not taken into account under the timing principles of § 1.1502-13(c) or § 1.1502-13(d) as a result of M becoming a nonmember, but is taken into account based on subsequent events such as B's sale of the land to a nonmember or P's sale of the stock of S or B to a nonmember.) The land is not an historic asset of M and, although taking M's loss into account reduces P's basis in the M stock under § 1.1502-32, the negative adjustment only eliminates the \$10 duplicate stock loss. Under paragraph (h) of this

section, M's loss is never taken into account. M's stock basis, and the earnings and profits of M and P, are reduced by \$10 under §§ 1.1502-32 and 1.1502-33 immediately before P's sale of the M stock.

(k) *Cross-reference.* For additional rules applicable to the disposition or deconsolidation of the stock of members of consolidated groups, see §§ 1.337(d)-1, 1.337(d)-2, 1.1502-13T(f)(6), and 1.1502-20.

(l) *Effective dates—(1) In general.* This section applies with respect to transactions occurring in S's years beginning on or after July 12, 1995. If both this section and prior law apply to a transaction, or neither applies, with the result that items are duplicated, omitted, or eliminated in determining taxable income (or tax liability), or items are treated inconsistently, prior law (and not this section) applies to the transaction.

(2) *Avoidance transactions.* This paragraph (l)(2) applies if a transaction is engaged in or structured on or after April 8, 1994, with a principal purpose to avoid the rules of this section applicable to transactions occurring in years beginning on or after July 12, 1995, to duplicate, omit, or eliminate an item in determining taxable income (or tax liability), or to treat items inconsistently. If this paragraph (l)(2) applies, appropriate adjustments must be made in years beginning on or after July 12, 1995, to prevent the avoidance, duplication, omission, elimination, or inconsistency.

(3) *Prior law.* For transactions occurring in S's years beginning before July 12, 1995 see the applicable regulations issued under sections 267 and 1502. See, e.g., §§ 1.267(f)-1, 1.267(f)-1T, 1.267(f)-2T, 1.267(f)-3, 1.1502-13, 1.1502-13T, 1.1502-14, 1.1502-14T, and 1.1502-31 (as contained in the 26 CFR part 1 edition revised as of April 1, 1995).

**§§ 1.267(f)-1T, 1.267(f)-2T, and 1.267(f)-3 [Removed]**

**Par. 7.** Sections 1.267(f)-1T, 1.267(f)-2T, and 1.267(f)-3 are removed.

**Par. 8.** Section 1.460-0 is amended in the table of contents by revising the entries for § 1.460-4 to read as follows:

**§ 1.460-0 Outline of regulations under section 460.**

\* \* \* \* \*

**§ 1.460-4 Methods of accounting for long-term contracts.**

- (a) through (i) [Reserved]
- (j) Consolidated groups and controlled groups.
  - (1) Intercompany transactions.
    - (i) In general.
    - (ii) Definitions and nomenclature.

- (2) Example
- (3) Effective dates.
- (i) In general.
- (ii) Prior law.
- (4) Consent to change method of accounting.

**Par. 9.** Section 1.460-4 is amended by:

1. Revising the section heading.
2. Adding and reserving paragraphs (a) through (i).
3. Adding paragraph (j).

The revisions and additions read as follows:

**§ 1.460-4 Methods of accounting for long-term contracts.**

(a) through (i) [Reserved]  
 (j) *Consolidated groups and controlled groups*—(1) *Intercompany transactions*—(i) *In general.* Section 1.1502-13 does not apply to the income, gain, deduction, or loss from an intercompany transaction between members of a consolidated group, and section 267(f) does not apply to these items from an intercompany sale between members of a controlled group, to the extent—

(A) The transaction or sale directly or indirectly benefits, or is intended to benefit, another member's long-term contract with a nonmember;

(B) The selling member is required under section 460 to determine any part of its gross income from the transaction or sale under the percentage-of-completion method (PCM); and

(C) The member with the long-term contract is required under section 460 to determine any part of its gross income from the long-term contract under the PCM.

(ii) *Definitions and nomenclature.* The definitions and nomenclature under § 1.1502-13 and § 1.267(f)-1 apply for purposes of this paragraph (j).

(2) *Example.* The following example illustrates the principles of paragraph (j)(1) of this section.

*Example.* Corporations P, S, and B file consolidated returns on a calendar-year basis. In 1996, B enters into a long-term contract with X, a nonmember, to manufacture 5 airplanes for \$500 million, with delivery scheduled for 1999. Section 460 requires B to determine the gross income from its contract with X under the PCM. S enters into a contract with B to manufacture for \$50 million the engines that B will install on X's airplanes. Section 460 requires S to determine the gross income from its contract with B under the PCM. S estimates that it will incur \$40 million of total contract costs during 1997 and 1998 to manufacture the engines. S incurs \$10 million of contract costs in 1997 and \$30 million in 1998. Under paragraph (j) of this section, S determines its gross income from the long-term contract under the PCM rather than taking its income

or loss into account under section 267(f) or § 1.1502-13. Thus, S includes \$12.5 million of gross receipts and \$10 million of contract costs in gross income in 1997 and includes \$37.5 million of gross receipts and \$30 million of contract costs in gross income in 1998.

(3) *Effective dates*—(i) *In general.* This paragraph (j) applies with respect to transactions and sales occurring pursuant to contracts entered into in years beginning on or after July 12, 1995.

(ii) *Prior law.* For transactions and sales occurring pursuant to contracts entered into in years beginning before July 12, 1995, see the applicable regulations issued under sections 267(f) and 1502, including §§ 1.267(f)-1T, 1.267(f)-2T, and 1.1502-13(n) (as contained in the 26 CFR part 1 edition revised as of April 1, 1995).

(4) *Consent to change method of accounting.* For transactions and sales to which this paragraph (j) applies, the Commissioner's consent under section 446(e) is hereby granted to the extent any changes in method of accounting are necessary solely to comply with this section, provided the changes are made in the first taxable year of the taxpayer to which the rules of this paragraph (j) apply. Changes in method of accounting for these transactions are to be effected on a cut-off basis.

**Par. 10.** In § 1.469-0, the table of contents is amended by:

1. Revising the entries for § 1.469-1:
  - a. Paragraphs (a) through (d)(1).
  - b. Paragraphs (g)(5) through (h)(3).
  - c. Paragraphs (h)(5) through (k).
2. Revising the entries for § 1.469-1T, paragraphs (c)(8), and (h)(1), (2), and (6). The revisions read as follows:

**§ 1.469-0 Table of contents.**

\* \* \* \* \*

**§ 1.469-1 General rules.**

- (a) through (c)(7) [Reserved]
- (c)(8) Consolidated groups.
- (c)(9) through (d)(1) [Reserved]

\* \* \* \* \*

- (g)(5) [Reserved]
- (h)(1) In general.
- (h)(2) Definitions.
- (h)(3) [Reserved]

\* \* \* \* \*

- (h)(5) [Reserved]
- (h)(6) Intercompany transactions.
- (i) In general.
- (ii) Example.
- (ii) Effective dates.
- (h)(7) through (k) [Reserved]

**§ 1.469-1T General rules (temporary).**

\* \* \* \* \*

- (c)(8) [Reserved]

\* \* \* \* \*

- (h)(1) [Reserved]

- (h)(2) [Reserved]

\* \* \* \* \*

- (h)(6) [Reserved]

\* \* \* \* \*

**Par. 11.** Section 1.469-1 is amended by adding paragraphs (c)(8), (h)(1), (h)(2) and (h)(6) to read as follows (paragraphs (a) through (c)(7), (c)(9) through (d)(1), (g)(5), (h)(3), (h)(5) and (h)(7) through (k) continue to be reserved):

**§ 1.469-1 General rules.**

(a) through (c)(7) [Reserved]  
 (c)(8) Consolidated groups. Rules relating to the application of section 469 to consolidated groups are contained in paragraph (h) of this section.

(c)(9) through (d)(1) [Reserved]

\* \* \* \* \*

(g)(5) [Reserved]

(h)(1) In general. This paragraph (h) provides rules for applying section 469 in computing a consolidated group's consolidated taxable income and consolidated tax liability (and the separate taxable income and tax liability of each member).

(2) Definitions. The definitions and nomenclature in the regulations under section 1502 apply for purposes of this paragraph (h). See, e.g., §§ 1.1502-1 (definitions of group, consolidated group, member, subsidiary, and consolidated return year), 1.1502-2 (consolidated tax liability), 1.1502-11 (consolidated taxable income), 1.1502-12 (separate taxable income), 1.1502-13 (intercompany transactions), 1.1502-21 (consolidated net operating loss), and 1.1502-22 (consolidated net capital gain or loss).

(3) [Reserved]

\* \* \* \* \*

(5) [Reserved]

(6) Intercompany transactions—(i) In general. Section 1.1502-13 applies to determine the treatment under section 469 of intercompany items and corresponding items from intercompany transactions between members of a consolidated group. For example, the matching rule of § 1.1502-13(c) treats the selling member (S) and the buying member (B) as divisions of a single corporation for purposes of determining whether S's intercompany items and B's corresponding items are from a passive activity. Thus, for purposes of applying § 1.469-2(c)(2)(iii) and § 1.469-2T(d)(5)(ii) to property sold by S to B in an intercompany transaction—

(A) S and B are treated as divisions of a single corporation for determining the uses of the property during the 12-month period preceding its disposition to a nonmember, and generally have an aggregate holding period for the property; and



(B) § 1.469-2(c)(2)(iv) does not apply.

(ii) **Example.** The following example illustrates the application of this paragraph (h)(6).

**Example.** (i) P, a closely held corporation, is the common parent of the P consolidated group. P owns all of the stock of S and B. X is a person unrelated to any member of the P group. S owns and operates equipment that is not used in a passive activity. On January 1 of Year 1, S sells the equipment to B at a gain. B uses the equipment in a passive activity and does not dispose of the equipment before it has been fully depreciated.

(ii) Under the matching rule of § 1.1502-13(c), S's gain taken into account as a result of B's depreciation is treated as gain from a passive activity even though S used the equipment in a nonpassive activity.

(iii) The facts are the same as in paragraph (a) of this Example, except that B sells the equipment to X on December 1 of Year 3 at a further gain. Assume that if S and B were divisions of a single corporation, gain from the sale to X would be passive income, attributable to a passive activity. To the extent of B's depreciation before the sale, the results are the same as in paragraph (ii) of this Example. B's gain and S's remaining gain taken into account as a result of B's sale are treated as attributable to a passive activity.

(iv) The facts are the same as in paragraph (iii) of this Example, except that B recognizes a loss on the sale to X. B's loss and S's gain taken into account as a result of B's sale are treated as attributable to a passive activity.

(iii) **Effective dates.** This paragraph (h)(6) applies with respect to transactions occurring in years beginning on or after July 12, 1995. For transactions occurring in years beginning before July 12, 1995, see § 1.469-1T(h)(6) (as contained in the 26 CFR part 1 edition revised as of April 1, 1995).

(h)(7) through (k) [Reserved]

#### § 1.469-1T [Amended]

**Par. 12.** Section 1.469-1T is amended by removing and reserving paragraphs (c)(8), (h)(1), (2), and (6).

**Par. 13.** Section 1.1502-13 is revised to read as follows:

#### § 1.1502-13 Intercompany transactions.

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

(2) **Separate entity and single entity treatment.** Under this section, the selling member (S) and the buying member (B) are treated as separate

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

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

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

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

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

(B) **Cut-off basis.** Any change in method of accounting described in paragraph (a)(3)(ii)(A) of this section is

to be effected on a cut-off basis for transactions entered into on or after the first day of the year for which consent is granted under paragraph (a)(3)(ii)(A) of this section.

(4) **Other law.** The rules of this section apply in addition to other applicable law (including nonstatutory authorities). For example, this section applies in addition to sections 267(f) (additional rules for certain losses), 269 (acquisitions to evade or avoid income tax), and 482 (allocations among commonly controlled taxpayers). Thus, an item taken into account under this section can be deferred, disallowed, or eliminated under other applicable law, for example, section 1091 (losses from wash sales).

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

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

Paragraphs (f) and (g) of this section provide additional rules for stock and obligations of members. Paragraphs (h) and (j) of this section provide anti-avoidance rules and miscellaneous operating rules.

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

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

Example 1. Intercompany sale of land.

Example 2. Dealer activities.

Example 3. Intercompany section 351 transfer.

Example 4. Depreciable property.

Example 5. Intercompany sale followed by installment sale.

Example 6. Intercompany sale of installment obligation.

Example 7. Performance of services.

Example 8. Rental of property.

Example 9. Intercompany sale of a partnership interest.

Example 10. Net operating losses subject to section 382 or the SRLY rules.

Example 11. Section 475.

Example 12. Section 1092.

Example 13. Manufacturer incentive payments.

Example 14. Source of income under section 863.

Example 15. Section 1248.

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

Example 1. Becoming a nonmember—timing.

Example 2. Becoming a nonmember—attributes.

Example 3. Selling member's disposition of installment note.

Example 4. Cancellation of debt and attribute reduction under section 108(b).

Example 5. Section 481.

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

Example 1. Increment averaging method.

Example 2. Increment valuation method.

Example 3. Other reasonable inventory methods.

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

Example 1. Dividend exclusion and property distribution.

Example 2. Excess loss accounts.

Example 3. Intercompany reorganization.

Example 4. Stock redemptions and distributions.

Example 5. Intercompany stock sale followed by section 332 liquidation.

Example 6. Intercompany stock sale followed by section 355 distribution.

**Obligations of members.** (§ 1.1502-13(g)(5))

Example 1. Interest on intercompany debt.

Example 2. Intercompany debt becomes nonintercompany debt.

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

Example 4. Nonintercompany debt becomes intercompany debt.

Example 5. Notional principal contracts.

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

Example 1. Sale of a partnership interest.

Example 2. Transitory status as an intercompany obligation.

Example 3. Corporate mixing bowl.

Example 4. Partnership mixing bowl.

Example 5. Sale and leaseback.

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

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

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

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

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

Example 5. Successor group.

Example 6. Liquidation—80% distributee.

Example 7. Liquidation—no 80% distributee.

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

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

providing services, and B is the member receiving the property or services.

Intercompany transactions include—

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

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

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

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

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

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

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

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

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

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

(ii) **Disallowed or eliminated amounts.** B's corresponding items include amounts that are permanently disallowed or permanently eliminated, whether directly or indirectly. Thus, corresponding items include amounts disallowed under section 265 (expenses relating to tax-exempt income), and amounts not recognized under section 311(a) (nonrecognition of loss on distributions), section 332

(nonrecognition on liquidating distributions), or section 355(c) (certain distributions of stock of a subsidiary). On the other hand, an amount is not permanently disallowed or permanently eliminated (and therefore is not a corresponding item) to the extent it is not recognized in a transaction in which B receives a successor asset within the meaning of paragraph (j)(1) of this section. For example, B's corresponding items do not include amounts not recognized from a transaction with a nonmember to which section 1031 applies or from another transaction in which B receives exchanged basis property.

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

(5) *Treatment as a separate entity.* Treatment as a separate entity means treatment without application of the rules of this section, but with the application of the other consolidated return regulations. For example, if S sells the stock of another member to B, S's gain or loss on a separate entity basis is determined with the application of § 1.1502-80(b) (non-applicability of section 304), but without redetermination under paragraph (c) or (d) of this section.

(6) *Attributes.* The attributes of an intercompany item or corresponding item are all of the item's characteristics, except *amount*, *location*, and *timing*, necessary to determine the item's effect on taxable income (and tax liability). For example, attributes include character, source, treatment as excluded from gross income or as a noncapital, nondeductible amount, and treatment as built-in gain or loss under section 382(h) or 384. In contrast, the characteristics of property, such as a member's holding period, or the fact that property is included in inventory,

are not attributes of an item, but these characteristics might affect the determination of the attributes of items from the property.

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

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

(ii) *Holding periods.* The holding period of property transferred in an intercompany transaction is the aggregate of the holding periods of S and B. However, if the basis of the property is determined by reference to the basis of other property, the property's holding period is determined by reference to the holding period of the other property. For example, if S distributes stock to B in a transaction to which section 355 applies, B's holding period in the distributed stock is determined by reference to B's holding period in the stock of S.

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

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

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

(i) Operating separate trades or businesses. See, e.g., § 1.446-1(d) (accounting methods for a taxpayer engaged in more than one business).  
(ii) Having any special status that they have under the Internal Revenue Code or regulations. For example, a bank defined in section 581, a domestic building and loan association defined in section 7701(a)(19), and an insurance company to which section 801 or 831 applies are treated as divisions having separate special status. On the other hand, the fact that a member holds property for sale to customers in the ordinary course of its trade or business is not a special status.

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

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

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

is otherwise permanently disallowed or eliminated, the attributes of B's corresponding item always control the attributes of S's offsetting intercompany item.

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

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

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

§§ 1.1502-32 and 1.1502-33 (adjustments to S's stock basis and earnings and profits to reflect amounts so treated).

(ii) *Limitation on treatment of intercompany items as excluded from gross income.* Notwithstanding the general rule of paragraph (c)(1)(i) of this section, S's intercompany income or gain is redetermined to be excluded from gross income only to the extent one of the following applies:

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

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

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

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

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

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

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

(C) *Other amounts.* The Commissioner determines that treating

S's intercompany item as excluded from gross income is consistent with the purposes of this section and other applicable provisions of the Internal Revenue Code and regulations.

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

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

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

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

(c) *Attributes.* Under the matching rule of paragraph (c) of this section, S's \$30 intercompany gain and B's \$10 corresponding gain are taken into account to produce the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation. In addition, the holding periods of S and B for the land are aggregated. Thus, the group's entire \$40 of gain is long-term capital gain. Because both S's intercompany item and B's corresponding item on a separate entity basis are long-term capital gain, the attributes are not redetermined under paragraph (c)(1)(i) of this section.

(d) *Timing.* For each consolidated return year, S takes its intercompany item into account under the matching rule to reflect the difference for the year between B's corresponding item taken into account and the recomputed corresponding item. If S and B were divisions of a single corporation and the intercompany sale were a transfer between the divisions, B would succeed to S's \$70 basis in the land and would have a \$40 gain from the sale to X in Year 3, instead of a \$10 gain. Consequently, S takes no gain



into account in Years 1 and 2, and takes the entire \$30 gain into account in Year 3, to reflect the \$30 difference in that year between the \$10 gain B takes into account and the \$40 recomputed gain (the recomputed corresponding item). Under §§ 1.1502-32 and 1.1502-33, P's basis in its S stock and the earnings and profits of S and P do not reflect S's \$30 gain until the gain is taken into account in Year 3. (Under paragraph (a)(3) of this section, the results would be the same if S sold the land to B in an installment sale to which section 453 would otherwise apply, because S must take its intercompany gain into account under this section.)

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

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

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

its \$30 gain into account under the matching rule in Year 3 to reflect the difference between B's \$10 corresponding unrecognized loss and the \$20 recomputed gain. B's \$10 corresponding loss offsets \$10 of S's intercompany gain and, under paragraph (c)(4)(i) of this section, the attributes of B's corresponding item control the attributes of S's intercompany item. Paragraph (c)(6) of this section does not prevent the redetermination of S's intercompany item as excluded from gross income. (See paragraph (c)(6)(ii)(B) of this section). Thus, \$10 of S's \$30 gain is redetermined to be excluded from gross income.

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

(i) *Intercompany sale followed by section 351 transfer to nonmember.* The facts are the same as in paragraph (a) of this Example 1, except that, instead of selling the land to X, B transfers the land to X in a transaction to which section 351(a) applies and X remains a nonmember. There is no difference in Year 3 between B's \$0 corresponding item taken into account and the \$0 recomputed corresponding item. Thus, none of S's intercompany gain is taken into account under the matching rule as a result of the section 351(a) transfer. However, S's entire gain is taken into account in Year 3 under the acceleration rule of paragraph (d) of this section (because X, a nonmember, reflects B's \$100 cost basis in the land under section 362).

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

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

*Example 3. Intercompany section 351 transfer.* (a) *Facts.* S holds land with a \$70

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

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

(c) *Intercompany section 351 transfer with boot.* The facts are the same as in paragraph (a) of this Example 3, except that S receives \$10 cash in addition to the B stock in the transfer. S recognizes \$10 of gain under section 351(b), and its basis in the B stock is \$70 under section 358. Under section 362, B's basis in the land is \$80. S takes its \$10 intercompany gain into account in Year 3 to reflect the \$10 difference between B's \$20 corresponding gain taken into account and the \$30 recomputed gain. Both S's \$10 gain and B's \$20 gain are ordinary income.

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

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

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

(c) *Timing.* S's \$50 gain is taken into account to reflect the difference for each

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

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

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

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

(b) *Timing and attributes.* S takes its \$30x gain into account to reflect the difference in each consolidated return year between B's gain taken into account for the year and the recomputed gain. Under section 453, B takes

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

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

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

(e) *Intercompany loss, installment gain.* The facts are the same as in paragraph (a) of this Example 5, except that S has a \$130x (rather than \$70x) basis in the land. Under paragraph (c)(1)(i) of this section, the separate entity attributes of S's and B's items from the intercompany transaction must be redetermined to produce the same effect on consolidated taxable income (and tax liability) as if the transaction had been a transfer between divisions. If S and B were divisions of a single corporation, B would

succeed to S's basis in the land and the group would have \$20x loss from the sale to X. Installment reporting would be unavailable, and the interest charge under section 453A(c) would not apply. Accordingly, B's gain from the transaction is not eligible for installment treatment under section 453. B takes its \$10x gain into account in Year 3, and S takes its \$30x of loss into account in Year 3 to reflect the difference between B's \$10x gain and the \$20x recomputed loss.

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

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

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

(c) *Worthlessness.* The facts are the same as in paragraph (a) of this Example 6, except that X's note becomes worthless on December 1 of Year 3 and B has a \$100x short-term capital loss under section 165(g) on a separate entity basis. Under paragraph (c)(1)(ii) of this section, B's holding period



for X's note is aggregated with S's holding period. Thus, B's loss is a long-term capital loss. S takes its \$30x gain into account in Year 3 to reflect the \$30x difference between B's \$100x loss taken into account and the \$70x recomputed loss. Under paragraph (c)(1)(i) of this section, S's gain is long-term capital gain.

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

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

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

(c) *Timing and attributes.* S's \$20 of intercompany income is taken into account under the matching rule to reflect the \$20 difference between B's corresponding items taken into account (based on its \$100 cost basis in the well) and the recomputed corresponding items (based on the \$80 basis that B would have if S and B were divisions of a single corporation and B's basis were determined by reference to S's \$80 of expenses). In Year 1, S takes into account \$80 of its income and the \$80 of expenses. In each of Years 2 through 11, S takes \$2 of its \$20 intercompany income into account to reflect the annual \$2 difference between B's \$10 of cost recovery deductions taken into account and the \$8 of recomputed cost recovery deductions. S's \$100 income and \$80 expenses, and B's cost recovery deductions, are ordinary items (because S's and B's items would be ordinary on a separate entity basis, the attributes are not redetermined under paragraph (c)(1)(i) of this section). If S's offsetting \$80 of income and expense would not be taken into account in the same year under its separate entity method of accounting, they nevertheless must be taken into account under this section in a manner that clearly reflects consolidated taxable income. See paragraph (a)(3)(i) of this section.

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

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

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

(b) *Timing and attributes.* S's gain is taken into account during Years 1 through 10 to reflect the difference in each year between B's depreciation deductions from the partnership taken into account and the recomputed depreciation deductions from the partnership. Under paragraphs (c)(1)(i) and (c)(4)(i) of this section, S's gain taken into account is ordinary income. (The acceleration rule does not apply to S's gain as a result of the section 743(b) adjustment, because the adjustment is solely with respect to B and therefore no nonmember reflects any part of the intercompany transaction.)

(c) *Partnership sale of assets.* The facts are the same as in paragraph (a) of this Example 9, and the partnership sells some of its depreciable assets to X at a gain on December

31 of Year 4. In addition to the intercompany gain taken into account as a result of the partnership's depreciation, S takes intercompany gain into account in Year 4 to reflect the difference between B's partnership items taken into account from the sale (which reflect the basis increase under section 743(b)) and the recomputed partnership items. The attributes of S's additional gain are redetermined to produce the same effect on consolidated taxable income as if S and B were divisions of a single corporation (recapture income or section 1231 gain).

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

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

*Example 10. Net operating losses subject to section 382 or the SRLY rules.* (a) *Facts.* On January 1 of Year 1, P buys all of S's stock. S has net operating loss carryovers from prior years. P's acquisition results in an ownership change under section 382 with respect to S's loss carryovers, and S has a net unrealized built-in gain (within the meaning of section 382(h)(3)). S owns nondepreciable property with a \$70 basis and \$100 value. On July 1 of Year 3, S sells the property to B for \$100, and its \$30 gain is recognized built-in gain (within the meaning of section 382(h)(2)) on a separate entity basis. On December 1 of Year 5, B sells the property to X for \$90.

(b) *Timing and attributes.* S's \$30 gain is taken into account in Year 5 to reflect the \$30 difference between B's \$10 loss taken into account and the recomputed \$20 gain. S and B are treated as divisions of a single corporation for purposes of applying section 382 in connection with the intercompany transaction. Under a single entity analysis, the single corporation has losses subject to limitation under section 382, and this limitation may be increased under section

382(h) if the single corporation has recognized built-in gain with respect to those losses. B's \$10 corresponding loss offsets \$10 of S's intercompany gain, and thus, under paragraph (c)(4)(i) of this section, \$10 of S's intercompany gain is redetermined not to be recognized built-in gain. S's remaining \$20 intercompany gain continues to be treated as recognized built-in gain.

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

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

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

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

(c) *Timing and character.* S has a \$30 gain when it disposes of the security by selling it to B. This gain is intercompany gain that is taken into account in Year 1 to reflect the \$30 difference between B's \$0 gain taken into account from marking the security to market under section 475 and the recomputed \$30 gain that would be taken into account. The

character of S's gain and B's gain are redetermined as if the security were transferred between divisions. Accordingly, S's gain is ordinary income under section 475(d)(3)(A)(i), but under section 475(d)(3)(B)(ii) B's \$10 gain from its sale to X is capital gain that is taken into account in Year 2.

(d) *Nondealer to dealer.* The facts are the same as in paragraph (a) of this Example 11, except that S is not a dealer and holds the security for investment with a \$70 basis. B is a dealer to which section 475 applies and, immediately after acquiring the security from S for \$100, B holds the security for sale to customers in the ordinary course of its trade or business. Because S is not a dealer and held the security for investment, the security is treated as properly identified as held for investment under section 475(b)(1) until it is sold to B. Under section 475(b)(3), the security thereafter ceases to be described in section 475(b)(1) because B holds the security for sale to customers. The mark-to-market requirement applies only to changes in the value of the security after B's acquisition. B's mark-to-market gain taken into account and the recomputed mark-to-market gain are both determined based on changes from the \$100 value of the security at the time of B's acquisition. There is no difference between B's \$0 mark-to-market gain taken into account in Year 1 and the \$0 recomputed mark-to-market gain. Therefore, none of S's gain is taken into account in Year 1 as a result of B's marking the security to market in Year 1. In Year 2, B has a \$10 gain when it disposes of the security by selling it to X, but would have had a \$40 gain if S and B were divisions of a single corporation. Thus, S takes its \$30 gain into account in Year 2 under the matching rule. Under section 475(d)(3), S's gain is capital gain even though B's subsequent gain or loss from marking to market or disposing of the security is ordinary gain or loss. If B disposes of the security at a \$10 loss in Year 2, S's gain taken into account in Year 2 is still capital because on a single entity basis section 475(d)(3) would provide for \$30 of capital gain and \$10 of ordinary loss. Because the attributes are not redetermined under paragraph (c)(1)(i) of this section, paragraph (c)(4)(i) of this section does not apply. Furthermore, if B held the security for investment, and so identified the security under section 475(b)(1), the security would continue to be excepted from marking to market.

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

(b) *Timing and attributes.* If the sale from S to B were a transfer between divisions of

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

*Example 13. Manufacturer incentive payments.* (a) *Facts.* B is a manufacturer that sells its products to independent dealers for resale. S is a credit company that offers financing, including financing to customers of the dealers. S also purchases the product from the dealers for lease to customers of the dealers. During Year 1, B initiates a program of incentive payments to the dealers' customers. Under B's program, S buys a product from an independent dealer for \$100 and leases it to a nonmember. S pays \$90 to the dealer for the product, and assigns to the dealer its \$10 incentive payment from B. Under their separate entity accounting methods, B would deduct the \$10 incentive payment in Year 1 and S would take a \$90 basis in the product. Assume that if S and B were divisions of a single corporation, the \$10 payment would not be deductible and the basis of the property would be \$100.

(b) *Timing and attributes.* Under paragraph (b)(1) of this section, the incentive payment transaction is an intercompany transaction. Under paragraph (b)(2)(iii) of this section, S has a \$10 intercompany item not yet taken into account under its separate entity method of accounting. Under the matching rule, S takes its intercompany item into account to reflect the difference between B's corresponding item taken into account and the recomputed corresponding item. In Year 1 there is a \$10 difference between B's \$10 deduction taken into account and the \$0 recomputed deduction. Accordingly, under the matching rule S must take the \$10 incentive payment into account as intercompany income in Year 1. S's \$10 of income and B's \$10 deduction are ordinary items. S's basis in the product is \$100 rather than the \$90 it would be under S's separate entity method of accounting. S's additional \$10 of basis in the product is recovered based on subsequent events (e.g., S's cost recovery deductions or its sale of the product).

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

as if \$100 of income were recognized from producing in the United States and selling in Country Y. Assume that applying the section 863 regulations on a single entity basis, \$50 is treated as foreign source income and \$50 as U.S. source income. Assume further that on a separate entity basis, S would have \$37.50 of foreign source income and \$37.50 of U.S. source income, and that all of B's \$25 of income would be foreign source income. Thus, on a separate entity basis, S and B would have \$62.50 of combined foreign source income and \$37.50 of U.S. source income. Accordingly, under single entity treatment, \$12.50 that would be treated as foreign source income on a separate entity basis is redetermined to be U.S. source income. Under paragraph (c)(1)(i) of this section, attributes are redetermined only to the extent of the \$12.50 necessary to achieve the same effect as a single entity determination. Under paragraph (c)(4)(ii) of this section, the redetermined attribute must be allocated between S and B using a reasonable method. For example, it may be reasonable to recharacterize only S's foreign source income as U.S. source income because only S would have any U.S. source income on a separate entity basis. However, it may also be reasonable to allocate the redetermined attribute between S and B in proportion to their separate entity amounts of foreign source income (in a 3:2 ratio, so that \$7.50 of S's foreign source income is redetermined to be U.S. source and \$5 of B's foreign source income is redetermined to be U.S. source), provided the same method is applied to all similar transactions within the group.

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

(c) *Sale of property reflecting intercompany services or intangibles.* S earns \$10 of income performing services in the United States for B. B capitalizes S's fees into the basis of property that it manufactures in the United States and sells to an unrelated person in Country Y at a \$90 profit, with title passing in Country Y. Under the matching rule, S's \$10 income and B's \$90 income are taken into account in Year 1. In determining the source of income, S and B are treated as divisions of a single corporation, and section 863 applies as if \$100 were earned from manufacturing in the United States and selling in Country Y. Assume that on a single entity basis \$50 is treated as foreign source income and \$50 is treated as U.S. source

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

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

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

(c) *Attributes.* Under the matching rule, the attributes of S's intercompany gain and B's corresponding gain are redetermined to have the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation. On a single entity basis, there is \$60 of gain and the portion which is characterized as a dividend under section 1248 is determined on the basis of FT's \$30 of earnings and profits at the time of the sale of FT to X (the sum of FT's \$40 of earnings and profits while held by S and FT's \$10 deficit in earnings and profits while held by B). Therefore, \$30 of the \$60 gain is treated as a dividend under section 1248. The remaining \$30 is treated as capital gain. On a separate entity basis, all of S's \$40 gain would be treated as a dividend under section 1248 and all of B's \$20 gain would be treated as capital gain. Thus, as a result of the single entity determination, \$10 that would be treated as a dividend under section 1248 on a separate entity basis is redetermined to be capital gain. Under paragraph (c)(4)(ii) of this section, this redetermined attribute must be allocated between S's intercompany item and B's corresponding item by using a reasonable method. On a separate entity basis, only S would have any amount treated as a dividend under section 1248 available for redetermination. Accordingly, \$10 of S's income is redetermined to be not subject to section 1248, with the result that \$30 of S's intercompany gain is treated as a dividend and the remaining \$10 is treated as capital gain. All of B's corresponding gain is treated as capital gain, as it would be on a separate entity basis.

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

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

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

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

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

(ii) *Attributes.* The attributes of S's intercompany items taken into account



under this paragraph (d)(1) are determined as follows:

(A) *Sale, exchange, or distribution.* If the item is from an intercompany sale, exchange, or distribution of property, its attributes are determined under the principles of the matching rule as if B sold the property, at the time the item is taken into account under paragraph (d)(1)(i) of this section, for a cash payment equal to B's adjusted basis in the property (i.e., at no net gain or loss), to the following person:

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

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

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

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

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

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

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

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

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

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

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

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

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

(e) *Sale of B's stock.* The facts are the same as in paragraph (a) of this Example 1, except that P sells 60% of B's stock (rather than S's stock) to X for \$60 and, as a result, B becomes a nonmember. Because the effect of treating S and B as divisions of a single corporation cannot be produced once B becomes a nonmember, S takes its \$30 gain into account under the acceleration rule immediately before B becomes a nonmember. (The results would be the same if S sold the land to B in an installment sale to which section 453 would otherwise apply, because S must take its intercompany gain into account under this section.)

(f) *Discontinue filing consolidated returns.* The facts are the same as in paragraph (a) of this Example 1, except that the P group

receives permission under § 1.1502-75(c) to discontinue filing consolidated returns beginning in Year 3. Under the acceleration rule, S takes its \$30 gain into account on December 31 of Year 2.

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

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

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

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

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

provides for principal payments of \$55 in Year 4 and \$55 in Year 5. On July 1 of Year 3, S sells B's note to X for \$110.

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

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

(b) *Acceleration rule.* As a result of B's basis reduction under section 1017, \$60 of S's intercompany gain will not be taken into account under the matching rule (because there is only a \$40 difference between B's \$40 basis in the land and the \$0 basis the land would have if S and B were divisions of a single corporation). Accordingly, S takes \$60 of its gain into account under the acceleration rule in Year 3. S's gain is long-term capital gain, determined under paragraph (d)(1)(ii) of this section as if B sold the land to an affiliated corporation that is not a member of the group for \$100 immediately before the basis reduction.

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

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

an acceleration of the balance of the section 481(a) adjustment to Year 3.

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

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

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

(B) *Increment averaging method.* Under this paragraph (e)(1)(ii)(B), the amount not taken into account is the amount of S's intercompany inventory income or loss multiplied by the ratio of the LIFO value of B's current-year costs

of its layer of increment to B's total inventory costs incurred for the year under its LIFO inventory method. If B includes more than its inventory costs incurred during any subsequent year in its cost of goods sold (a decrement), S takes into account the intercompany inventory income or loss layers in the same manner and proportion as B takes into account its inventory decrements.

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

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

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

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

**Example 1. Increment averaging method.** (a) *Facts.* Both S and B use a double-

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

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

(c) *Timing.* (i) Under the increment averaging method of paragraph (e)(1)(ii)(B) of

this section, \$35 of S's \$350 of intercompany inventory income is not taken into account in Year 2, computed as follows:

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

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

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

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

(e) *B incurs a decrement.* The facts are the same as in paragraph (a) of this Example 1,

except that B incurs a decrement in Year 2. S must take into account the entire \$350 of Year 2 intercompany inventory income because all 100 units of product Q are deemed sold by B in Year 2.

*Example 2. Increment valuation method.*

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

(b) *Timing.* (i) Under the increment valuation method of paragraph (e)(1)(ii)(C) of this section, \$21 of S's \$350 of intercompany inventory income is not taken into account in Year 2, computed as follows:

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

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

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

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

*Example 3. Other reasonable inventory methods.* (a) *Facts.* Both S and B use a dollar-value LIFO inventory method for their inventory transactions. During Year 1, S sells inventory to B and to X. Under paragraph (e)(1)(iv) of this section, to compute its intercompany inventory income and the amount of this income not taken into account, S computes its intercompany inventory income using the transfer price of the inventory items less a FIFO cost for the

goods, takes into account these items based on a FIFO cost flow assumption for B's corresponding items, and the LIFO methods used by S and B are ignored for these computations. These computations are comparable to the methods used by S and B for financial reporting purposes, and the book methods and results are used for tax purposes. S adjusts the amount of intercompany inventory items not taken into account as required by section 263A.

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

amount from being taken into account more than once).

(2) *Reserve accounting—(i) Banks and thrifts.* Except as provided in paragraph (g)(3)(iv) of this section (deferral of items from an intercompany obligation), a member's addition to, or reduction of, a reserve for bad debts that is maintained under section 585 or 593 is taken into account on a separate entity basis. For example, if S makes a loan to a nonmember and subsequently sells the loan to B, any deduction for an addition to a bad debt reserve under section 585 and any recapture income (or reduced bad debt deductions) are taken into account on a separate entity basis rather than as intercompany items or corresponding items taken into account under this section. Any gain or loss of S from its sale of the loan to B is taken into account under this section, however, to the extent it is not attributable to recapture of the reserve.

(ii) *Insurance companies—(A) Direct insurance.* If a member provides insurance to another member in an intercompany transaction, the



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

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

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

(3) *Consent to treat intercompany transactions on a separate entity basis—*

(i) *General rule.* The common parent may request consent to take into account on a separate entity basis items from intercompany transactions other than intercompany transactions with respect to stock or obligations of members. Consent may be granted for all items, or for items from a class or classes of transactions. The consent is effective only if granted in writing by the Internal Revenue Service. Unless revoked with the written consent of the Internal Revenue Service, the separate entity treatment applies to all affected intercompany transactions in the consolidated return year for which consent is granted and in all subsequent consolidated return years. Consent under this paragraph (e)(3) does not apply for purposes of taking into

account losses and deductions deferred under section 267(f).

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

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

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

on a separate entity basis as provided in paragraph (e)(3)(i) of this section. This treatment is applicable only to the items, class or classes of transactions for which consent was granted under prior law.

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

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

(ii) *Distributee member.* An intercompany distribution is not included in the gross income of the distributee member (B). However, this exclusion applies to a distribution only to the extent there is a corresponding negative adjustment reflected under § 1.1502-32 in B's basis in the stock of the distributing member (S). For example, no amount is included in B's gross income under section 301(c)(3) from a distribution in excess of the basis of the stock of a subsidiary that results in an excess loss account under § 1.1502-32(a) which is treated as negative basis under § 1.1502-19. See § 1.1502-26(b) (applicability of the dividends received deduction to distributions not excluded from gross income, such as a distribution from the common parent to a subsidiary owning stock of the common parent).

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

(iv) *Entitlement rule*—(A) *In general.* For all Federal income tax purposes, an intercompany distribution is treated as taken into account when the shareholding member becomes entitled to it (generally on the record date). For example, if B becomes entitled to a cash distribution before it is made, the distribution is treated as made when B becomes entitled to it. For this purpose, B is treated as entitled to a distribution

no later than the time the distribution is taken into account under the Internal Revenue Code (e.g., under section 305(c)). To the extent a distribution is not made, appropriate adjustments must be made as of the date it was taken into account.

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

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

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

(4) *Acquisition by issuer of its own stock.* If a member acquires its own stock, or an option to buy or sell its own stock, in an intercompany transaction, the member's basis in that stock or option is treated as eliminated for all purposes. Accordingly, S's intercompany items from the stock or options of B are taken into account under this section if B acquires the stock or options in an intercompany transaction (unless, for example, B acquires the stock in exchange for

successor property within the meaning of paragraph (j)(1) of this section in a nonrecognition transaction). For example, if B redeems its stock from S in a transaction to which section 302(a) applies, S's gain from the transaction is taken into account immediately under the acceleration rule.

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

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

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

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

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

(B) *Section 332—(1) In general.* If section 332 applies to T's liquidation into B, and B transfers T's assets to a new member (new T) in a transaction not otherwise pursuant to the same plan or arrangement as the liquidation, the transfer is nevertheless treated for all Federal income tax purposes as

pursuant to the same plan or arrangement as the liquidation. For example, if T liquidates into B, but B forms new T by transferring substantially all of T's former assets to new T, S's intercompany gain or loss generally is not taken into account solely as a result of the liquidation if the liquidation and transfer would qualify as a reorganization described in section 368(a). (Under paragraph (j)(1) of this section, B's stock in new T would be a successor asset to B's stock in T, and S's gain would be taken into account based on the new T stock.)

(2) *Time limitation and adjustments.* The transfer of an asset to new T not otherwise pursuant to the same plan or arrangement as the liquidation is treated under this paragraph (f)(5)(ii)(B) as pursuant to the same plan or arrangement only if B transfers it to new T pursuant to a written plan, a copy of which is attached to a timely filed original return (including extensions) for the year of T's liquidation, and the transfer is completed within 12 months of the filing of that return. Appropriate adjustments are made to reflect any events occurring before the formation of new T and to reflect any assets not transferred to new T as part of the same plan or arrangement. For example, if B retains an asset in the reorganization, the asset is treated under paragraph (f)(3) of this section as acquired by new T but distributed to B immediately after the reorganization.

(3) *Downstream merger, etc.* The principles of this paragraph (f)(5)(ii)(B) apply, with appropriate adjustments, if B's basis in the T stock is eliminated in a transaction similar to a section 332 liquidation, such as a transaction described in section 368 in which B merges into T. For example, if S and B are subsidiaries, and S sells all of T's stock to B at a gain followed by B's merger into T in a separate transaction described in section 368(a), S's gain is not taken into account solely as a result of the merger if T (as successor to B) forms new T with substantially all of T's former assets.

(C) *Section 338(h)(10)—(1) In general.* This paragraph (f)(5)(ii)(C) applies to a deemed liquidation of T under section 332 as the result of an election under section 338(h)(10). This paragraph (f)(5)(ii)(C) does not apply if paragraph (f)(5)(ii)(B) of this section is applied to the deemed liquidation. Under this paragraph, B is treated with respect to each share of its T stock as recognizing as a corresponding item any loss or deduction it would recognize (determined after adjusting stock basis under § 1.1502-32) if section 331 applied to the deemed liquidation. For

all other Federal income tax purposes, the deemed liquidation remains subject to section 332.

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

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

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

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

(D) *Section 355.* If B distributes the T stock in an intercompany transaction to which section 355 applies (including an intercompany transaction to which 355 applies because of the application of paragraph (f)(3) of this section), the redetermination of the basis of the T stock under section 358 could cause S's gain or loss to be taken into account under this section. This paragraph (f)(5)(ii)(D) applies to treat B's distribution as subject to sections 301 and 311 (as modified by this paragraph (f)), rather than section 355. The election will prevent S's gain or loss from being taken into account immediately to the extent matching remains possible, but B's gain or loss from the distribution will also be taken into account under this section.

(E) *Election.* An election to apply this paragraph (f)(5)(ii) is made in a separate statement entitled "[Insert Name and Employer Identification Number of Common Parent] HEREBY ELECTS THE APPLICATION OF § 1.1502-13(f)(5)(ii)." The election must include a description of S's intercompany

transaction and T's liquidation (or other transaction). It must specify which provision of § 1.1502-13(f)(5)(ii) applies and how it alters the otherwise applicable results under this section (including, for example, the amount of S's intercompany items and the amount deferred or offset as a result of this § 1.1502-13(f)(5)(ii)). A separate election must be made for each application of this paragraph (f)(5)(ii). The election must be signed by the common parent and filed with the group's income tax return for the year of T's liquidation (or other transaction). The Commissioner may impose reasonable terms and conditions to the application of this paragraph (f)(5)(ii) that are consistent with the purposes of this section.

(6) [Reserved]

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

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

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

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

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

(e) *Entitlement rule.* The facts are the same as in paragraph (a) of this *Example 1*, except that, after P becomes entitled to the distribution but before the distribution is made, S issues additional stock to the public and becomes a nonmember. Under paragraph (f)(2)(i) of this section, the determination of whether a distribution is an intercompany distribution is made under the entitlement rule of paragraph (f)(2)(iv) of this section. Treating S's distribution as made when P becomes entitled to it results in the distribution being an intercompany distribution. Under paragraph (f)(2)(ii) of this section, the distribution is not included in P's gross income. S's \$30 gain from the distribution is intercompany gain that is taken into account under the acceleration rule immediately before S becomes a nonmember. Thus, there is a net \$70 decrease in P's basis in its S stock under § 1.1502-32 (\$100 decrease for the distribution and a \$30 increase for S's \$30 gain). See also § 1.1502-20(b) (additional stock basis reductions applicable to certain deconsolidations). Under paragraph (f)(2)(iv) of this section, P does not take the distribution into account again under separate return rules when received, and P is not entitled to a dividends received deduction.

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

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

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



events (for example, under the matching rule if P subsequently sells its T stock, or under the acceleration rule if S becomes a nonmember).

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

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

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

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

*Example 3. Intercompany reorganization.*

(a) *Facts.* P forms S and B by contributing

\$200 to the capital of each. During Years 1 through 4, S and B each earn \$50, and under § 1.1502-32 P adjusts its basis in the stock of each to \$250. (See § 1.1502-33 for adjustments to earnings and profits.) On January 1 of Year 5, the fair market value of S's assets and its stock is \$500, and S merges into B in a tax-free reorganization. Pursuant to the plan of reorganization, P receives B stock with a fair market value of \$350 and \$150 of cash.

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

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

(d) *Divisive transaction.* Assume instead that, pursuant to a plan, S distributes the stock of a lower-tier subsidiary in a spin-off transaction to which section 355 applies together with \$150 of cash. The distribution of stock is a transaction to which paragraph (f)(3) of this section applies. P is treated as receiving the \$150 of cash immediately before the section 355 distribution, as a distribution to which section 301 applies. Section 356(b) does not apply and no basis adjustments are required under section 358(a)(1)(A) and (B). Because the \$150 distribution is treated as made before the section 355 distribution, the distribution reduces P's basis in the S stock under

§ 1.1502-32, and the basis allocated under section 358(c) between the S stock and the lower-tier subsidiary stock received reflects this basis reduction.

*Example 4. Stock redemptions and distributions.* (a) *Facts.* Before becoming a member of the P group, S owns P stock with a \$30 basis. On January 1 of Year 1, P buys all of S's stock. On July 1 of Year 3, P redeems the P stock held by S for \$100 in a transaction to which section 302(a) applies.

(b) *Gain under section 302.* Under paragraph (f)(4) of this section, P's basis in the P stock acquired from S is treated as eliminated. As a result of this elimination, S's intercompany item will never be taken into account under the matching rule because P's basis in the stock does not reflect S's intercompany item. Therefore, S's \$70 gain is taken into account under the acceleration rule in Year 3. The attributes of S's item are determined under paragraph (d)(1)(ii) of this section by applying the matching rule as if P had sold the stock to an affiliated corporation that is not a member of the group at no gain or loss. Although P's corresponding item from a sale of its stock would have been excluded from gross income under section 1032, paragraph (c)(6)(ii) of this section prevents S's gain from being treated as excluded from gross income; instead S's gain is capital gain.

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

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

*Example 5. Intercompany stock sale followed by section 332 liquidation.* (a) *Facts.* S owns all of the stock of T, with a \$70 basis and \$100 value, and T's assets have a \$10 basis and \$100 value. On January 1 of Year 1, S sells all of T's stock to B for \$100. On July 1 of Year 3, when T's assets are still worth \$100, T distributes all of its assets to B in an unrelated complete liquidation to which section 332 applies.

(b) *Timing and attributes.* Under paragraph (b)(3)(iii) of this section, B's unrecognized gain or loss under section 332 is a corresponding item for purposes of applying the matching rule. In Year 3 when T liquidates, B has \$0 of unrecognized gain or loss under section 332 because B has a \$100 basis in the T stock and receives a \$100 distribution with respect to its T stock. Treating S and B as divisions of a single corporation, the recomputed corresponding item would have been \$30 of unrecognized gain under section 332 because B would have succeeded to S's \$70 basis in the T stock. Thus, under the matching rule, S's \$30 intercompany gain is taken into account in

Year 3 as a result of T's liquidation. Under paragraph (c)(1)(i) of this section, the attributes of S's gain and B's corresponding item are redetermined as if S and B were divisions of a single corporation. Although S's gain ordinarily would be redetermined to be treated as excluded from gross income to reflect the nonrecognition of B's gain under section 332, S's gain remains capital gain because B's unrecognized gain under section 332 is not permanently and explicitly disallowed under the Code. See paragraph (c)(6)(ii) of this section. However, relief may be elected under paragraph (f)(5)(ii) of this section.

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

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

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

(c) *Section 355 distribution within the group.* The facts are the same as under paragraph (a) of this Example 6, except that M distributes the T stock to B (another member of the group), and B takes a \$75 basis in the T stock under section 358. Under paragraph (j)(2) of this section, B is a successor to M for purposes of taking S's intercompany gain into account, and therefore both M and B might have corresponding items with respect to S's intercompany gain. To the extent it is

possible, matching with respect to B's corresponding items produces the result most consistent with treating S, M, and B as divisions of a single corporation. See paragraphs (j)(3) and (j)(4) of this section. However, because there is only \$5 difference between B's \$75 basis in the T stock and the \$70 basis the stock would have if S, M, and B were divisions of a single corporation, only \$5 can be taken into account under the matching rule with respect to B's corresponding items. (This \$5 is taken into account with respect to B's corresponding items based on subsequent events.) The remaining \$25 of S's \$30 intercompany gain is taken into account in Year 6 under the matching rule with respect to M's corresponding item from its distribution of the T stock. The attributes of S's remaining \$25 of gain are determined in the same manner as in paragraph (b) of this Example 6.

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

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

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

(i) *Obligation of a member.* An obligation of a member is—

(A) Any obligation of the member constituting indebtedness under general principles of Federal income tax law (for example, under nonstatutory authorities, or under section 108, section 163, section 171, or section 1275), but not an executory obligation to purchase or provide goods or services; and

(B) Any security of the member described in section 475(c)(2)(D) or (E), and any comparable security with respect to commodities, but not if the security is a position with respect to the member's stock. See paragraph (f)(4) of this section and § 1.1502-13T(f)(6) for special rules applicable to positions with respect to a member's stock.

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

(3) *Deemed satisfaction and reissuance of intercompany obligations—(i) Application—(A) In*

*general.* If a member realizes an amount (other than zero) of income, gain, deduction, or loss, directly or indirectly, from the assignment or extinguishment of all or part of its remaining rights or obligations under an intercompany obligation, the intercompany obligation is treated for all Federal income tax purposes as satisfied under paragraph (g)(3)(ii) of this section and, if it remains outstanding, reissued under paragraph (g)(3)(iii) of this section. Similar principles apply under this paragraph (g)(3) if a member realizes any such amount, directly or indirectly, from a comparable transaction (for example, a marking-to-market of an obligation or a bad debt deduction), or if an intercompany obligation becomes an obligation that is not an intercompany obligation.

(B) *Exceptions.* This paragraph (g)(3) does not apply to an obligation if any of the following applies:

(1) The obligation became an intercompany obligation by reason of an event described in § 1.108-2(e) (exceptions to the application of section 108(e)(4)).

(2) The amount realized is from reserve accounting under section 585 or section 593 (see paragraph (g)(3)(iv) of this section for special rules).

(3) The amount realized is from the conversion of an obligation into stock of the obligor.

(4) Treating the obligation as satisfied and reissued will not have a significant effect on any person's Federal income tax liability for any year. For this purpose, obligations issued in connection with the same transaction or related transactions are treated as a single obligation. However, this paragraph (g)(3)(i)(B)(4) does not apply to any obligation if the aggregate effect of this treatment for all obligations in a year would be significant.

(ii) *Satisfaction—(A) General rule.* If a creditor member sells intercompany debt for cash, the debt is treated as satisfied by the debtor immediately before the sale for the amount of the cash. For other transactions, similar principles apply to treat the intercompany debt as satisfied immediately before the transaction. Thus, if the debt is transferred for property, it is treated as satisfied for an amount consistent with the amount for which the debt is deemed reissued under paragraph (g)(3)(iii) of this section, and the basis of the property is also adjusted to reflect that amount. If this paragraph (g)(3) applies because the debtor or creditor becomes a nonmember, the obligation is treated as satisfied for cash in an amount equal to its fair market value immediately before

the debtor or creditor becomes a nonmember. Similar principles apply to intercompany obligations other than debt.

(B) *Timing and attributes.* For purposes of applying the matching rule and the acceleration rule—

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

(2) Any gain or loss from an intercompany obligation is not subject to section 108(a), section 354 or section 1091.

(iii) *Reissuance.* If a creditor member sells intercompany debt for cash, the debt is treated as a new debt (with a new holding period) issued by the debtor immediately after the sale for the amount of cash. For other transactions, if the intercompany debt remains outstanding, similar principles apply to treat the debt as reissued immediately after the transaction. Thus, if the debt is transferred for property, it is treated as new debt issued for the property. See, for example, section 1273(b)(3) or section 1274. If this paragraph (g)(3) applies because the debtor or creditor becomes a nonmember, the debt is treated as new debt issued for an amount of cash equal to its fair market value immediately after the debtor or creditor becomes a nonmember. Similar principles apply to intercompany obligations other than debt.

(iv) *Bad debt reserve.* A member's deduction under section 585 or section 593 for an addition to its reserve for bad debts with respect to an intercompany obligation is not taken into account, and is not treated as realized under this paragraph (g)(3) until the intercompany obligation becomes an obligation that is not an intercompany obligation, or, if earlier, the redemption or cancellation of the intercompany obligation.

(4) *Deemed satisfaction and reissuance of obligations becoming intercompany obligations—(i) Application—(A) In general.* This paragraph (g)(4) applies if an obligation that is not an intercompany obligation becomes an intercompany obligation.

(B) *Exceptions.* This paragraph (g)(4) does not apply to an obligation if—

(1) The obligation becomes an intercompany obligation by reason of an event described in § 1.108-2(e) (exceptions to the application of section 108(e)(4)); or

(2) Treating the obligation as satisfied and reissued will not have a significant effect on any person's Federal income tax liability for any year. For this

purpose, obligations issued in connection with the same transaction or related transactions are treated as a single obligation. However, this paragraph (g)(4)(i)(B)(2) does not apply to any obligation if the aggregate effect of this treatment for all obligations in a year would be significant.

(ii) *Intercompany debt.* If this paragraph (g)(4) applies to an intercompany debt—

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

(B) The debt is treated for all Federal income tax purposes, immediately after it becomes an intercompany debt, as satisfied and a new debt issued to the holder (with a new holding period) in an amount determined under the principles of § 1.108-2(f);

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

(D) Any intercompany gain or loss taken into account is treated as not subject to section 354 or section 1091; and

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

(iii) *Other intercompany obligations.* If this paragraph (g)(4) applies to an intercompany obligation other than debt, the principles of paragraph (g)(4)(ii) of this section apply to treat the intercompany obligation as satisfied and reissued for an amount of cash equal to its fair market value immediately after the obligation becomes an intercompany obligation.

(5) *Examples.* The application of this section to obligations of members is illustrated by the following examples.

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

(b) *Matching rule.* Under paragraph (b)(1) of this section, the accrual of interest on B's note is an intercompany transaction. Under the matching rule, S takes its \$10 of income into account in each of Years 1 through 5 to reflect the \$10 difference between B's \$10 of interest expense taken into account and the \$0 recomputed expense. S's income and B's deduction are ordinary items. (Because S's

intercompany item and B's corresponding item would both be ordinary on a separate entity basis, the attributes are not redetermined under paragraph (c)(1)(i) of this section.)

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

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

*Example 2. Intercompany debt becomes nonintercompany debt.* (a) *Facts.* On January 1 of Year 1, B borrows \$100 from S in return for B's note providing for \$10 of interest annually at the end of each year, and repayment of \$100 at the end of Year 20. As of January 1 of Year 3, B has paid the interest accruing under the note and S sells B's note to X for \$70, reflecting a change in the value of the note as a result of increases in prevailing market interest rates. B is never insolvent within the meaning of section 108(d)(3).

(b) *Deemed satisfaction.* Under paragraph (g)(3) of this section, B's note is treated as satisfied for \$70 immediately before S's sale to X. As a result of the deemed satisfaction of the obligation for less than its adjusted issue price, B takes into account \$30 of discharge of indebtedness income under section 61(a)(12). On a separate entity basis, S's \$30 loss would be a capital loss under section 1271(a)(1). Under the matching rule, however, the attributes of S's intercompany item and B's corresponding item must be redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. B's corresponding item completely offsets S's intercompany item in amount. Accordingly, under paragraph (c)(4)(i) of this section, the attributes of B's \$30 of discharge of indebtedness income control the attributes of S's loss. Thus, S's loss is treated as ordinary loss.

(c) *Deemed reissuance.* Under paragraph (g)(3) of this section, B is also treated as reissuing, directly to X, a new note with a \$70 issue price and a \$100 stated redemption



price at maturity. The new note is not an intercompany obligation, it has a \$70 issue price and \$100 stated redemption price at maturity, and the \$30 of original issue discount will be taken into account by B and X under sections 163(e) and 1272.

(d) *Creditor deconsolidation.* The facts are the same as in paragraph (a) of this Example 2, except that P sells S's stock to X (rather than S's selling the note of B). Under paragraph (g)(3) of this section, the note is treated as satisfied by B for its \$70 fair market value immediately before S becomes a nonmember, and B is treated as reissuing a new note to S immediately after S becomes a nonmember. The results for S's \$30 of loss and B's discharge of indebtedness income are the same as in paragraph (b) of this Example 2. The new note is not an intercompany obligation, it has a \$70 issue price and \$100 stated redemption price at maturity, and the \$30 of original issue discount will be taken into account by B and S under sections 163(e) and 1272.

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

(f) *Appreciated note.* The facts are the same as in paragraph (a) of this Example 2, except that S sells B's note to X for \$130 (rather than \$70), reflecting a decline in prevailing market interest rates. Under paragraph (g)(3) of this section, B's note is treated as satisfied for \$130 immediately before S's sale of the note to X. Under § 1.163-7(c), B takes into account \$30 of repurchase premium. On a separate entity basis, S's \$30 gain would be a capital gain under section 1271(a)(1), and B's \$30 premium deduction would be an ordinary deduction. Under the matching rule, however, the attributes of S's intercompany item and B's corresponding item must be redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of B's corresponding premium deduction control the attributes of S's intercompany gain. Accordingly, S's gain is treated as ordinary income. B is also treated as reissuing a new note directly to X which is not an intercompany obligation. The new note has a \$130 issue price and a \$100 stated redemption price at maturity. Under § 1.61-12(c), B's \$30 premium income under the new note is taken into account over the life of the new note.

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

(b) *Deemed satisfaction and reissuance.* Under paragraph (g)(3) of this section, B is treated as satisfying its note for \$60 immediately before the sale, and reissuing a new note directly to P with a \$60 issue price

and a \$100 stated redemption price at maturity. On a separate entity basis, S's \$40 loss would be a capital loss, and B's \$40 income would be ordinary income. Under the matching rule, however, the attributes of S's intercompany item and B's corresponding item must be redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of B's corresponding discharge of indebtedness income control the attributes of S's intercompany loss. Accordingly, S's loss is treated as ordinary loss.

(c) *Partial bad debt deduction.* The facts are the same as in paragraph (a) of this Example 3, except that S claims a \$40 partial bad debt deduction under section 166(a)(2) (rather than selling the note to P). The results are the same as in paragraph (b) of this Example 3. B's note is treated as satisfied and reissued with a \$60 issue price. S's \$40 intercompany deduction and B's \$40 corresponding income are both ordinary.

(d) *Insolvent debtor.* The facts are the same as in paragraph (a) of this Example 3, except that B is insolvent within the meaning of section 108(d)(3) at the time that S sells the note to P. On a separate entity basis, S's \$40 loss would be capital, B's \$40 income would be excluded from gross income under section 108(a), and B would reduce attributes under section 108(b) or section 1017. However, under paragraph (g)(3)(ii)(B) of this section, section 108(a) does not apply to B's income to characterize it as excluded from gross income. Accordingly, the attributes of S's intercompany loss and B's corresponding income are redetermined in the same manner as in paragraph (b) of this Example 3.

*Example 4. Nonintercompany debt becomes intercompany debt.* (a) *Facts.* On January 1 of Year 1, B borrows \$100 from X in return for B's note providing for \$10 of interest annually at the end of each year, and repayment of \$100 at the end of Year 5. As of January 1 of Year 3, B has fully performed its obligations, but the note's fair market value is \$70. On January 1 of Year 3, P buys all of X's stock. B is solvent within the meaning of section 108(d)(3).

(b) *Deemed satisfied and reissuance.* Under paragraph (g)(4) of this section, B is treated as satisfying its indebtedness for \$70 (determined under the principles of § 1.108-2(f)(2)) immediately after X becomes a member. Both X's \$30 capital loss under section 1271(a)(1) and B's \$30 of discharge of indebtedness income under section 61(a)(12) are taken into account in determining consolidated taxable income for Year 3. Under paragraph (g)(4)(ii)(C) of this section, the attributes of items resulting from the satisfaction are determined on a separate entity basis. But see section 382 and § 1.1502-15 (limitations on the absorption of built-in losses). B is also treated as reissuing a new note. The new note is an intercompany obligation, it has a \$70 issue price and \$100 stated redemption price at maturity, and the \$30 of original issue discount will be taken into account by B and X in the same manner as provided in paragraph (c) of Example 1 of this paragraph (g)(5).

(c) *Election to file consolidated returns.* Assume instead that B borrows \$100 from S

during Year 1, but the P group does not file consolidated returns until Year 3. Under paragraph (g)(4) of this section, B's indebtedness is treated as satisfied and a new note reissued immediately after the debt becomes intercompany debt. The satisfaction and reissuance are deemed to occur on January 1 of Year 3, for the fair market value of the note (determined under the principles of § 1.108-2(f)(2)) at that time.

*Example 5. Notional principal contracts.* (a) *Facts.* On April 1 of Year 1, M1 enters into a contract with counterparty M2 under which, for a term of five years, M1 is obligated to make a payment to M2 each April 1, beginning in Year 2, in an amount equal to the London Interbank Offered Rate (LIBOR), as determined on the immediately preceding April 1, multiplied by a \$1,000 notional principal amount. M2 is obligated to make a payment to M1 each April 1, beginning in Year 2, in an amount equal to 8% multiplied by the same notional principal amount. LIBOR is 7.80% on April 1 of Year 1. On April 1 of Year 2, M2 owes \$2 to M1.

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

(c) *Dealer.* The facts are the same as in paragraph (a) of this Example 5, except that M2 is a dealer in securities, and the contract with M1 is not inventory in the hands of M2. Under section 475, M2 must mark its securities to market at year-end. Assume that under section 475, M2's loss from marking to market the contract with M1 is \$100. Under paragraph (g)(3) of this section, M2 is treated as making a \$100 payment to M1 to terminate the contract immediately before section 475 is applied. M1's \$100 of income from the termination payment is taken into account under the matching rule to reflect M2's deduction under § 1.446-3(h). The attributes of M1's intercompany income and M2's corresponding deduction are redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of M2's corresponding

deduction control the attributes of M1's intercompany income. Accordingly, M1's income is treated as ordinary income. Paragraph (g)(3) of this section also provides that, immediately after section 475 would apply, a new contract is treated as reissued with an upfront payment of \$100. Under § 1.446-3(f), the deemed \$100 payment by M2 to M1 is taken into account over the term of the new contract in a manner reflecting the economic substance of the contract (for example, allocating the payment in accordance with the forward rates of a series of cash-settled forward contracts that reflect the specified index and the \$1,000 notional principal amount). (The timing of taking items into account is the same if M1, rather than M2, is the dealer subject to the market-to-market requirement of section 475 at year-end. However in this case, because the attributes of the corresponding deduction control the attributes of the intercompany income, M1's income from the deemed termination payment might be ordinary or capital.)

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

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

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

(b) *Adjustments.* Under § 1.1502-21(c), the partnership's \$90 built-in gain allocated to B

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

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

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

*Example 3. Corporate mixing bowl.* (a) *Facts.* M1 and M2 are subsidiaries of P. M1 operates a manufacturing business on land it leases from M2. The land is the only asset held by M2. P intends to dispose of the M1 business, including the land owned by M2; P's basis in the M1 stock is equal to the stock's fair market value. M2's land has a value of \$20 and a basis of \$0 and P has a \$0 basis in the stock of M2. In Year 1, with a principal purpose of avoiding gain from the sale of the land (by transferring the land to M1 with a carry-over basis without affecting P's basis in the stock of M1 or M2), M1 and M2 form corporation T: M1 contributes cash in exchange for 80% of the T stock and M2 contributes the land in exchange for 20% of the stock. In Year 3, T liquidates, distributing \$20 cash to M2 and the land (plus \$60 cash) to M1. Under § 1.1502-34, section 332 applies to both M1 and M2. Under section 337, T recognizes no gain or loss from its

liquidating distribution of the land to M1. T has neither gain nor loss on its distribution of cash to M2. In Year 4, P sells all of the stock of M1 to X and liquidates M2.

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

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

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

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

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

(i) [Reserved]

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

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

(2) *Successor persons*—(i) *In general.* Any reference to a person includes, as the context may require, a reference to a predecessor or successor. For this

purpose, a predecessor is a transferor of assets to a transferee (the successor) in a transaction—

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

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

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

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

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

(3) *Multiple triggers.* If more than one corresponding item can cause an intercompany item to be taken into account under the matching rule, the intercompany item is taken into account in connection with the corresponding item most consistent with the treatment of members as divisions of a single corporation. For example, if S sells a truck to B, its intercompany gain from the sale is not taken into account by reference to B's depreciation if the depreciation is capitalized under section 263A as part of B's cost for a building; instead, S's gain relating to the capitalized depreciation is taken into account when the building is sold or as it is depreciated. Similarly, if B purchases appreciated land from S and transfers the land to a lower-tier member in exchange for stock, thereby duplicating the basis of the land in the basis of the stock, items with respect to both the stock and the land can cause S's intercompany gain to be taken into account; if the lower-tier member becomes a nonmember as a result of the sale of its stock, the attributes of S's intercompany gain are determined with respect to the land rather than the stock.

(4) *Multiple or successive intercompany transactions.* If a member's intercompany item or corresponding item affects the accounting for more than one intercompany transaction, appropriate adjustments are made to treat all of the

intercompany transactions as transactions between divisions of a single corporation. For example, if S sells property to M, and M sells the property to B, then S, M, and B are treated as divisions of a single corporation for purposes of applying the rules of this section. Similar principles apply with respect to intercompany transactions that are part of the same plan or arrangement. For example, if S sells separate properties to different members as part of the same plan or arrangement, all of the participating members are treated as divisions of a single corporation for purposes of determining the attributes (which might also affect timing) of the intercompany items and corresponding items from each of the properties.

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

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

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

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

(6) *Former common parent treated as continuation of group.* If a group terminates because the common parent is the only remaining member, the common parent succeeds to the treatment of the terminating group for purposes of applying this section so long as it neither becomes a member of an affiliated group filing separate returns nor becomes a corporation described in section 1504(b). For example, if the only subsidiary of the group liquidates into the common parent in a complete liquidation to

which section 332 applies, or the common parent merges into the subsidiary and the subsidiary is treated as the common parent's successor under paragraph (j)(2)(i) of this section, the taxable income of the surviving corporation is treated as the group's consolidated taxable income in which the intercompany and corresponding items must be included. See § 1.267(f)-1 for additional rules applicable to intercompany losses or deductions.

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

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

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

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

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



(c) *Timing and attributes resulting from the stock sale.* Under paragraph (c)(3) of this section, M is treated as owning and selling B's stock for purposes of the matching rule even though, as divisions, M could not own and sell stock in B. Under paragraph (j)(3) of this section, both M's B stock and B's land can cause S's intercompany gain to be taken into account under the matching rule. Thus, S takes \$6 of its gain into account in Year 5 to reflect the \$6 difference between M's \$2 gain taken into account from its sale of B stock and the \$8 recomputed gain. Under paragraph (j)(4) of this section, the attributes of this gain are determined by treating S, M, and B as divisions of a single corporation. Under paragraph (c)(1) of this section, S's \$6 gain and M's \$2 gain are treated as long-term capital gain. The gain would be capital on a separate entity basis (assuming that section 341 does not apply), and this treatment is not inconsistent with treating S, M, and B as divisions of a single corporation because the stock sale and subsequent land sale are unrelated transactions and B remains a member following the sale.

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

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

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

in a recapitalization described in section 368(a)(1)(E).

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

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

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

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

*Example 4. Back-to-back intercompany transactions—acceleration.* (a) *Facts.* During Year 1, S performs services for M in exchange for \$10 from M. S incurs \$8 of employee expenses. M capitalizes the \$10 cost of S's services under section 263 as part of M's cost to acquire real property from X. Under its separate entity method of accounting, S would take its income and expenses into account in Year 1. M holds the real property for investment and, on July 1 of Year 5, M

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

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

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

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

(e) *Intercompany income followed by intercompany loss.* The facts are the same as in paragraph (a) of this Example 4, except that M sells the real property to B at a \$1 loss (rather than a gain). M takes its \$1 loss into account under the acceleration rule immediately before M becomes a nonmember. But see § 1.267(f)-1 (which might further defer M's loss if M and B remain in a controlled group relationship after M becomes a nonmember). Under paragraph (j)(4) of this section appropriate adjustments must be made to treat the group as if both intercompany transactions occurred between divisions of a single corporation. Accordingly, P's sale of M stock also results in S taking into account \$1 of intercompany income as capital gain to offset M's \$1 of corresponding capital loss. The remaining \$1 of S's intercompany income is taken into account based on subsequent events.



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

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

(c) *No subgroups.* The facts are the same as in paragraph (a) of this Example 5, except that X simultaneously acquires the stock of S and B from P (rather than X acquiring all of P's stock). Paragraph (j)(5) of this section does not apply to X's acquisitions. Unless an exception described in paragraph (g)(3)(i)(B) applies, B's note is treated as satisfied immediately before S and B become nonmembers, and reissued immediately after they become members of the X consolidated group. The amount at which the note is satisfied and reissued under paragraph (g)(3) of this section is based on the fair market value of the note at the time of P's sales to X. Paragraph (g)(4) of this section does not apply to the reissued B note in the X consolidated group, because the new note is always an intercompany obligation of the X consolidated group.

**Example 6. Liquidation—80% distributee.**

(a) *Facts.* X has had preferred stock described in section 1504(a)(4) outstanding for several years. On January 1 of Year 1, S buys all of X's common stock for \$60, and B buys all of X's preferred stock for \$40. X's assets have a \$0 basis and \$100 value. On July 1 of Year 3, X distributes all of its assets to S and B in a complete liquidation. Under § 1.1502-34, section 332 applies to both S and B.

Under section 337, X has no gain or loss from its liquidating distribution to S. Under sections 336 and 337(c), X has a \$40 gain from its liquidating distribution to B. B has a \$40 basis under section 334(a) in the assets received from X, and S has a \$0 basis under section 334(b) in the assets received from X.

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

not govern the allocation of any other attributes.)

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

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

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

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

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

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

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

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

(l) *Effective dates—(1) In general.* This section applies with respect to transactions occurring in years beginning on or after July 12, 1995. If both this section and prior law apply to a transaction, or neither applies, with the result that items may be duplicated, omitted, or eliminated in determining taxable income (or tax liability), or items may be treated inconsistently, prior law

(and not this section) applies to the transaction. For example, S's and B's items from S's sale of property to B which occurs before July 12, 1995 are taken into account under prior law, even though B may dispose of the property after July 12, 1995. Similarly, an intercompany distribution to which a shareholder becomes entitled before July 12, 1995 but which is distributed after that date is taken into account under prior law (generally when distributed), because this section generally takes dividends into account when the shareholder becomes entitled to them but this section does not apply at that time. If application of prior law to S's deferred gain or loss from a deferred intercompany transaction (as defined under prior law) occurring prior to July 12, 1995 would be affected by an intercompany transaction (as defined under this section) occurring after July 12, 1995, S's deferred gain or loss continues to be taken into account as provided under prior law, and the items from the subsequent intercompany transaction are taken into account under this section. Appropriate adjustments must be made to prevent items from being duplicated, omitted, or eliminated in determining taxable income as a result of the application of both this section and prior law to the successive transactions, and to ensure the proper application of prior law.

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

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

or loss from stock with respect to all stock elimination transactions.

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

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

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

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

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

(iii) *Time and manner of making election.* An election under this paragraph (l)(3) is made by attaching to a timely filed original return (including extensions) for the consolidated return year including July 12, 1995 a statement entitled "[Insert Name and Employer Identification Number of Common Parent] HEREBY ELECTS THE APPLICATION OF § 1.1502-13(l)(3)." See paragraph (f)(5)(ii)(E) of this section for the manner of electing the relief provisions of paragraph (f)(5)(ii) of this section.

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

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

**§§ 1.1502-13T, 1.1502-14, and 1.1502-14T (Removed)**

**Par. 14.** Sections 1.1502-13T, 1.1502-14, and 1.1502-14T are removed.

**Par. 15.** Section 1.1502-17 is amended as follows:

1. Paragraph (b) is revised.
2. Paragraph (c) is redesignated as paragraph (d).
3. New paragraphs (c) and (e) are added.

4. Newly designated paragraph (d) is amended by:

a. Revising the paragraph heading and the introductory text.

b. Designating the existing example as *Example 1* and adding a heading.

c. Adding *Examples 2* and *3*.  
The added and revised provisions read as follows:

**§ 1.1502-17 Methods of accounting.**

\* \* \* \* \*

(b) *Adjustments required if method of accounting changes—(1) General rule.* If a member of a group changes its method of accounting for a consolidated return year, the terms and conditions prescribed by the Commissioner under section 446(e), including section 481(a) where applicable, shall apply to the member. If the requirements of section 481(b) are met because applicable adjustments under section 481(a) are substantial, the increase in tax for any prior year shall be computed upon the basis of a consolidated return or a separate return, whichever was filed for such prior year.

(2) *Changes in method of accounting for intercompany transactions.* If a member changes its method of accounting for intercompany transactions for a consolidated return year, the change in method generally will be effected on a cut-off basis.

(c) *Anti-avoidance rules—(1) General rule.* If one member (B) directly or indirectly acquires an activity of another member (S), or undertakes S's activity, with the principal purpose to avail the group of an accounting method that would be unavailable (or would be unavailable without securing consent from the Commissioner) if S and B were treated as divisions of a single corporation, B must use the accounting method for the acquired or undertaken activity determined under paragraph (c)(2) of this section or must secure consent from the Commissioner under applicable administrative procedures to use a different method.

(2) *Treatment as divisions of a single corporation.* B must use the method of accounting that would be required if B acquired the activity from S in a transaction to which section 381 applied. Thus, the principles of section 381 (c)(4) and (c)(5) apply to resolve any conflicts between the accounting methods of S and B, and the acquired or undertaken activity is treated as having the accounting method used by S. Appropriate adjustments are made to treat all acquisitions or undertakings that are part of the same plan or arrangement as a single acquisition or undertaking.

(d) *Examples.* The provisions of this section are illustrated by the following examples:

*Example 1. Separate return treatment generally.* \* \* \*

*Example 2. Adopting methods.* Corporation P is a member of a consolidated group. P provides consulting services to customers under various agreements. For one type of customer, P's agreements require payment only when the contract is completed (payment-on-completion contracts). P uses an overall accrual method of accounting. Accordingly, P takes its income from consulting contracts into account when earned, received, or due, whichever is earlier. With the principal purpose to avoid seeking the consent of the Commissioner to change its method of accounting for the payment-on-completion contracts to the cash method, P forms corporation S, and S begins to render services to those customers subject to the payment-on-completion contracts. P continues to render services to those customers not subject to these contracts.

(b) Under paragraph (c) of this section, S must account for the consulting income under the payment-on-completion contracts on an accrual method rather than adopting the cash method contemplated by P.

*Example 3. Changing inventory sub-method.* (a) Corporation P is a member of a consolidated group. P operates a manufacturing business that uses dollar-value LIFO, and has built up a substantial LIFO reserve. P has historically manufactured all its inventory and has used one natural business unit pool. P begins purchasing goods identical to its own finished goods from a foreign supplier, and is concerned that it must establish a separate resale pool under § 1.472-8(c). P anticipates that it will begin to purchase, rather than manufacture, a substantial portion of its inventory, resulting in a recapture of most of its LIFO reserve because of decrements in its manufacturing pool. With the principal purpose to avoid the decrements, P forms corporation S in Year 1. S operates as a distributor to nonmembers, and P sells all of its existing inventories to S. S adopts LIFO, and elects dollar-value LIFO with one resale pool. Thereafter, P continues to manufacture and purchase inventory, and to sell it to S for resale to nonmembers. P's intercompany gain from sales to S is taken into account under § 1.1502-13. S maintains its Year 1 base dollar value of inventory so that P will not be required to take its intercompany items (which include the effects of the LIFO reserve recapture) into account.

(b) Under paragraph (c) of this section, S must maintain two pools (manufacturing and resale) to the same extent that P would be required to maintain those pools under § 1.472-8 if it had not formed S.

(e) *Effective dates.* Paragraph (b) of this section applies to changes in method of accounting effective for years beginning on or after July 12, 1995. For changes in method of accounting effective for years beginning before that date, see § 1.1502-17 (as contained in the 26 CFR part 1 edition revised as of

April 1, 1995) Paragraphs (c) and (d) apply with respect to acquisitions occurring or activities undertaken in years beginning on or after July 12, 1995.

Par. 16. Section 1.1502-18 is amended by revising the heading for paragraph (f) and adding paragraph (g) to read as follows:

**§ 1.1502-18 Inventory adjustment.**

\* \* \* \* \*

(f) *Transitional rules for years before 1966.* \* \* \*

(g) *Transitional rules for years beginning on or after July 12, 1995.* Paragraphs (a) through (f) of this section do not apply for taxable years beginning on or after July 12, 1995. Any remaining unrecovered inventory amount of a member under paragraph (c) of this section is recovered in the first taxable year beginning on or after July 12, 1995, under the principles of paragraph (c)(3) of this section by treating the first taxable year as the first separate return year of the member. The unrecovered inventory amount can be recovered only to the extent it was previously included in taxable income. The principles of this section apply, with appropriate adjustments, to comparable amounts under paragraph (f) of this section.

Par. 17. Section 1.1502-20 is amended as follows:

1. Paragraph (a)(5) *Example 6* is amended as follows:
  - a. The fifth sentence of paragraph (i) is revised.
  - b. Paragraph (ii) is revised.
  - c. Paragraphs (iii) and (iv) are added.
2. Paragraph (b)(6) *Example 5* is amended as follows:
  - a. The fifth sentence of paragraph (i) is revised.
  - b. A sentence is added at the beginning of paragraph (ii).
  - c. Paragraph (iii) is revised.
  - d. Paragraph (iv) is removed.
3. Paragraph (b)(6) *Example 7* is amended as follows:
  - a. The fourth sentence of paragraph (i) is revised.
  - b. The first sentence of paragraph (iii) is revised.
4. Paragraph (c)(4) is amended as follows:
  - a. *Example 3* is amended by removing paragraph (iii).
  - b. *Example 9* is added.
5. Paragraph (e)(3) is amended as follows:
  - a. *Examples 2* and *8* are removed.
  - b. *Example 3* through *Example 7* are redesignated as *Example 2* through *Example 6*.
  - c. Newly designated *Example 5* is revised.

6. In paragraph (h)(1), the second sentence is revised. The revised and added provisions read as follows:

**§ 1.1502-20 Disposition or deconsolidation of subsidiary stock.**

(a) \* \* \*  
(5) \* \* \*

*Example 6.* \* \* \*

(i) \* \* \* S sells its T stock to P for \$100 in an intercompany transaction, recognizing a \$60 intercompany loss that is deferred under section 267(f) and § 1.1502-13. \* \* \*

(ii) Under paragraph (a)(3)(i) of this section, the application of paragraph (a)(1) of this section to S's \$60 intercompany loss on the sale of its T stock to P is deferred, because S's intercompany loss is deferred under section 267(f) and § 1.1502-13. P's sale of the T stock to X ordinarily would result in S's intercompany loss being taken into account under the matching rule of § 1.1502-13(c). The deferred loss is not taken into account under § 1.267(f)-1, however, because P's sale to X (a member of the same controlled group as P) is a second intercompany transaction for purposes of section 267(f). Nevertheless, paragraph (a)(3)(ii) of this section provides that paragraph (a)(1) of this section applies to the intercompany loss as a result of P's sale to X because the T stock ceases to be owned by a member of the P consolidated group. Thus, the loss is disallowed under paragraph (a)(1) of this section immediately before P's sale and is therefore never taken into account under section 267(f).

(iii) The facts are the same as in (i) of this *Example*, except that S is liquidated after its sale of the T stock to P, but before P's sale of the T stock to X, and P sells the T stock to X for \$110. Under §§ 1.1502-13(j) and 1.267(f)-1(b), P succeeds to S's intercompany loss as a result of S's liquidation. Thus, paragraph (a)(3)(i) of this section continues to defer the application of paragraph (a)(1) of this section until P's sale to X. Under paragraph (a)(4) of this section, the amount of S's \$60 intercompany loss disallowed under paragraph (a)(1) of this section is limited to \$50 because P's \$10 gain on the disposition of the T stock is taken into account as a consequence of the same plan or arrangement.

(iv) The facts are the same as in (i) of this *Example*, except that P sells the T stock to A, a person related to P within the meaning of section 267(b)(2). Although S's intercompany loss is ordinarily taken into account under the matching rule of § 1.1502-13(c) as a result of P's sale, § 1.267(f)-1(c)(2)(ii) provides that none of the intercompany loss is taken into account because A is a nonmember that is related to P under section 267(b). Under paragraph (a)(3)(i) of this section, paragraph (a)(1) of this section does not apply to loss that is disallowed under any other provision. Because § 1.267(f)-1(c)(2)(ii) and section 267(d) provide that the benefit of the intercompany loss is retained by A if the property is later disposed of at a gain, the intercompany loss is not disallowed for purposes of paragraph (a)(3)(i) of this section. Thus, the intercompany loss is disallowed

under paragraph (a)(1) of this section immediately before P's sale and is therefore never taken into account under section 267(d).

(b) \* \* \*  
(6) \* \* \*

*Example 5.* \* \* \*

(i) \* \* \* S sells its T stock to P for \$100 in an intercompany transaction, recognizing a \$60 intercompany loss that is deferred under section 267(f) and § 1.1502-13. \* \* \*

(ii) Under paragraph (a)(3)(i) of this section, the application of paragraph (a)(1) of this section to S's intercompany loss on the sale of its T stock to P is deferred because S's loss is deferred under section 267(f) and § 1.1502-13. \* \* \*

(iii) T's issuance of the additional shares to the public does not result in S's intercompany loss being taken into account under the matching or acceleration rules of § 1.1502-13(c) and (d), or under the application of the principles of those rules in section 267(f). However, the deconsolidation of T is an overriding event under paragraph (a)(3)(ii) of this section, and paragraph (a)(1) of this section disallows the intercompany loss immediately before the deconsolidation even though the intercompany loss is not taken into account at that time.

*Example 7.* \* \* \*

(i) \* \* \* S recently purchased its T stock from S1, a lower tier subsidiary, in an intercompany transaction in which S1 recognized a \$30 intercompany gain that was deferred under § 1.1502-13. \* \* \*

\* \* \* \* \*

(iii) Under the matching rule of § 1.1502-13, S's sale of its T stock results in S1's \$30 intercompany gain being taken into account. \* \* \*

\* \* \* \* \*

(c) \* \* \*  
(4) \* \* \*

*Example 9. Intercompany stock sales.*

(i) P is the common parent of a consolidated group. S is a wholly owned subsidiary of P, and T is a wholly owned recently purchased subsidiary of S. S has a \$100 basis in the T stock, and T has a capital asset with a basis of \$0 and a value of \$100. T's asset declines in value to \$60. Before T has any positive investment adjustments or extraordinary gain dispositions, S sells its T stock to P for \$60. T's asset reappreciates and is sold for \$100, and T recognizes \$100 of gain. Under the investment adjustment system, P's basis in the T stock increases to \$160. P then sells all of the T stock for \$100 and recognizes a loss of \$60.

(ii) S's sale of the T stock to P is an intercompany transaction. Thus, S's \$40 loss is deferred under section 267(f) and § 1.1502-13. Under paragraph (a)(3) of this section, the application of paragraph (a)(1) of this section to S's \$40 loss is deferred until the loss is taken into account. Under the matching rule of § 1.1502-13(c), the loss is taken into account to reflect the difference for each year between P's corresponding items taken into account and P's recomputed corresponding items (the corresponding items that P would take into account for the year if S and P were divisions of a single corporation). If S and P

were divisions of a single corporation and the intercompany sale were a transfer between the divisions, P would succeed to S's \$100 basis and would have a \$200 basis in the T stock at the time it sells the T stock (\$100 of initial basis plus \$100 under the investment adjustment system). S's \$40 loss is taken into account at the time of P's sale of the T stock to reflect the \$40 difference between the \$60 loss P takes into account and P's recomputed \$100 loss.

(iii) Under the matching rule of § 1.1502-13(c), the attributes of S's \$40 loss and P's \$60 loss are redetermined to produce the same effect on consolidated taxable income (and consolidated tax liability) as if S and P were divisions of a single corporation. Under § 1.1502-13(b)(6), attributes of the losses include whether they are disallowed under this section. Because the amount described in paragraph (c)(1) of this section is \$100, both S's \$40 loss and P's \$60 loss are disallowed.

\* \* \* \* \*  
(e) \* \* \*  
(3) \* \* \*

**Example 5. Absence of a view.**

(i) In Year 1, P buys all the stock of T for \$100, and T becomes a member of the P group. T has 2 historic assets, asset 1 with a basis of \$40 and value of \$90, and asset 2 with a basis of \$60 and value of \$10. In Year 2, T sells asset 1 for \$90. Under the investment adjustment system, P's basis in the T stock increases from \$100 to \$150. Asset 2 is not essential to the operation of T's business, and T distributes asset 2 to P in Year 5 with a view to having the group retain its \$50 loss inherent in the asset. Under § 1.1502-13(f)(2), and the application of the principles of this rule in section 267(f), T has a \$50 intercompany loss that is deferred. Under § 1.1502-32(b)(3)(iv), the distribution reduces P's basis in the T stock by \$10 to \$140 in Year 5. In Year 6, P sells all the T stock for \$90. Under the acceleration rule of § 1.1502-13(d), and the application of the principles of this rule in section 267(f), T's intercompany loss is ordinarily taken into account immediately before P's sale of the T stock. Assuming that the loss is absorbed by the group, P's basis in T's stock would be reduced from \$140 to \$90 under § 1.1502-32(b)(3)(i), and there would be no gain or loss from the stock disposition. (Alternatively, if the loss is not absorbed and the loss is reattributed to P under paragraph (g) of this section, the reattribution would reduce P's basis in T's stock from \$140 to \$90.)

(ii) A \$50 loss is reflected both in T's basis in asset 2 and in P's basis in the T stock. Because the distribution results in the loss with respect to asset 2 being taken into account before the corresponding loss reflected in the T stock, and asset 2 is an historic asset of T, the distribution is not with the view described in paragraph (e)(2) of this section.

\* \* \* \* \*  
(h) \* \* \*  
(1) \* \* \*

For this purpose, dispositions deferred under § 1.1502-13 are deemed to occur at the time the deferred gain or loss is taken into account unless the stock was

deconsolidated before February 1, 1991.

\* \* \* \* \*

**Par. 18.** Section 1.1502-26 is amended by revising paragraph (b) to read as follows:

**§ 1.1502-26 Consolidated dividends received deduction.**

\* \* \* \* \*

(b) *Intercompany dividends.* The deduction determined under paragraph (a) of this section is determined without taking into account intercompany dividends to the extent that, under § 1.1502-13(f)(2), they are not included in gross income. See § 1.1502-13 for additional rules relating to intercompany dividends.

\* \* \* \* \*  
**Par. 19.** Section 1.1502-33 is amended by revising paragraph (c)(2) to read as follows:

**§ 1.1502-33 Earnings and profits.**

\* \* \* \* \*

(c) \* \* \*

(2) *Intercompany transactions.* Intercompany items and corresponding items are not reflected in earnings and profits before they are taken into account under § 1.1502-13. See § 1.1502-13 for the applicable rules and definitions.

\* \* \* \* \*

**§ 1.1502-79 [Amended]**

**Par. 20.** Section 1.1502-79 is amended by removing paragraph (f).

**Par. 21.** Section 1.1502-80 is amended by adding paragraphs (e) and (f) to read as follows:

**§ 1.1502-80 Applicability of other provisions of law.**

\* \* \* \* \*

(e) *Non-applicability of section 163(e)(5).* Section 163(e)(5) does not apply to any intercompany obligation (within the meaning of § 1.1502-13(g)) issued in a consolidated return year beginning on or after July 12, 1995.

(f) *Non-applicability of section 1031.* Section 1031 does not apply to any intercompany transaction occurring in consolidated return years beginning on or after July 12, 1995.

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

**Par. 22.** The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

**Par. 23.** In § 602.101, paragraph (c) is amended as follows:

1. Removing the following entries from the table:

**§ 602.101 OMB Control numbers.**

\* \* \* \* \*  
(c) \* \* \*

CFR part or section where identified and described	Current OMB control number
1.267(f)-1T	1545-0885
1.469-1T	1545-1008
1.1502-14	1545-0123
1.1502-14T	1545-1161

2. Adding entries in numerical order to the table for §§ 1.267(f)-1 and 1.469-1 and revising the entry for § 1.1502-13 to read as follows:

**§ 602.101 OMB Control numbers.**

\* \* \* \* \*

CFR part or section where identified and described	Current OMB control number
1.267(f)-1	1545-0885
1.469-1	1545-1008
1.1502-13	1545-0123, 1545-0885, 1545-1161, 1545-1433

**Michael P. Dolan,**  
*Acting Commissioner of Internal Revenue.*

Approved: June 29, 1995.

**Leslie Samuels,**  
*Assistant Secretary of the Treasury (Tax Policy).*

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**DEPARTMENT OF JUSTICE**

**28 CFR Part 0**

[AG Order No. 1977-95]

**Service of Subpoenas Upon the Attorney General**

**AGENCY:** Department of Justice.

**ACTION:** Final rule.