New York State Bar Association
Tax Section

Report on Statutory Provisions Regarding the Importation and Duplication of Tax Losses

January 6, 2006

TABLE OF CONTENTS

Pages

Report No. 1101

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON STATUTORY PROVISIONS REGARDING THE IMPORTATION AND DUPLICATION OF TAX LOSSES[1]

I. INTRODUCTION.

The "American Jobs Creation Act of 2004," (the "**Jobs Act**"),[2] enacted on October 22, 2004, contained, among other matters, provisions intended to address perceived corporate tax abuses connected to the "importation" and "duplication" of tax losses. This report of the Tax Section of the New York State Bar Association (the "**Section**") offers suggestions and comments regarding such provisions, and offers recommendations regarding potential regulatory guidance in respect of such provisions. As discussed in more detail in the body of this report, the provisions, which are contained in sections 362(e) and 334(b) of the Internal Revenue Code of 1986, as amended (the "**Code**"),[3] generally are addressed to two basic fact patterns.

Under the first fact pattern, a non-U.S. person or U.S. tax-exempt entity holds "built-in loss" property — that is, property for which the basis measured under U.S. tax principles exceeds the property's fair market value. Because the non-U.S. person or U.S. tax-exempt entity generally is not subject to U.S. federal income tax in respect of such property, any gain or loss realized by such person or entity upon the disposition of the property effectively would be irrelevant for U.S. federal income tax purposes. The non-U.S. person or U.S. tax-exempt entity, however, then transfers the built-in loss

---

[1] The principal author of this report is William McRae. Assistance was provided by Elena Romanova. Helpful comments were received from Kimberly Blanchard, Larry Garrett, David Hariton, Douglas McFadyen, Michael Schler, and Andrew Walker.

[2] P.L. 108-357 (2004).

[3] Unless indicated otherwise, all section references in this report are either to the Code or to Treasury regulations promulgated thereunder.

property to a U.S. corporation in a carryover basis transaction (either a corporate reorganization or section 351 exchange), and thereby makes the built-in loss available to offset the tax liabilities of the U.S. corporate recipient of the property (*i.e.*, "imports" the loss into the U.S. tax system).

As discussed below, Congress considered such loss importation transactions to be abusive, on the grounds that it is inappropriate to allow a U.S. federal income tax deduction in respect of an economic loss that arose outside of the U.S. "tax net." Accordingly, sections 362(e)(1) and 334(b) generally require the corporate recipient of transferred built-in loss property to take a fair-market-value tax basis in the property, and the sections thereby eliminate the built-in tax loss.

Under the second fact pattern, a U.S. taxpayer holds built-in loss property and, in a transaction described in section 351, transfers the property to a U.S. corporation in exchange for stock in which the taxpayer takes a substituted basis under the general application of section 358. Accordingly, the corporation holds the built-in loss property with a carryover basis, and the shareholder/transferor holds stock with the same aggregate basis (and presumably, the same fair market value) as the transferred property. The built-in loss has thus been retained in the assets, and duplicated in the stock. As discussed in more detail below, Congress considered such "loss duplications" to be abusive, on the grounds that a single economic loss should give rise to only a single loss recognized for U.S. federal income tax purposes. Accordingly, section 362(e)(2) prevents such loss duplication by requiring either the corporation/transferee to take a stepped-down basis in the property, or the shareholder/transferor to take a stepped-down basis in the stock.[4]

II. REPORT STRUCTURE.

A. Overview.

This Section II.A provides a general overview of the structure of this report. First, Section II.B, below, provides a summary of the Section's recommendations concerning the proper implementation of sections 362(e) and 334(b). Part III then provides a general overview of the history behind the sections, and Congress' reasons for enacting the sections in 2004. Part IV describes the general working of sections 362(e) and 334(b), and points out several policy choices that are reflected in the operation of the sections.

Parts V through VIII contain discussions of various policy issues and present the Section's recommendations with respect thereto. Part V discusses certain issues related to measuring built-in loss, including whether, in the case where multiple assets are transferred by multiple transferors, built-in loss should be measured for purposes of section 362(e) on a "transferor-by-transferor" basis by reference to the specific assets transferred by each transferor, or whether all of the transferred property should be aggregated. Part VI discusses issues related to transfers of property by partnerships, and Part VII discusses certain issues in determining when property has been "imported" into the U.S. tax system. Finally, Part VIII discusses certain issues arising from the overlap between section 362(e) and the consolidated return regulations.

---

4 The Jobs Act introduced anti-loss-duplication rules in the partnership context through the so–called "mandatory section 754 election" provisions contained in sections 734 and 743, which require downward basis adjustments to partnership assets in cases where a tax loss is realized by a partner upon a disposition of its partnership interest or upon a liquidating partnership distribution. Those partnership provisions are beyond the scope of this report.

B. Summary of Recommendations.

For the reasons set forth in this report, our principal recommendations are as follows:

- Measuring Built-In Loss Under Section 362(e). We recommend that the Treasury Department ("Treasury") and the Internal Revenue Service (the "Service") issue guidance clarifying how net built-in loss is measured in the context of property transfers by multiple transferors. Specifically, we recommend that: (i) for purposes of determining whether a transaction as a whole gives rise to an importation of a net built-in loss under section 362(e)(1), all property "imported" into the U.S. tax system in a single section 351 transaction (or in a reorganization) be aggregated, and (ii) for purposes of determining whether a transfer of property made in connection with a section 351 transaction gives rise to a loss duplication under section 362(e)(2), a separate determination be made with respect to each separate transferor.

- Coordination of Sections 362(e)(1) and 362(e)(2). Because section 362(e)(2) applies only to a "transaction" that is not "described in" section 362(e)(1), we recommend that any forthcoming guidance under section 362(e) interpret the term "transaction" for these purposes so that (i) transfers of Section 362(e)(1)(B) Property under a single arrangement are deemed to constitute a single "transaction" for purposes of applying section 362(e)(1), and (ii) any transfers of other property that are part of the same overall arrangement are deemed to constitute a separate "transaction" for purposes of applying section 362(e)(2).

- Valuation Rules and Safe Harbor. In the interests of increasing predictability and minimizing controversy, we urge Treasury and the Service to provide a regulatory safe harbor pursuant to which taxpayers will be entitled to rely upon valuations derived under certain methods for purposes of applying sections 362(e) and 334(b). We further recommend that Treasury and the Service adopt a rule that the relevant values of property for purposes of applying sections 362(e) and 334(b) should be determined as of the time that the parties commit to the transaction, subject to certain market-standard conditions.

- Partnerships and Other Pass-Through Entities as Transferors. In the case of a transfer of property by a partnership, section 362(e)(1) provides that, for purposes of determining whether the transfer gives rise to the importation of a built-in loss, each partner shall be treated as "holding such partner's proportionate share of the property of the partnership." Accordingly, we suggest that Treasury and the Service issue guidance prescribing methods for attributing transferred property among partners. We acknowledge the difficulties in devising a comprehensive rule that would both reflect the economic reality of complex partnership arrangements and be easily administrable. We recommend, however, that, at least as a general rule, property should be attributed to partners by reference to how taxable gain or loss from a hypothetical cash sale of the property would be allocated among the partners under the terms of the partnership agreement. We also believe that a similar attribution rule would be appropriate for S corporations.

- Determining Whether Property Is Subject to U.S. Federal Income Tax. We urge Treasury and the Service to issue guidance to the effect that, in order for gain or loss in respect of property to be considered "subject to tax" in the hands of the transferor or transferee for purposes of section 362(e)(1), the holder of the property must be subject to U.S. federal income tax on a net-income basis in respect of gains and losses from such property. We believe that this standard is consistent with the most natural reading of the statutory language, and that a standard encompassing property with a more attenuated connection to the U.S. tax system (*e.g.*, property held by a "controlled foreign corporation" ("**CFC**")) could prove difficult to administer. Property held by entities that are generally able to eliminate their U.S. federal income tax liability by virtue of a dividends paid deduction (*i.e.*, "real estate investment trusts" ("**REITs**") and "regulated investment companies" ("**RICs**")) would be considered subject to U.S. federal income tax in the hands of such entities.

- Overlap With the Consolidated Return Regulations. We recommend that Treasury and the Service address issues of coordination with section 362(e)(2) in the forthcoming proposed consolidated return regulations. We further recommend that in the interim Treasury and the Service issue guidance to clarify that the stock basis adjustment rules of the consolidated return regulations together with section 362(e)(2) are not to be read in a manner that would give rise to the complete elimination of a loss.

III. BACKGROUND OF SECTION 362(e) AND SECTION 334(b).

Sections 362(e) and 334(b) were enacted as part of Congress' overall response to the various scandals involving Enron Corporation ("**Enron**").[5] Specifically, in the mid-1990s, Enron actively sought to enter into various highly-structured transactions with the dual purpose of increasing Enron's net income for financial accounting purposes while simultaneously generating tax deductions.[6] Many of those

[5] *See Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* at 118-64, (JSC-3-03), Feb. 2003 (the "**Enron Report**").

[6] Although certain of Enron's transactions were clearly structured to achieve specific tax results, the primary objective of those transactions was to manipulate financial accounting income, and the Enron Report acknowledged that, although the tax benefits from the transactions were generally sizable, the tax benefits alone would *not* have been sufficient in and of themselves to attract Enron's participation. *See, e.g.*, Enron Report at 137.

transactions involved manipulation of the tax rules in order to duplicate losses on built-in loss property.

For example, in a transaction termed "Project Tanya," Enron contributed high-basis assets to one of its subsidiaries in exchange for voting preferred stock of the subsidiary, and as part of the same transaction, the subsidiary assumed certain unrelated contingent liabilities from Enron.[7] Under the then-current application of section 358, Enron took a substituted tax basis in the voting preferred stock equal to the high basis of the contributed assets, even though the actual fair market value of the stock was much lower than that basis as a result of the subsidiary's assumption of the liabilities.[8] Enron thus was able to generate an immediate tax deduction by selling the preferred stock to an accommodation party and generating a short-term capital loss. Furthermore, the voting preferred stock was sold subject to a put/call arrangement that effectively allowed Enron (i) to repurchase the preferred stock in several years' time, (ii) to assume the then-remaining contingent liabilities by liquidating the subsidiary in a section 332 liquidation, and thus (iii) to receive a second tax deduction when the remaining liabilities were paid.[9] In response to the Enron scandals, the Senate Committee on Finance decided, among other matters, that:

---

[7] *See* Enron Report at 118-23.

[8] Of course, section 362(e) was not needed to address that particular abuse presented by Project Tanya. That specific abuse was addressed by the enactment in 2000 of section 358(h), which provides generally that, when built-in loss stock is issued by a corporation in a section 351 exchange, the basis of the stock is reduced by the amount of any liabilities assumed by the issuing corporation that are not already reflected in the basis of the stock and are not related to a trade or business that has been transferred to issuing corporation.

[9] Project Steele involved a similar loss duplication strategy. *See* Enron Report at 135-46. Project Cochise involved the contribution of residual interests in a "Real Estate Mortgage Investment Conduit" ("**REMIC**") by the London branch of a U.S. bank to a tax-consolidated subsidiary of Enron that deconsolidated by electing to be treated as a REIT. Although Project Cochise also was a loss duplication transaction (since the London branch of the U.S. bank was looking to realize a tax loss from the sale of built-in loss stock generated from the transaction), Project Cochise did have a "loss importation" aspect, in that it involved the transfer of built-in loss assets from a London branch to a U.S. corporation. *Id.* at 147.

> "[In spite of Congress' past efforts to prevent tax-abusive transactions,] new schemes that purport to duplicate tax losses continue to proliferate. In furtherance of the overall tax policy objective of accurately measuring taxable income, the Committee believes that a single economic loss should not be deducted more than once. Thus, the Committee believes that it is generally appropriate to limit a corporation's basis in property acquired in a tax-free transfer to the fair market value of such property. In addition, the Committee believes that it is appropriate to prevent the importation of economic losses into the U.S. tax system if such losses arose prior to the assets becoming subject to the U.S. tax system."[10]

Accordingly, sections 362(e) and 334(b) were enacted as a legislative response to a highly publicized case of tax abuse. The specific operation of those sections is discussed in more detail in Part IV, below.

IV. OPERATION OF SECTIONS 362(e) and 334(b).

This Part IV discusses the basic principles of the operation of sections 362(e) and 334(b). Specifically, Section IV.A, below, describes the operation of sections 362(e)(1) and 334(b), which are concerned with loss importation transactions, and Section IV.B then describes the operation of section 362(e)(2), which is concerned with loss duplication transactions.

A. Provisions Addressed at Loss Importation.

As discussed above, the two provisions in the Jobs Act addressed at loss importation transactions are now contained in sections 362(e)(1) and 334(b). Specifically, section 362(e)(1) covers potential loss importations arising from inbound reorganizations, inbound section 351 transactions and similar transactions in which built-in loss property is transferred from a U.S. tax-exempt entity to a taxable entity. Section 334(b) applies to corporate liquidations of a foreign subsidiary into a domestic parent that are nontaxable under section 332. Because section 334(b) builds on several defined

[10] Senate Comm. Rep. No 108-192, at 125 (the "**2004 Senate Report**").

terms and concepts used in section 362(e)(1), the discussion below first describes section 362(e)(1) and then describes section 334(b).

1. Section 362(e)(1); Inbound Reorganizations and Section 351 Transactions. Section 362(e)(1) addresses the importation of losses into the U.S. tax system in certain cases by requiring the transferee of built-in loss property to take a fair-market-value basis in the transferred property and thereby eliminate the built-in loss. As discussed above, section 362(e)(1) applies only to transfers of property in connection with corporate reorganizations and section 351 exchanges, but in order for section 362(e)(1) to apply to a transfer, two conditions must be met:

(i) *Property Must Be Imported Into the U.S. Tax System*: Section 362(e)(1) applies only to property described in section 362(e)(1)(B) ("**Section 362(e)(1)(B) Property**"). Section 362(e)(1)(B), in turn, describes property only if the property is transferred in connection with a reorganization or section 351 transaction and both: (1) "gain or loss with respect to such property is not subject to [U.S. federal income tax] in the hands of the transferor immediately before the transfer" and (2) "gain or loss with respect to such property is subject to such tax in the hands of the transferee immediately after such transfer."

Under the above-quoted definition of Section 362(e)(1)(B) Property, section 362(e)(1) applies both to inbound transfers by non-U.S. persons to U.S. corporations and to transfers by tax-exempt entities to taxable ones. In the case of transfers by a partnership, the determination of whether property constitutes Section 362(e)(1)(B) Property is made by looking through the partnership and treating each partner as the direct owner of "such partner's share of the [partnership property]."

(ii) *Importation of a Net Built-In Loss*: Section 362(e)(1) by its terms applies only to transfers of property that give rise to the "importation of a net built-in loss." For these purposes, section 362(e)(1)(C) provides that "there is an importation of a net built-in loss in a transaction if the transferee's aggregate adjusted bases [in Section 362(e)(1)(B) Property] would [but for the application of section 362(e)(1)] exceed the fair market value of such property immediately after such transaction."

At this point, it is worth noting that, by referring to the *aggregate* bases and fair market values of all property transferred in a transaction, section 362(e)(1)(C) effectively allows for the importation of built-in losses into the U.S. tax system without interference from section 362(e)(1), so long as those losses are not greater than an offsetting amount of built-in gains that are imported into the U.S. tax system in the same transaction — *i.e.*, the statute nets losses against gains and requires a basis adjustment only if there is a built-in loss remaining after the netting process. The following examples illustrate this "netting" aspect of section 362(e)(1):

> Example 1: The assets of Foreign Target are to be acquired by an unrelated U.S. Acquiror, in exchange for U.S. Acquiror's voting stock, in an inbound reorganization described in section 368(a)(1)(C). Foreign Target has only two assets: Asset A, which has a fair market value of $100 million, and in which Foreign Target has a basis under U.S. federal income tax principles of $31 million; and Asset B, which also has a fair market value of $100 million, but in which Foreign Target has a basis of $170 million. Under the above-quoted definition from section 362(e)(1)(C), the inbound reorganization gives rise to the importation of a net built-in loss, because the aggregate bases of Foreign Target's assets ($201 million), is greater by $1 million than the aggregate fair market value of those assets ($200 million). Accordingly, section 362(e)(1) applies to this inbound reorganization. U.S. Acquiror thus takes a fair-market-value basis of $100 million in each of Assets A and B.
>
> Example 2: The facts are the same as in Example 1, except that, in addition to Assets A and B, Foreign Target also owns a third asset, Asset C, that has a fair market value of $10 million, and in which Foreign Target has a basis under U.S. federal income tax principles of only $8 million. Because of the addition of Asset C, the inbound reorganization no longer gives rise to the importation of a net built-in loss: the aggregate basis of the property transferred in the reorganization is $209 million, and the aggregate fair market value of the assets is $210 million. Accordingly, section 362(e)(1) does not apply to this inbound reorganization, and U.S. Acquiror takes a carryover basis in Assets A, B, and C.

As suggested by these two examples, the "netting" approach under section 362(e)(1) of looking to aggregate bases and fair market values of multiple properties in order to determine whether there is an importation of a net built-in loss (rather than measuring built-in loss on an asset-by-asset basis) has at least three notable consequences.

First, the statutory definition of "importation of a net built-in loss" creates a "cliff effect," whereby the presence of, say, only $1 of aggregate net built-in loss can give rise to very significant adjustments to the bases of individual assets, and the absence of that $1 loss would allow the transaction in question to avoid the application of section 362(e)(1) altogether. As a result, at least in the close cases, transferors may be able to avoid the application of section 362(e)(1) by adding assets with built-in gains to the overall mix of Section 362(e)(1)(B) Property being transferred to the U.S. corporate transferee. Furthermore, although such "asset stuffing" may seem to constitute a manipulation of the tax rules, asset stuffing in order to avoid the application of section 362(e)(1) appears, at least as a general matter, to be fully consistent with the implied policies behind section 362(e)(1)(C)'s definition of "net built-in loss." By looking to the aggregate bases and fair market value of the relevant transferred property, section 362(e)(1)(C) implicitly acknowledges that the "importation" of a built-in loss in respect of a single asset is acceptable, to the extent that such loss is offset by the importation of a built-in gain in respect of another asset. Accordingly, at least under the logic of the statute, the offering of additional built-in gain to the U.S. tax system is, at least arguably, a legitimate means of extricating one's self from the scope of section 362(e)(1).

Second, at least in the close cases, the "cliff effect" puts a great deal of pressure on taxpayers to determine accurately the values of the assets they are transferring. The approach also puts taxpayers at some degree of risk that a transaction could come under the application of section 362(e)(1) as the result of fluctuations in the value of property between the transaction's "signing" and "closing." Consider the following example:

> Example 3. The facts are the same as in Example 1, except that, as of the time that Foreign Target and U.S. Acquiror agree to the inbound reorganization, the amount of voting stock that U.S. Acquiror has agreed to pay to Foreign Target in exchange for Foreign Target's assets has a value on public trading markets of exactly $201 million (the amount of the aggregate bases of Assets A and B, which amount reflects a reasonable assessment of the worth of the two assets). By the time of closing, however, the value of that stock has dropped (for reasons wholly unrelated to U.S. Acquiror's transaction with Foreign Target) to $198 million. The drop in price does not excuse Foreign Target under the terms of the acquisition agreement from completing the transaction, and accordingly, the transaction is consummated. Given that Foreign Target has effectively disposed of its assets for only $198 million worth of stock, must U.S. Acquiror take the view that the transaction that was not expected to give rise to an "importation of a net built-in loss" at the time of signing now does give rise to one? If the stock's value had been $198 million at closing and then rose to $201 million, would that rise in value have removed the merger from the scope of section 362(e)(1)?

Third, the definition of "built-in loss" under section 362(e)(1)(C) makes the arguable mistake of treating unequal assets equally. To illustrate, consider again Example 1, in which a $1 million aggregate loss caused U.S. Acquiror to take a "fair-market-value" basis in Assets A and B. Although it is certainly true that the individual adjustments to the bases of the two assets offset each other and produced a net downward adjustment of only $1 million, the two "offsetting" adjustments might not have been of equal worth in terms of affecting the tax benefits from a U.S. federal income tax perspective. If, for example, Asset A were a depreciable asset, and Asset B were not, then the U.S. Acquiror would, at a minimum, derive a net timing benefit from marking both assets to market. A similar result would obtain if U.S. Acquiror were of the intention to sell Asset A (after a respectable waiting period to avoid any step-transaction concerns), but to retain Asset B.

2. Section 334(b): Inbound Corporate Liquidations. As discussed above, section 334(b) applies to transfers of property in connection with inbound corporate liquidations. In order for section 334(b) to apply to such a transfer of property, however, three conditions must be met:

(i) *Section 362(e)(1)(B) Property*: The property transferred in the liquidation must be Section 362(e)(1)(B) Property, as defined in the previous section of this report.

(ii) *Foreign-to-Domestic Nontaxable Liquidation*: The liquidation in question must be a complete liquidation of a foreign subsidiary into a U.S. corporate parent, and must be described in section 332 (*i.e.*, the parent must own directly at least 80 percent of the stock of the subsidiary, measured by both vote and value prior to the liquidation).[11]

(iii) *Net Built-In Loss Exists With Respect to Section 362(e)(1)(B) Property*: The distributee's aggregate adjusted bases of the Section 362(e)(1)(B) Property received in the liquidation must exceed (in the absence of section 334(b)) the fair market value of such property immediately following the liquidation.[12]

If each of these conditions is met, then section 334(b) will apply to require the domestic parent to take a fair-market-value basis in the Section 362(e)(1)(B) Property "imported" into the U.S. tax system pursuant to the liquidation.[13]

B. Provisions Addressed at Loss Duplication.

1. General Application of Section 362(e)(2). As discussed above, section 362(e)(2) applies to prevent the duplication of tax losses in cases where built-in loss

---

[11] Section 334(b)(1)(B).

[12] *Id.*

[13] As originally drafted under the Jobs Act, section 334(b) would have required mark-to-market basis adjustments for *all* property of the CFC, and not merely the property that gave rise to the importation of a net built-in loss. This apparent mistake was corrected retroactively in the Gulf Opportunity Zone Act of 2005 (P.L. 109-135), which was signed into law on December 21, 2005.

property is transferred to a corporation in exchange for stock in a section 351 transaction, such that, absent the application of section 362(e)(2), the built-in tax loss in respect of the transferred property would be maintained in the hands of the corporate transferee, and would also be replicated in the stock by virtue of the substituted-basis rules of section 358. Although section 362(e)(2) is targeted primarily at domestic-to-domestic transfers (*i.e.*, those transfers in which a built-in U.S. tax loss is relevant at both the stock level and the asset level), the section, by its terms, applies with equal force to outbound transfers and foreign-to-foreign transfers, as well as to inbound transactions that are not covered by section 362(e)(1).[14] In order for section 362(e)(2) to apply to a section 351 transaction, the following conditions must be met:

(i) *Section 351 Transaction Not Covered by Section 362(e)(1)*: The section 351 "transaction" in question must not be described in section 362(e)(1).[15]

(ii) *Net Built-In Loss Property Transferred*: The transferee's aggregate adjusted bases of all property transferred in the transaction must exceed (in the absence of section 362(e)(2)) the fair market value of such property immediately after the transfer.[16]

If those two conditions are met, then section 362(e)(2) provides that the aggregate bases of the properties transferred shall be reduced so that they do not exceed the aggregate fair market value of the property transferred. In contrast to the mark-to-market approach of sections 362(e)(1) and 334(b), section 362(e)(2) does *not* eliminate all built-in gains and losses when it applies to a transfer, but instead allows built-in losses to be preserved to the extent that built-in gains are also present in the transferred

[14] The policy rationale for applying section 362(e)(2) to transactions that do not result in duplicated losses that are both potentially realizable inside the U.S. "tax net" is unclear.
[15] Section 362(e)(2)(A)(i).
[16] Section 362(e)(2)(A)(ii).

property.[17] Under section 362(e)(2)(B), the amount of any basis reduction is allocated among the various transferred properties in proportion to their built-in losses. The following example demonstrates the application of section 362(e)(2):

> Example 4: Transferor 1 has two assets: Asset A, which has a fair market value of $100 million and a basis in Transferor 1's hands of $50 million, and Asset B, which has a fair market value of $100 million and a basis in Transferor 1's hands of $151 million. Transferor 2 has $200 million in cash. Transferor 1 contributes Assets A and B to Newco, a newly-formed domestic corporation, and Transferor 2 contributes $200 million in cash to Newco. Transferors 1 and 2 each receive 50 percent of Newco's only outstanding class of stock, and accordingly the formation of Newco is a section 351 transaction. In the absence of section 362(e)(2), Newco would have a built-in loss in respect of the property transferred by Transferor 1, since the aggregate fair market value of such property is $200 million, and Transferor 1's aggregate bases in the property is $201 million. Accordingly, section 362(e)(2) requires the aggregate bases of the property contributed by Transferor 1 to be reduced by $1 million, and under the basis reduction allocation rules of section 362(e)(2)(B), that reduction is allocated fully to Asset B. Therefore, in Newco's hands, Asset A has a basis of $50 million, and Asset B has a basis of $150 million, so that the $50 million built-in loss in respect of Asset B is offset under the rules by the $50 million built-in gain in respect of Asset A. Section 358 will nonetheless generally apply to the determination of Transferor 1's basis in the stock received in the section 351 transfer, which will be $201 million. Accordingly, the built-in loss will be preserved at the stockholder level, but will not have been "duplicated" at the corporate level.

As an initial matter in considering section 362(e)(2) and comparing it to section 362(e)(1), we note that we are puzzled by the choice of adopting a mark-to-market basis regime to address loss importation transactions, while simultaneously adopting a different regime based on *pro rata* basis reductions to address loss duplication transactions. We believe that loss importation and loss duplication transactions raise a single policy concern (that is, the creation of a potentially realizable

[17] As discussed above in Section IV.A.1, however, this policy of tolerating built-in losses to the extent of offsetting built-in gains is also reflected in the definition of "importation of a net built-in loss" contained in section 362(e)(1)(C).

tax loss through a nontaxable carryover basis transaction), and accordingly, we do not understand the policy justification for addressing this single concern through two different sets of rules. Although each of the basis adjustment regimes is justifiable as a substantive matter, we believe that a single set of rules would have addressed this single issue in a more straightforward and simple fashion than does the current statutory scheme.

2. The Stock Election. Section 362(e)(2)(C) provides that, in lieu of a basis reduction at the asset level, the transferor and transferee in a section 351 exchange may elect for the basis reduction to apply to the transferor's stock received in the exchange (the "**Stock Election**"), so that, in the example above, Transferor 1 would take a $200 million basis in its stock, and the net built-in loss would be preserved in the hands of Newco. If the transferor and transferee make the Stock Election, then, under the wording of section 362(e)(2)(C) the "transferor's basis in the stock received for the property . . . shall not exceed [the stock's] fair market value immediately after the transfer." The Stock Election suggests that Congress recognized as a valid planning concern the fact that, on average, a taxpayer would benefit from preserving the built-in loss potential in the transferred assets, rather than in the received stock, especially if the transferor does not expect to dispose of the stock in the near future.

In Notice 2005-41,[18] the Service provided guidelines for filing a Stock Election, which guidelines are effective until such time as more definitive guidance may be issued. Notice 2005-41 provides generally that a transferor may file the election on behalf of both itself and the transferee by filing an appropriate certification of the election

[18] I.R.B. 2005-41 (September 12, 2005).

on or with its tax return filed by the relevant due date (taking into account extensions) for the taxable year in which the relevant transaction occurred.

V. ISSUES IN MEASURING BUILT-IN LOSS.

This Part V discusses various issues related to how built-in loss should be measured for purposes of sections 362(e) and 334(b). Section V.A discusses cases where property is transferred by multiple transferors in a section 351 transaction (either an inbound section 351 transaction potentially giving rise to a loss importation, a domestic-to-domestic section 351 transaction potentially giving rise to a loss duplication, or a combination of the two), and discusses whether the presence or absence of a built-in loss should be determined (i) on a transferor-by-transferor basis (under which a separate determination is made in respect of the property transferred by each transferor), or (ii) by reference to all of the transferred property on an aggregate basis, so that a single aggregate determination is made. Section V.B then discusses the desirability of regulatory rules and a safe harbor that taxpayers could use in valuing assets and determining whether or not a particular transfer of property would be subject to section 362(e).

A. Should Net Built-In Loss Be Measured on a Transferor-by-Transferor Basis, or by Reference to the Aggregate Amount of Property Contributed by All Transferors?

In the case where multiple transferors transfer property to a corporation in a section 351 transaction, section 362(e) is unclear as to whether, or in which cases, the presence or absence of a net built-in loss is determined separately with respect to the specific property transferred by each transferor, or whether instead the determination is made by reference to the aggregate of all of the relevant property transferred. Section V.A.1, below, considers these issues as they arise under section 362(e)(1) in the case of an inbound section 351 transaction (where multiple transferors "import" property into the U.S. "tax net"), and recommends that the Service adopt an aggregate approach for purposes of determining whether an inbound section 351 transfer gives rise to the "importation of a net built-in loss," within the meaning of section 362(e)(1)(C). Section V.A.2, then discusses one technical matter related to the interaction of sections 362(e)(1) and (e)(2), which would be raised by the adoption of an aggregate approach in the loss importation context. Finally, Section V.A.3 discusses these issues as they arise under the anti-loss-duplication rules of section 362(e)(2), and concludes that, even though there are policy reasons why an aggregate approach might be appropriate, a transferor-by-transferor treatment is required by the relevant statutory language, and is more consistent with the overall statutory scheme of section 362(e)(2) than an aggregate approach.

1. Section 362(e)(1).[19] Beginning with the anti-loss-importation rules, we note that the most straightforward reading of section 362(e)(1) requires that all Section 362(e)(1)(B) Property transferred by multiple transferors be aggregated for purposes of determining whether the transfers, taken together, give rise to the "importation of a net built-in loss." As discussed above, section 362(e)(1)(C) states that "there is an importation of a net built-in loss in a transaction if the transferee's aggregate adjusted bases of [Section 362(e)(1)(B) Property] which is transferred in such transaction would (but for [the application of section 362(e)(1)]) exceed the fair market value of such property immediately after such transaction." By focusing on the transferee's aggregate bases in the property "transferred in such transaction," the language suggests that it is unimportant which of the transferred properties came from which specific transferors.

[19] The issue of how to treat multiple transferors does not arise in the context of section 334(b), because section 334(b) applies only to transfers of property by a single, liquidating transferor.

By way of illustration of the practical significance of this approach, consider the following example:

> Example 5: Foreign Transferor 1 contributes Section 362(e)(1)(B) Property with a basis in Foreign Transferor 1's hands of $200 million, and a fair market value of $100 million to a newly-incorporated U.S. Newco. Foreign Transferor 2 contributes Section 362(e)(1)(B) Property with a basis in Foreign Transferor 2's hands of $0 and a fair market value of $100 million. Each transferor receives 50 percent of the only class of outstanding U.S. Newco stock, and accordingly, the transfers are described in section 351.

Under the "aggregate" reading of section 362(e)(1)(B), these transfers of property to U.S. Newco do *not* give rise to the "importation of a net built-in loss," because the aggregate bases of all property transferred to U.S. Newco in the relevant "transaction" is $200 million, and the property's aggregate fair market value is also $200 million.

There is another reading of section 362(e)(1)(C), however, under which the relevant "transaction" to be analyzed is a specific transfer of property by a specific transferor, and not the collection of transfers by multiple transferors. In other words, one could analyze the incorporation of U.S. Newco as consisting of two "transactions" — the contribution of property by Foreign Transferor 1 and the contribution of property by Foreign Transferor 2 — each of which might or might not give rise to the "importation of a net built-in loss" when analyzed on a standalone basis. Under such a "transferor-by-transferor" approach, the transfer of assets by Foreign Transferor 1 does give rise to the "importation of a net built-in loss," and accordingly, U.S. Newco would take a $200 million basis in those assets. The "transaction" in which Foreign Transferor 2 transferred assets would remain outside the reach of section 362(e)(1), and thus the built-in gain in respect of those assets would be preserved in U.S. Newco's hands.

The Section believes that the "aggregate" reading of section 362(e)(1)(C) is the more persuasive of the two readings for several reasons. First, the "aggregate" reading is the more natural reading of section 362(e)(1)(C), and of the term "transaction" as it is used in that section. In order to determine whether section 351 applies to multiple transfers of property to a corporation in exchange for stock, it is necessary to view all such transfers (and pre-arranged subsequent dispositions of stock received in exchange for the transferred property) as a single, integrated transaction, in which all transferors are viewed as belonging potentially to a single control group.[20] In this regard, section 362(e)(1)'s potential jurisdiction over the incorporation of U.S. Newco is established by section 362(a), which in turn, refers to "a transaction" to which section 351 applies. Again, although this language is not dispositive (a single transfer could be the relevant "transaction" to which section 351 applies), the more natural reading of that language is to treat multiple transfers of property as belonging to a single, integrated section 351 transaction.[21]

Second, the aggregate approach is consistent with a policy that underlies the operation of section 362(e)(1) more generally, *i.e.*, the policy of eliminating the importation only of a *net* built-in loss. For example, if all of the assets transferred in Example 5 had been transferred by a single Foreign Transferor, the transfer clearly would

[20] In this regard, it is relevant that the control test of section 351 is applied on an aggregate, rather than a separate, transferor basis. If the transferors as a group are in control of the transferee corporation immediately after the transfer, each member of the group who receives only stock of the transferee corporation qualifies for nonrecognition treatment, even though none of the transferors alone would have the required control. *See* Treasury regulation section 1.351-1(a)(1), (2) Ex. (1); *Burr Oaks Corp. v. Commissioner*, 43 T.C. 635 (1965), *aff'd*, 365 F.2d 24 (7th Cir. 1966); Bittker & Eustice, Para. 3.08[1].

[21] Similarly, the section of the legislative history of the Jobs Act purporting to describe the application of section 362(e)(2) is entitled "Limitation on transfer of built-in-losses in section 351 transactions," which, again, implies that a "section 351 transaction" is intended to comprise all of the related transfers of property that together qualify for tax-free treatment under section 351. *See* 2004 Senate Report at 125.

have fallen outside the scope of section 362(e)(1), because section 362(e)(1) by its terms would have netted built-in gains and built-in losses in respect of the transferred property, and would have required a mark-to-market basis adjustment only in the cases where the built-in losses exceeded the built-in gains.[22] It is unclear, therefore, why a different result should obtain simply because the property is transferred by two transferors, rather than one. Similarly, as noted above, this netting approach is also present in the application of section 362(e)(2), which allows the preservation of built-in losses to the extent of built-in gains following the application of section 362(e)(2)'s basis-reduction rule.

In considering the netting feature of section 362(e)(1), we note that the netting feature represents an implied compromise between the two conflicting policies of preserving the ability to tax imported built-in gains, on the one hand, and devising a rule that is fair to taxpayers, on the other hand. Specifically, Congress could have addressed the loss importation abuses described in the Enron Report simply by repealing the carryover basis regime for inbound reorganizations and section 351 transactions, and instead requiring that the recipient of all Section 362(e)(1)(B) Property in such transactions take a fair-market-value basis in that property. Such a rule, which was in fact proposed by the Clinton administration in 1999 to combat loss importation transactions,[23] would have constituted a more symmetrical application of mark-to-market

[22] It is true that, as discussed above in Section IV.A.1, an approach of netting built-in gains against built-in losses may create various timing disparities, because of the different tax attributes of the assets involved (*e.g.*, where built-in gain in respect of a depreciable asset offsets built-in loss in respect of a capital asset) or because the taxpayer intends to dispose of certain assets quickly and not to dispose of others. However, as also discussed in Section IV.A.1, section 362(e)(1) clearly accepts those types of disparities in the context of multiple assets transferred by a single transferor, and accordingly, those disparities appear to be consistent generally with the intended functioning of section 362(e)(1).

[23] *See* Treasury Dep't, *General Explanation of the Administration's Revenue Proposals* at 107 (Feb. 1999). In particular, the Clinton administration proposed that the then-current rules for inbound reorganizations and section 351 transactions be replaced with a "fresh start" regime, under which all property imported into the U.S. tax system by means of an inbound reorganization or section 351 transfer

principles, because it would have eliminated the importation of both built-in losses and built-in gains in such transactions. The drafters of the Jobs Act, however, chose to avoid this much simpler and more obvious rule, presumably because of a desire to preserve the taxation of imported built-in gains, but the drafters also limited the basis adjustment provisions of section 362(e)(1) to the importation only of *net* built-in losses.

Viewed in light of the above-described policy considerations, the netting approach of section 362(e) constitutes an integral means of ameliorating what would otherwise have been an extraordinarily asymmetric, pro-fisc rule (effectively a one-way mark-to-market regime in which the government always wins), and thus of limiting the scope of section 362(e) to its intended purpose of preventing tax abuses. In considering Example 5, therefore, the Section does not believe that a transferor-by-transferor approach — in which built-in losses are eliminated in respect of Foreign Transferor 1's property, but built-in gains are preserved in respect of Transferor 2's property — represents an equitable implementation of the policies underlying section 362(e).

One could worry, of course, about cases in which Foreign Transferor 1 might use Foreign Transferor 2 as an "accommodation party" to avoid the application of section 362(e)(1), but as discussed above in Section IV.A.1, the policy logic of section 362(e)(1) appears to allow the importation of built-in losses, so long as the taxpayer (or taxpayers) in question are willing to import an offsetting amount of built-in gain into the U.S. tax system. We therefore do not see a justification for distinguishing between (i) a taxpayer that avoids the application of section 362(e)'s "cliff effect" (as also described above in Section IV.A.1) by adding its own assets with built-in gains to the overall mix of

---

would have taken a fair-market-value basis and would have lost all previous tax attributes for U.S. federal income tax purposes, whether such attributes were favorable or unfavorable.

assets transferred in a given transaction, and (ii) a taxpayer that finds another party willing to contribute such an asset in exchange for stock in the acquiring corporation. For the reasons discussed above, the Section recommends that any regulatory guidance issued under section 362(e) adopt an "aggregate" reading of section 362(e)(1)(C).

2. Definition of "Transaction" and Coordination Between Section 362(e)(1) and Section 362(e)(2). If the Service chooses to accept our recommendation, discussed immediately above, to adopt an "aggregate" approach in order to calculate net built-in loss for purposes of section 362(e)(1), then we note that there is one tangential issue raised by that approach — related primarily to the interaction of sections 362(e)(1) and (e)(2) — that should be addressed. That issue is illustrated in the following example:

> Example 6: Foreign Transferor contributes Section 362(e)(1)(B) Property to U.S. Newco in connection with Newco's incorporation, which property clearly gives rise to an importation of a net built-in loss, and Domestic Transferor also contributes built-in loss property to Newco. Foreign Transferor and Domestic Transferor each receive 50 percent of the only outstanding class of Newco stock, and accordingly the incorporation of Newco is described in section 351.

We believe that the clear intention of section 362(e) is for Newco to take both (i) a fair-market-value basis under section 362(e)(1) in respect of the built-in loss property received from Foreign Transferor, and (ii) a stepped-down basis under section 362(e)(2) in respect of the built-in loss property received from Domestic Transferor. As discussed above, however, in order for the anti-loss duplication rules of section 362(e)(2) to apply to the transfer of assets by Domestic Transferor, those assets must, under the terms of section 362(e)(2)(A), be transferred in a "transaction" that is not "described in [section 362(e)(1)]."

If, in applying an aggregate approach to section 362(e)(1), the Service were to take the view that Foreign Transferor and Domestic Transferor each transferred property as part of a single "transaction," then there might be an implication that the "transaction" in which Domestic Transferor transferred property to Newco was, in fact, a "transaction" described in section 362(e)(1), because Foreign Transferor's transfer of property was described in section 362(e)(1). Accordingly, there is a technical reading of the statute under which Domestic Transferor might have escaped the application of section 362(e)(2) by virtue of being associated with a loss importation transaction. The Section does not believe that such a result could have been intended under any plausible analysis of the statute.

In order to address the issue described immediately above, we recommend that the term "transaction" be defined, as a general matter, to comprise all transfers to a corporation that make up a section 351 transaction, *provided that* for the specific purpose of determining whether a transfer of property (other than Section 362(e)(1)(B) Property) to a corporation is subject to section 362(e)(2), that transfer shall be deemed to constitute a "transaction" that is separate and distinct from any related transfers of Section 362(e)(1)(B) Property to the same corporation. Under this definition, section 362(e)(1) would be applied, first, to transfers of Section 362(e)(1)(B) Property for the purpose of determining whether the transfers give rise to the importation of a net built-in loss, and then section 362(e)(2) would be applied independently to transfers of all remaining property for the purpose of determining whether those transfers give rise to a loss duplication.[24]

3. Section 362(e)(2). Although the Section recommends an aggregate approach to section 362(e)(1), we believe that the anti-loss-duplication rules of section

[24] Accordingly, a transfer of Section 362(e)(1)(B) Property might be found to give rise to the importation of a net built-in loss, even though a related transfer of other property did *not* give rise to a loss duplication, and *vice versa*.

362(e)(2) require a transferor-by-transferor approach. As discussed above, section 362(e)(2) applies by its terms to cases where, "(i) property is transferred by a transferor in any transaction which is [described in section 351] and which is not described in section 362(e)(1), and (ii) the transferee's aggregate adjusted bases of such property so transferred would (but for [section 362(e)(2)] exceed the fair market value of such property immediately after such transaction."

As an initial matter, we note that the above-quoted statutory language appears, rather clearly, to adopt a transferor-by-transferor approach, because it refers to property transferred by "a [single] transferor." However, the legislative history of section 362(e)(2) creates some doubt as to whether Congress intended this result, because the legislative history describes section 362(e)(2) as applying in cases where "the aggregate adjusted bases of property contributed by a transferor (*or by a control group of which the transferor is a member*) to a corporation exceed the fair market value of the property transferred."[25] (Emphasis added.) Although it is therefore not entirely certain, from the language of the statute and the legislative history, whether Congress intended that built-in loss be measured on an aggregate basis or a transferor-by-transferor basis for purposes of section 362(e)(2), the Section believes that the plain meaning of the statute should prevail and that a transferor-by-transferor approach should be adopted. Furthermore, the application of an aggregate approach would give rise to certain results that we do not believe were intended. By way of illustration, consider the following example:

> <u>Example 7</u>: In an incorporation described in section 351, Domestic Transferor 1 contributes property to Newco with a basis of $0 and a fair market value of $50 million, and Domestic Transferor 2 contributes property with a basis of $100 million and a fair market value of $49 million.

---

[25] 2004 Senate Report at 125. *See also* note 21, above.

Under an aggregate approach to section 362(e)(2), there is only $1 million of net built-in loss in respect of the property received by Newco, which would give rise to an aggregate basis reduction of $1 million, to be applied against the various individual assets contributed to Newco in proportion to their built-in losses. Assume, however, that Newco and Domestic Transferor 2 decide to make the Stock Election[26] under section 362(e)(1)(C), pursuant to which "the transferor's basis in the stock received for property . . . shall not exceed its fair market value immediately after the transfer." In that case, under the plain meaning of section 362(e)(1)(C), Domestic Transferor 2's basis in its stock (which stock presumably would be worth $49 million in an arm's-length transaction) would be reduced by $51 million — in other words, the Stock Election would increase radically the basis reduction required by the loss duplication rules, a result that we doubt was intended.

Although the issue raised by Example 7 is a serious one, the Section does not believe that it is dispositive of the question of whether an aggregate or transferor-by-transferor approach should apply, or that a transferor-by-transferor approach necessarily provides the best policy outcome. An advocate of the aggregate approach could respond plausibly to Example 7 by acknowledging that, in certain cases, it is indeed highly disadvantageous for taxpayers to make the Stock Election, and then pointing out that taxpayers are always able to avoid these issues simply by not making the Stock Election. Furthermore, although the disparate results described above evidence the fact that a full netting of built-in gains and losses can occur only at the asset level within the recipient corporation, it is not clear that those results present a sufficient

[26] In terms of statutory textual analysis, it is telling that section 362(e)(2)(C) refers to the Stock Election as being made jointly by the transferee and the single "transferor."

justification for denying taxpayers the option of achieving full netting at the asset level, which netting is desirable as a general matter for the policy reasons discussed above in Section V.A.1.[27]

Ultimately, we would not be inclined to decide the issue of whether an aggregate or transferor-by-transferor approach should be adopted on the basis of the issue raised by Example 7. Instead, our recommendation of a transferor-by-transferor approach in the context of section 362(e)(2) is based on our belief that the wording of the statute requires such an approach, notwithstanding the inconsistent legislative history.

B. Valuation Rules and Safe Harbor.

As discussed above in Section IV.A.1, the netting approach that section 362(e)(1) adopts in order to measure built-in loss gives rise to a "cliff effect," under which a small amount of net loss can give rise to quite dramatic individual basis adjustments, and that "cliff effect" in turn, places a very high premium on correct and properly documented valuations. Furthermore, because the value of property may fluctuate between the signing and closing of a transaction, taxpayers, at least in the close cases, may not be able to predict at the time of committing themselves to a transaction whether or not the transaction in question will give rise to a loss importation or a loss duplication.[28]

---

[27] One argument in favor of maximizing netting comes from the fact that, for every built-in gain asset contributed to a corporation in a section 351 exchange, there is a duplication of the built-in gain, and, as in the context of section 362(e)(1), the netting approach serves to ameliorate what would otherwise be an unfairly asymmetric, pro-fisc rule.

[28] The problem of fluctuating values relates primarily to cases where assets are transferred in exchange for publicly-traded stock (as in Example 3). Assets that are not publicly traded (or assets the value of which has not been tied to publicly-traded securities by means of a binding merger agreement) cannot be valued as precisely on a day-to-day (or minute-to-minute) basis as can publicly-traded securities. Accordingly, it is less likely that such assets would undergo a detectible shift in their value between the signing and closing of a contract.

In the interest of providing taxpayers with a reasonable level of predictability in planning their transactions, and given the stakes of guessing incorrectly as to whether section 362(e) or section 334(b) will turn out to apply to a contemplated transaction, the Section recommends that the Service provide taxpayers with a regulatory safe harbor, under which valuations derived under certain methods (*e.g.*, valuing property by reference to the current public trading value of stock to be exchanged therefor) are deemed to be correct. We further recommend that the Service adopt a rule to the effect that — for purposes of determining whether a transaction gives rise to a loss importation or duplication and of determining the amount of any required basis adjustments — property values are to be measured as of the time that a transaction is signed (*i.e.*, the time that two parties commit to the transaction, subject to certain market-standard conditions).

Such a rule would be analogous to the recently-adopted rule under Treasury regulation section 1.368-1(e)(2) for measuring continuity of interest in corporate reorganizations, which rule states that the consideration provided for in the contract to complete a reorganization "shall be valued on the last business day before the first date such contract is a binding contract."[29] Like the rule we are proposing in respect of sections 362(e) and 334(b), the rule under Treasury regulation section 1.368-1(e)(2) was adopted to address uncertainties arising due to fluctuations in value of property between the signing and closing of a contract.

29 Treasury regulation section 1.368-1(e)(2)(i).

VI. PARTNERSHIPS AS TRANSFERORS.

As discussed above, section 362(e)(1) provides that, for purposes of determining whether property transferred to a corporation is Section 362(e)(1)(B) Property (*i.e.*, property in respect of which gain or loss is not subject to U.S. federal income tax before the transfer but is subject to U.S. federal income tax after the transfer), section 362(e)(1) provides that, in the case of property transferred by a partnership, the determination shall be made "by treating each partner in such partnership as holding such partner's proportionate share of the property of such partnership." In other words, section 362(e)(1) purports to use an aggregate theory of partnerships in order to allocate property among the partners — so that, for example, if property transferred by a foreign partnership to a U.S. corporation in an inbound section 351 transaction were allocated to a U.S. corporate partner, the property presumably would *not* qualify as Section 362(e)(1)(B) Property (because gains and losses from the property would be subject to tax in the U.S. corporate partner's hands). If the property were allocated to a foreign partner that does not pay U.S. federal income tax in respect of its partnership interests (for example, in a case where the partnership is not engaged in a trade or business in the United States), the property presumably would qualify as Section 362(e)(1)(B) Property.[30]

[30] In cases where a single property is allocated among two or more partners, presumably the basis in the property is also allocated among them, with the result that portions of the "split" basis may be subject to the mark-to-market adjustment while other portions are not. For example, consider a straight 50/50 partnership that owns a single asset having a basis of $200 and a fair market value of $100. If that asset is allocated between the two partners such that one half of the asset is considered to be Section 362(e)(1)(B) Property, then presumably, one half of the basis is adjusted to reflect the value of a one-half stake in the property. Accordingly, $100 of the $200 basis is "marked down" to $50 under section 362(e)(1), and prior to any potential application of section 362(e)(2) to the transaction, the asset would have a basis of $150 in the hands of the transferee. Although, we expect that section 362(e)(2) would require a "mark down" of the remaining half of the asset's basis to $50 in most cases (so that the asset's total basis would equal $100), there are cases where we believe such a result would not pertain — for example, if the taxable

In the case of very simple partnerships, in which each partner has a straight *pro rata* share of all items of partnership income, gain, loss, and deduction, the allocation of property among partners seems straightforward — each partner would be treated as owning a straight *pro rata* piece of each item of partnership property. The task of allocating property to partners becomes less straightforward, however, in the case of more complex partnership arrangements — *e.g.*, where gains and losses are often allocated asymmetrically among the partners, where different partners may have different non-*pro rata* interests in income derived from different partnership assets, and where partners' interests may shift over time under the terms of the partnership agreement.

For example, consider a partnership agreement where a U.S. partner is allocated all losses and deductions in respect of an asset, as well as the first $100 of gain from the disposition of the asset, and a non-U.S. partner is allocated any gain in excess of $100 (and would not pay U.S. tax on such gains). It is not clear how the asset should be allocated between the two partners. One approach might be to allocate the asset between them based on their proportionate share of partnership gains, but such an approach would presumably require a determination of how much built-in gain the asset contains at time of allocation (since $900 of gain would produce a different *pro rata* allocation than $200 of gain) — and built-in losses under such an approach would presumably lead to the asset being allocated fully to the U.S. partner. It is perhaps more consistent with the policies behind section 362(e)(1) to take the view that the asset should be allocated entirely to the U.S. partner, on the grounds that (i) the U.S. partner enjoys the full benefit of the tax basis (*i.e.*, takes full tax losses and gets the full benefit of the basis before taking any

domestic partner also were to transfer in the same transaction its own assets (other that Section 362(e)(1)(B) Property) held outside of the partnership and having built-in gain exceeding the built-in loss on the domestic partner's share of the partnership asset.

taxable gain into income), and (ii) the issue of whether an asset's tax basis is used fully to reduce U.S. tax liability is really the driving factor behind the statutory definition of Section 362(e)(1)(B) Property.

Of course, these sorts of allocation issues are not new. For example, Treasury regulation section 1.861-9T(e) provides in certain cases that, for purposes of allocating interest expense in accordance with the taxpayer's ratio of U.S-to-foreign assets, as required under section 864(e), a partner shall be treated as owning its "*pro rata* share of partnership assets,"[31] and even further provides that such *pro rata* allocation shall be made on the basis of the partner's interest in partnership income for the relevant taxable year.[32] Similarly, the constructive ownership rules of sections 318 and 267, as well as the indirect ownership rules of section 958, all provide for the allocation of partnership property to specific partners. None of these provisions, however, provides especially detailed guidance as to how specific assets are to be allocated to specific partners in the more complex cases, and effectively taxpayers are left to their own devices to develop methodologies that they believe to be reasonable.

It is possible that the general lack of detailed guidance in the allocation provisions discussed above reflects an acknowledgement, on the part of numerous drafters of statutory and regulatory provisions over the years, that there are no simple allocation rules that can provide an intuitively correct answer for every conceivable partnership arrangement (or even every reasonably common partnership arrangement) that may arise. Drafters may have concluded that it is preferable for taxpayers and the Service to resolve the more complex issues as they present themselves on a case-by-case

[31] Treasury regulation section 1.861-9T(e)(2) (describing the rule for corporate partners with a ten-percent-or-greater interest in a partnership).

[32] Treasury regulation section 1.861-9T(e)(1).

basis (either on audit or otherwise) than to attempt to establish bright-line rules ahead of the fact. Although we have sympathy for such a viewpoint, we nonetheless believe that the Service should attempt to adopt a set of rules that are as administrable and predictable in their application as possible, while also remaining consistent with the purpose of determining the extent to which a property was "subject to the U.S. tax system" prior to being transferred.[33]

In this regard, we recommend that the Service adopt a rule that: (i) considers a hypothetical cash sale of the property in question for its fair market value at the time when the property is in fact transferred to the U.S. corporate recipient, (ii) traces the taxable gain or loss from the disposition, as measured for U.S. federal income tax purposes, through to each partner in accordance with the full terms of the partnership agreement,[34] and (iii) allocates the property to each partner in accordance with each partner's share of the resulting gains or losses.[35]

Although we cannot claim that our proposed rule would necessarily provide an intuitively correct result in all cases (or even a clear result in all cases),[36] we

---

[33] *See* 2004 Senate Report at 125.

[34] The allocation rule must also take account of special allocations of gain or loss under section 704(c), because, again, the purpose of the rule is to measure the tax consequences of a sale prior to the transfer.

[35] One possible method of "tracing" gains and losses to a specific partner under this rule would be to compare the partner's net recognized income or loss from the partnership in the relevant taxable year to the partner's net income or loss for the taxable year if (all other factors being equal) the hypothetical sale actually had occurred. In cases where the partnership liquidates following the section 351 exchange (*e.g.*, because all of the partnership's assets have been transferred to the corporation), it might be appropriate to consider a partner's income from the hypothetical cash sale and to ignore any income or loss actually recognized by the partner in respect of the liquidation.

[36] For example, consider a partnership where one partner is allocated a preferred return, and the other partner is then entitled to "catch up" allocations, and once the "catch up" allocations are completed, the partners share all income and losses equally on a going-forward basis. In considering a hypothetical sale of potential Section 362(e)(1)(B) Property during the period when one partner is receiving the preferred return, the proposed rule would not take account of the fact that the preferred return may be undone at a later date. A criticism of this result would be stronger in cases where the partnership in fact had enough unrealized gain in other assets during the taxable year, such that the preferred return and the catch up could have been eliminated during that year had those losses in fact been realized.

believe that this rule would be reasonably administrable, and would achieve intuitively correct results in the majority of cases (*e.g.*, transfers of property by a straight 50/50 partnership would cause the property to be allocated equally between the two partners).

In the example discussed above in which one partner shared in gains from property only to the extent of $100, the allocation of the property between the two partners would depend upon the property's fair market value at the time of the transfer: if the property had a built-in loss at the time of the transfer, then it would be allocated entirely to the partner to whom the loss would be allocated, and if the property had a built-in gain, then it would be allocated between the two partners based on their percentages of the relevant gain. Although this result is not the only justifiable result, it has the virtues of (i) taking account of the partners' relative economic stakes in the property at the relevant time (*i.e.*, the time when tax attributes potentially are being "imported"), and (ii) providing a relatively clear rule that should allow taxpayers to predict the consequences of their cross-border transactions under section 362(e)(1) with a reasonable degree of accuracy.

Finally, the Section notes that section 362(e) contains no rule with respect to property held by a Subchapter S corporation, and the Section sees no reason why Subchapter S corporations should not be subject to the look-through rule that applies to partnerships. While it is true that Subchapter S corporations technically are treated as taxpayers, they are nonetheless subject to a taxation regime that is conceptually very similar to that applicable to partnerships.[37] Because Subchapter S corporations do not

---

[37] We note that the application of a look-through rule to Subchapter S corporations would lead to the result that property held by Subchapter S corporations should never constitute section 362(e)(1)(B) Property, because shareholders in Subchapter S corporations are subject to U.S. federal income tax in respect of gains or losses from property held by the Subchapter S corporations. Specifically, foreign

give rise to the same complex allocation schemes that are common to partnership arrangements, the application of a look-through rule should be more straightforward in the case of a Subchapter S corporation that in the case of a partnership.

VII. SECTION 362(e)(1)(B) PROPERTY; "SUBJECT TO TAX."

We recommend that the Service issue guidance concerning the standards for determining whether gain or loss in respect of property is subject to U.S. federal income tax, within the meaning of section 362(e)(1)(B). As discussed above, Section 362(e)(1)(B) Property is property where "gain or loss with respect to such property is not subject to [U.S. federal income tax] in the hands of the transferor immediately before the transfer," but is "subject to such tax in the hands of the transferee immediately after such transfer." Several commentators, however, have expressed some uncertainty regarding what it means exactly for gain or loss with respect to property to be "subject" to U.S. federal income tax.[38]

A number of commentators and practitioners, for example, have raised the issue of whether gain or loss in respect of property held by a CFC should be considered subject to U.S. federal income tax if a disposition of such property would give rise to Subpart F income.[39] Of course, it must be the case that at least some property held by a CFC is not treated as subject to U.S. federal income tax in the CFC's hands, since a

---

persons are precluded from owning shares in S corporations under sections 1361(b)(1)(B) and (C), and tax-exempt U.S. persons that own stock in Subchapter S are required under section 512(e) to treat all income from an investment in a Subchapter S corporation as "unrelated business taxable income" ("**UBTI**").

[38] *See e.g.*, Andrew M. Eisenberg, "Limitations on Importation and Transfer of Built-In Losses: Untangling the New Basis Adjustment Rules," *Tax Notes*, May 16, 2005, at 869; Jasper Cummings and Robert P. Hanson, "New Limitations on Corporate Built-In Losses,' *Tax Notes*, June 20, 2005, at 1553. Similar issues have arisen in the context of section 163(j), which attempts to prevent earnings stripping by highly-leveraged companies through foreign related-party debt interest paid on which is not subject to U.S. taxation. *See* section 163(j)(3); Proposed Treasury regulation section 1.163(j)-4.

[39] *Cf.* Proposed Treasury regulation section 1.163(j)-4(d)(1) (interest paid to a CFC considered subject to tax for purposes of section 163(j), generally to the extent such interest gives rise to a Subpart F inclusion in the hands of a U.S. taxpayer).

contrary conclusion would mean that section 334(b), which applies in cases where Section 362(e)(1)(B) Property is transferred to the domestic parent of a foreign corporation in a complete liquidation, would be completely inoperative. Similar questions have been raised concerning property held by various conduit entities such as REITs and RICs.

In considering the proper interpretation of a rule that references gain or loss subject to U.S. federal income tax in the hands of a particular person, we believe it is clear that such a rule is intended to reach persons that are either subject generally to U.S. federal income tax or that are subject to U.S. federal income tax in respect of the property in question on a net income basis (as opposed to being subject to tax under a gross withholding tax regime). This interpretation is consistent with the legislative history of section 362(e)(1), which, as discussed above, describes the purpose of the rule as being "to prevent the importation of economic losses into the U.S. tax system if such losses arose prior to the assets becoming subject to the U.S. tax system."[40] Similarly, the legislative history provides the following example of how the definition of Section 362(e)(1)(B) Property is intended to apply:

> "Thus, for example, if in a tax-free incorporation, some properties are received by a corporation from U.S. persons subject to tax, and some properties are received from foreign persons not subject to U.S. tax, this provision applies to limit the adjusted basis of each property received from the foreign persons to the fair market value of the property."[41]

For the reasons discussed above, the Section recommends that the Service issue guidance clarifying that, in order for gain or loss in respect of property to be considered subject to U.S. federal income tax in the hands of the transferor or transferee for purposes of section

[40] 2004 Senate Report at 125.
[41] *Id.*

362(e)(1)(B), the holder of the property must be subject to U.S. federal income tax on a net-income basis in respect of such property. Accordingly, gain or loss in respect of property held by U.S. corporations and resident individuals would be considered subject to U.S. federal income tax in the hands of such corporations and individuals. Similarly, gain or loss property held by a non-U.S. taxpayer in connection with a U.S. trade or business would also be considered subject to U.S. federal income tax, as would real estate investments by a foreigner that are subject to net income tax under FIRPTA.[42]

Gain or loss in respect of property held by a RIC or REIT would also be considered subject to U.S. federal income tax, on the grounds that such gain or loss is taken into account in determining the RIC or REIT's taxable income — the presence of a dividends paid deduction to shelter income in the hands of a RIC or REIT is indistinguishable for these purposes from an interest deduction or any other deduction that other U.S. taxpayers are allowed in order to offset income. Although one could argue for a contrary conclusion on the grounds that RICs and REITs are conduits and are subject to tax only as a formalistic matter, we note that: (i) such a contrary conclusion would presumably lead to the attribution of property to equity holders of such entities

---

[42] Under our proposed definition, gain or loss in respect of property held by a U.S. tax-exempt entity would not be considered subject to U.S. federal income tax, unless that property were held in connection with an "unrelated trade or business," within the meaning of section 513. In this regard, we note that there is a complication arising from the fact that there are assets that may give rise to UBTI in the hands of the tax-exempt entity, even though gains and losses from the sale of such assets nonetheless would be excluded from the definition of UBTI under section 512(b)(5). Because section 362(e)(1)(B) looks to whether "gain or loss" with respect to the property is subject to tax, there is a strong argument for concluding that such assets should not be considered Section 362(e)(1)(B) Property. We note, however, that the bases of such assets may nonetheless be reflected in determining the tax-exempt entity's UBTI (for example, through depreciation deductions) and accordingly, at least in some cases, could be considered to be within the U.S. "tax net." Also, any rule attempting to differentiate property held in connection with a trade or business on the basis of whether gain from the sale of such property gives rise to UBTI might prove to be complicated, because the rule presumably would require the taxpayer to take into account the extent to which property is debt-financed (so that gains or losses from the property are taxable under section 514), and to address cases, for example, where gain from the sale of an asset might be taxable (or partially taxable) under the depreciation recapture rules of sections 1245 or 1250.

under a "look through" approach similar to the rule for partnerships, (ii) it would be very difficult to administer the attribution of property to equity holders of publicly-traded RICS and REITs, and (iii) such an attribution approach presumably would need to address the fact that, unlike foreign partners in a U.S. partnership, foreign equity holders of RICs and REITs are subject to U.S. withholding tax, at least in respect of certain distributions received from RICs and REITs, so that not all property held by such entities and attributed to a foreign equity holder would escape the U.S. tax net.[43]

Gain or loss in respect of property held by a CFC would not be considered subject to U.S. tax, since such gain or loss could, at most, give rise to taxable income in the hands of United States shareholder of the CFC by means of a constructive dividend.[44] We believe that this conclusion is supported by the fact that sections 362(e)(1) and 334(b) are attempting to address property that would generate a U.S. tax *loss* if imported into the U.S. tax system, rather than property that would give rise to income. Although the realization of a loss with respect to property held by a CFC could lower the earnings and profits of a CFC and thus potentially prevent inclusions of Subpart F income,[45] such a connection to the U.S. tax system is highly attenuated and is a connection shared by *all*

---

[43] There are several exemptions from the U.S. withholding tax in respect of distributions received from RICs and REITs. Both RICs and REITs are permitted to pass through the character of their long-term capital gains to their shareholders by designating an appropriate amount of the dividends as capital gain dividends under sections 852 and 857, respectively. A RIC may elect not to withhold on such capital gain dividends distributed to non-U.S. shareholders pursuant to Treasury regulation section 1.1441-3. Although a REIT shareholder is subject to withholding on any capital gain dividends under Treasury regulation section 1.1441-8, such shareholder may obtain a refund of tax paid with respect to the capital gain other than on the sale of U.S. real property interests. In addition, section 871(k) added by the Jobs Act, provides that no withholding tax applies to any dividends paid by a RIC that are attributable either to qualified interest income or to short-term capital gain and, in each case, are so designated by the RIC. The section 871(k) exemptions are scheduled to expire after December 31, 2007.

[44] As discussed in Part VII, we believe that Subchapter S corporations should be treated under a look-through rule similar to that applicable to partnerships, and other "pure" conduits, such as grantor trusts.

[45] *See* section 952(c) (Subpart F income inclusions limited to the current earnings and profits of the CFC, reduced by "qualified deficits" of earnings and profits from prior years).

property of a CFC (not just property that could give rise to Subpart F income). As discussed above, a rule that resulted in all property of a CFC being considered subject to U.S. federal income tax effectively would read section 334(b) out of the Code.

VIII. OVERLAP WITH CONSOLIDATED RETURN REGULATIONS.

The interaction of the rules under section 362(e)(2) and the anti-loss-duplication rules contained in the consolidated return regulations raises numerous issues. Under at least one possible interpretation of Treasury regulation section 1.1502-32, the interaction of the rules could have the effect of eliminating losses altogether, rather than merely preventing the duplication of losses. Consider the following example:[46]

> Example 9: Corp. 1, which is a member of a U.S. consolidated tax group, contributes assets to a newly-formed subsidiary, Corp. 2, in a section 351 transaction, and the assets have a fair market value of $60 and a basis of $100. If no Stock Basis Election is made, then Corp. 2 will take a $60 basis in the asset contributed.

Under Treasury regulation section 1.1502-32(b)(2)(iii), a reduction in the basis of a subsidiary's assets will give rise to a negative adjustment in the basis of the subsidiary stock held by the parent if the basis adjustment at the asset level is a "noncapital, nondeductible expense." Under Treasury regulation section 1.1502-32(b)(3)(iii)(B), a negative basis adjustment in turn is treated as noncapital, nondeductible expense in cases where the reduction is not otherwise taken into account in determining the parent's basis in the subsidiary's stock, and where the reduced basis is permanently eliminated in determining the subsidiary's gain or loss. Treasury regulation section 1.1502-32(b)(3)(iii)(B) also provides, however, that "[w]hether a [basis] decrease is treated [as a noncapital, nondeductible expense] is determined by taking into account

[46] This example was taken from slides presented at a conference of the American Bar Association in San Francisco, California on September 16, 2005, by Audrey Nacamuli of the U.S. Treasury Department, Andrew Dubroff of Ernst & Young LLP, Don Leatherman of the University of Tennessee, and Devon Bodoh of Dewey Ballantine LLP.

both the purposes of the Code or regulatory provision resulting in the decrease and the purposes of [Treasury regulation section 1.1502-32(b)(3)(iii)(B)]."

We believe that a downward adjustment to the bases of the assets in Corp. 2's hands should *not* be considered a noncapital, nondeductible expense under the standards set forth in Treasury regulation section 1.1502-32(b)(3)(iii)(B), because a contrary result would clearly be inconsistent with the purpose of section 362(e)(2), which is to prevent loss duplication. Specifically, if the downward basis adjustment were held to be a noncapital, nondeductible expense, then Corp. 1 would be required, under the operation of Treasury regulation section 1.1502-32(b)(2)(iii), to take a $60 basis in the stock of Corp. 2. Under that result, the rules would have operated not merely to prevent the duplication of the $40 loss, but to eliminate the loss from the tax system altogether. Although we believe that this analysis of the interaction between section 362(e)(2) and the consolidated return regulations is clearly correct, we note that several practitioners have expressed some degree of concern over the issue, and accordingly recommend that the Service clarify that the stock basis adjustment rules of section 1.1502-32 are not to be read in a manner that gives rise to the complete elimination of a loss (as opposed to the prevention of the duplication of a loss).

Beyond that clarification, however, the Section recognizes that the operation of the anti-loss duplication rules under the consolidated return regulations is both (i) quite complex and (ii) the subject of current review by Treasury and the Service in connection with a project to issue new proposed regulations. Accordingly, this report will not make detailed recommendations concerning the proper coordination of section 362(e)(2) and current consolidated return regulations. Instead, we urge Treasury and the

Service to address issues of coordination with section 362(e)(2) in the forthcoming proposed consolidated return regulations, so that we may comment on the coordination provision in the context of the larger project once the new proposed regulations are made public.