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Federal Tax ADVISORY ■

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Loss Duplication Regulations Finalized
Reg. Section 1.362-4

Background

Nine years after enactment of Section 362(e)(2) and seven years after proposal of regulations, the Treasury issued final regulations, effective for transactions occurring after September 3, 2013.

The list of "loss duplication" regulations is growing longer, with that term having been applied to several generations of consolidated return regulations. However, this loss duplication rule has nothing to do with consolidated returns, although it can apply to transfers to or within consolidated groups: it aims to prevent the potential for duplication of loss under what used to be the standard basis rules applicable to Section 351 exchanges that do not involve a nontaxable-to-taxable importation of built-in loss—i.e., an inbound carryover basis exchange.

When the predecessor of Section 351 entered the income tax statute in the 1920s, it applied a sort of cloning approach to basis: the shareholder's asset basis was transferred to the corporation and was carried over to the stock received in exchange. That had the effect of duplicating built-in gain and built-in loss in the tax world.

We still have the built-in gain, but Congress became unhappy with the built-in loss for two reasons: (1) foreign-to-domestic exchanges and (2) tax shelters that involved the incorporation of built-in losses. Although the tax shelters were a relatively novel application of a potential that existed in the law, the foreign-to-domestic exchanges were right down the middle of the fairway of a potential abuse that the tax law allowed with its eyes open.

Basis acquired in a transaction beyond the reach of the U.S. tax laws should not have been allowed into the U.S. tax system without some toll charge or marking to market. However, in those infant days of the tax system, inbound transactions were not so common. Therefore, for purposes of simplicity, importation of basis was allowed.

The 2004 legislation attacked built-in loss importation in Section 362(e)(1), as well as the residual but more common Section 351 loss duplication in Section 362(e)(2).

The Rules

By now, the basic rules of Section 362(e)(2) are familiar: if the aggregate adjusted basis of property transferred by one transferor in the Section 351 exchange or contribution to capital exceeds fair market value, then the property with the built-in loss suffers proportional basis reduction to eliminate the aggregate built-in loss. However, the shareholder and corporation can elect to have the reduction applied to the stock rather than the corporate assets.

The Important Regulation Features

First, the regulation does not apply to foreign-person-to-foreign-corporation exchanges if all of these conditions are satisfied:

- neither person is a U.S. person, a CFC or a controlled foreign partnership;
- neither person is required to file a U.S. return for the year;
- certain events related to the United States that would produce an effective importation of the basis do not occur within two years; and
- if those certain events do occur after two years, the original transaction was not done with a view to avoiding the section.

The later events are either the transferor or transferee becoming a U.S. person, a CFC or a CFP or required to file a U.S. return, or the basis of the transferred property otherwise becomes relevant for U.S. tax purposes. If the later events do occur within the two-year period, an election to reduce the stock basis rather than the asset basis can be filed. But if the later event is an importation of a built-in loss, Section 362(e)(1) can be applied separately to it.

Second, the basis reduction rule applies to any transaction described in Section 351, even if it is also described in some other section, such as a B reorganization; however, it does not apply to a forward triangular merger.

Third, the mechanics of the election to reduce stock basis are spelled out in greater detail and the transferor and transferee must enter into a written agreement to make the election; these are separate requirements, both of which must be satisfied. Generally, the statement must be filed with the return for the year of the exchange, but the regulations detail exactly who must file the statement on what return for all the variants of exchanges (including CFC shareholders filing on their returns).

Fourth, the rule does not apply to a transaction such as a D/355 reorganization because there is no loss duplication: the basis in the stock of the Controlled corporation distributed to the shareholders disappears in the spin-off.

Fifth, the rule applies to the deemed Section 351 exchange that occurs in a Section 304(a)(1) transaction. However, if the election is made to reduce the basis in the stock deemed received, that may not hurt the taxpayer at that point if the distribution is taxed as a dividend.

Sixth, rules are provided for pushing the basis reduction upon an election up to S corporation shareholders and partners.

Conclusion

By now, any taxpayer exchanging built-in loss property in a Section 351 transaction probably will be aware of the potential for a limitation of the duplication of loss. These regulations and their many examples provide a roadmap to how to limit the damage.

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