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TAX LAW CONFERENCE

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Losses, Interest, and Other Attributes

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Update on the New NOL Rules

New NOL Rules

- Net operating losses (NOLs) arising in tax years ***ending after*** 12/31/2017
  - Indefinite carryforward and no carrybacks
  - No more CERT rules or specified liability losses for the new NOLs
  - Prior law continues to apply to NOLs from years prior to these effective dates
- NOLs arising in tax years ***beginning after*** 12/31/2017
  - Deduction is limited to 80% of taxable income for the tax year to which the NOL is carried
  - Exceptions apply
  - Prior law continues to apply to NOLs from years prior to these effective dates
- Legislative history
- No changes to capital loss carryover and carryback rules
  - Carry back 2 years and carry forward 5 years
  - Only capital gains can offset capital losses

NOL Ordering

- **Section 172(a)** – NOL deduction for the taxable year an amount equal to the lesser of:
  - The aggregate of the net operating loss carryovers to such year, plus the net operating loss carrybacks to such year, <u>or</u>
  - 80 percent of taxable income computed without regard to the deduction allowable under this section
- **Example**
  - Calendar year LossCo has $90 million in NOLs generated through 12/31/17 and incurs a $50 million NOL in the tax year ending 12/31/18
  - LossCo earns $100 million of taxable income in 2019
  - Result?
    - The entire $90M of NOLs generated through 12/31/17 would be available to offset 2019 taxable income
    - Can LossCo offset the remaining $10M with the 2018 NOL? If so, how much?
- **Notice 2018-67** – In section 9 of this notice, the IRS noted that: "The limitation in §172(a) applies only to post-2017 NOLs, but a question exists regarding how the §172(a) 80 percent income limitation applies when both pre-2018 and post-2017 NOLs exist. The Treasury Department and the IRS intend to issue guidance regarding how §172 generally applies."

Section 172(a) - NOL Ordering
JCT Bluebook and
Discussion Draft Technical Corrections Bill

NOL Ordering – JCT Bluebook and Discussion Draft Technical Corrections Bill

- **Question** – Is the 80-percent limitation of section 172(a)(2) calculated with or without regard to any NOLs arising in tax years beginning before 1/1/2018 ("pre-2018 NOL carryovers")?
- JCT General Explanation of Public Law 115-97 (*i.e.*, the JCT Bluebook)
  - Pre-2018 NOL carryovers are utilized without regard to the 80-percent limitation of section 172(a)(2)
  - NOL carryovers from tax years beginning after 12/31/17 ("post-2017 NOL carryovers") are utilized to the extent they do not exceed:
    - 80 percent of the excess (if any) of the taxpayer's taxable income (before any NOL deduction attributable to post-2017 NOL carryovers), <u>over</u>
    - The NOL deduction attributable to pre-2018 NOL carryovers
  - JCT notes that a technical correction "may be necessary to reflect this intent“

NOL Ordering – JCT Bluebook and Discussion Draft Technical Corrections Bill

- Discussion Draft Technical Corrections Bill
  - Would amend section 172 by adding new section 172(g) as a "special rule" for pre-2018 NOL carryovers
    - Proposed amendment appears intended to give effect to the outcome described in the JCT Bluebook
    - Thus, the Discussion Draft Technical Corrections Bill suggests that a technical correction to section 172 is necessary in order to give effect to the intent described by the JCT in the TCJA Bluebook.
  - This amendment to section 172 would "take effect as if included in" the TCJA
- Draft Technical Corrections Bill would also clarify the following:
  - The amendments relating to the 80-percent limitation would apply to taxable years to which NOLs *arising in taxable years beginning after* December 31, 2017, may be carried.
  - The amendments relating to NOL carryovers and carrybacks apply to NOLs *arising in taxable years beginning after* December 31, 2017.

JCT Bluebook – Example 1

<u>Year 1 – 2019</u>

- Calendar year LossCo has $120 of pre-2018 NOL carryovers and a $70 post-2017 NOL carryover that carries forward to 2019
- LossCo earns $100 of taxable income in 2019
- Result?
  - $100 of pre-2018 NOL carryovers are used to offset the entire amount of LossCo's taxable income in 2019
  - The remaining $20 of pre-2018 NOL carryovers and the $70 post-2017 NOL carryover carry forward to 2020

<u>Year 2 – 2020</u>

- LossCo earns another $100 of taxable income in 2020
- Result?
  - $20 of pre-2018 NOL carryovers are used to offset $20 of LossCo's taxable income in 2020; thus, the pre-2018 NOL carryovers are exhausted
  - 80% of the remaining $80 of LossCo's taxable income ($100 taxable income earned – $20 pre-2018 NOL carryover utilization) is allowed to be offset by the post-2017 NOL carryover; therefore, LossCo is entitled to a $64 NOL deduction with respect to the post-2017 NOL carryover, leaving taxable income of $16 for 2020
  - LossCo has $6 (*i.e.*, $70 - $64) of the post-2017 NOL carryover that carries forward to 2021

New Section 163(j)

New §163(j) Topics

- In General
  - Statute
  - Proposed Regulations
- Depreciation
- §382 Aspects
- Allocation of Interest
- Consolidated Return Issues

New §163(j) Statute – In General

- Replaces prior §163(j) "earnings strippings" limitations on the deductibility of a corporation's "disqualified" interest expense, which included interest paid to a related person not subject to US tax (e.g., a foreign person).
- New §163(j) limits deductions for all "business interest" and generally applies to **all** taxpayers with average gross receipts in excess of $25 million over the prior 3 tax years.
  - "Business interest" is "any interest paid or accrued on indebtedness properly allocable to a trade or business" and does not include "investment interest" under §163(d).
  - Applies to individuals, partnerships and corporations, regardless of whether –
    - The taxpayer is part of an "inbound" or "outbound" group
    - The interest payment is made to a US or foreign person
    - The recipient of interest is related
    - The recipient is exempt from US tax
    - The debt was outstanding before December 31, 2017 (i.e., no grandfathering)
- Generally effective for tax years beginning after December 31, 2017.

New §163(j) Statute – In General (cont'd)

- Limits business interest expense deduction to sum of –
  - Business interest income
  - 30% of "adjusted taxable income" ("ATI")
  - Floor plan financing interest
- ATI is taxable income computed without regard to –
  - Items not allocable to a trade or business
  - Business interest income and expense
  - Net operating losses under §172
  - The 20% §199A deduction
  - For tax years beginning before January 1, 2022, deductions for depreciation, amortization and depletion
- If an amount of business interest is not allowed as a deduction for a tax year due to the §163(j) limitation, the amount is carried forward and treated as business interest paid in the next tax year (i.e., a disallowed business interest expense carryforward).
- But there is no carryforward of an excess §163(j) limitation amount.
- Following general carryforward rules, current year business interest expense is deducted before disallowed business interest expense carryforwards.

New §163(j) Statute – In General (cont'd)

- Excepted Trades or Businesses
  - Interest expense allocable to a trade or business described in §163(j)(7) (i.e., an "excepted" trade or business) is not subject to limitation under §163(j).
  - The term "trade or business" does **not** include –
    - Employee services
    - Certain regulated utilities
    - An electing real property business
    - An electing farming business
  - An election by an electing real property or farming business is irrevocable.
  - Property used in a trade or business that is exempt from the §163(j) limitation generally is excluded from the definition of "qualified property" for 100% bonus depreciation eligibility under §168(k).

New §163(j) Proposed Regulations – In General

- Treasury released proposed regulations on November 26, 2018 that address new §163(j) (the "Proposed Regulations").
- The Proposed Regulations are organized into 11 sections – Prop. Reg. §§ 1.163(j)-1 through 1.163(j)-11.
  - 1: Definitions
  - 2: Computation of limitation
  - 3: Relationship of limitation to other provisions affecting interest
  - 4: C corporations and consolidated group members
  - 5: Disallowed business interest expense carryforwards of C corporations
  - 6: Partnerships and S corporations
  - 7: Foreign corporations
  - 8: Foreign persons with effectively connected income
  - 9: Excepted trades or businesses
  - 10: Allocation of income and expense to non-excepted and excepted trades or businesses
  - 11: Transition rules
- Effective Date – prospective but taxpayers may elect to adopt the Proposed Regulations on retroactive basis
  - Final regulations will be effective for tax years ending after the date on which they are published in the Federal Register.
  - Taxpayers and related parties (within the meaning of §§267(b) and 707(b)(1)) may elect to adopt the Proposed Regulations for tax years beginning after December 31, 2017, so long as all rules are applied on a consistent basis.

New §163(j) Interest

- The Proposed Regulations provide a broad definition of interest. Items described as interest generally can be divided into 2 categories – amounts traditionally considered interest and then interest equivalents.
- **Interest** includes amounts paid, received or accrued for the use or forbearance of money and amounts treated as interest under other Code provisions, such as OID, qualified stated interest, acquisition discount, market discount, repurchase premium and amounts treated as interest under §§467 and 7872.
- **Interest equivalents** include guaranteed payments, loan commitment fees, substitute interest payments and debt issuance costs.
- The Proposed Regulations also include an "anti-avoidance rule" to the effect that amounts "predominantly incurred in consideration of the time value of money" that would otherwise be deductible are treated as interest. The rule likely would cover, for example, guarantee fees and forbearance fees.

New §163(j) ATI

- Certain Adjustments to ATI
  - The Proposed Regulations include as adjustments to taxable income the items set forth in the statute. However, the Proposed Regulations include additional adjustments and certain clarifications.
  - An adjustment is taken into account only once for purposes of determining ATI.
    - For example, a deduction for the depreciation of nonbusiness property under §167 cannot be taken into account as both a deduction for depreciation and an item of deduction that is not allocable to a trade or business.
  - Only the adjustments to taxable income in the Proposed Regulations may be made.
    - For example, a deduction under §243 for dividends received by a C corporation (that is not a RIC or REIT) reduces the taxable income of the C corporation; the C corporation cannot add back the amount of the deduction in computing ATI.
  - The §250 deduction is calculated without regard to adjustments required by the taxable income limitation under §250(a)(2), with the result that a taxpayer has 2 §250 calculations – 1 for §163(j) purposes and 1 for §250 purposes.
  - An amount incurred as depreciation, amortization or depletion, but capitalized to inventory under §263A and included in cost of goods sold, is not a deduction for depreciation, amortization or depletion for purposes of §163(j).
  - Special rules apply for purposes of computing ATI –
    - For partnerships and CFCs
    - Involving dispositions of depreciable property

New §163(j) Certain Operating Rules

- Ordering and operating rules govern the interaction between §163(j) and other provisions of the Code affecting interest –
  - Provisions that defer, capitalize or disallow interest expense (e.g., §§163(e)(5)(A)(i), (f), (l) or (m) or 264(a), 265, 267A, 279, 1277 or 1282) apply ***before*** §163(j).
  - §§263A and 263(g) apply ***before*** §163(j).
  - §246A applies ***before*** §163(j).
  - §163(j) applies ***before*** §§461(l), 465 and 469.
- Character of a C corporation's interest income and interest expense –
  - A C corporation can only have business interest income and expense for purposes of §163(j) (unless allocable to an excepted trade or business).
  - A corporation's items of income, gain, deduction or loss are properly allocable to a trade or business for purposes of §163(j) and therefore taken into account in determining ATI (unless allocable to an excepted trade or business).
  - Above treatment generally applies to items allocated from a partnership to a corporate partner, with a special rule for certain §951(a) and §951A(a) inclusions by a domestic partnership.

New §163(j) Additional Rules (cont'd)

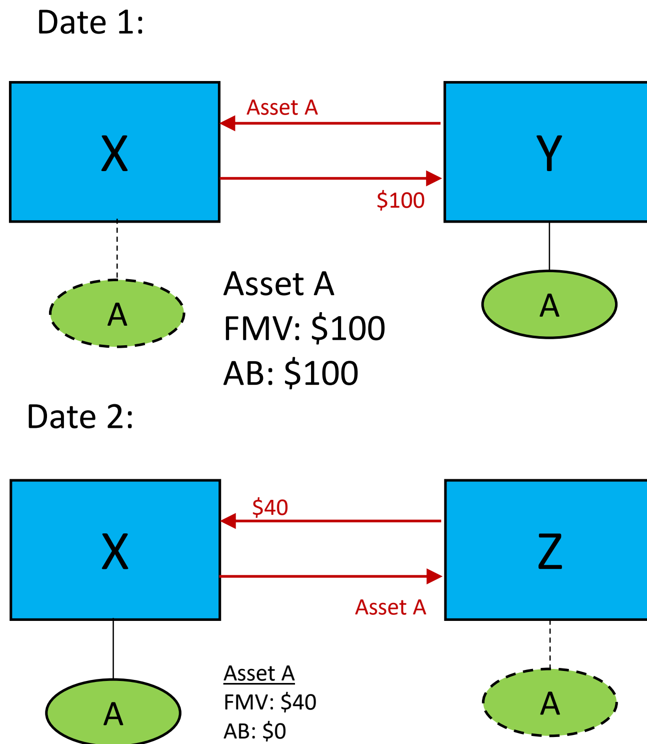
- §381(c)(20) treats a disallowed business interest expense carryforward as a §381 attribute, meaning an acquiring corporation succeeds to the disallowed business interest expense carryforwards of a target in a §381(a) transaction. The Proposed Regulations –
  - Clarify that the carryover item includes disallowed business interest expense from the tax year ending on the date of the transfer; and
  - Limit the acquiring corporation's ability to use the carryforward in its 1st taxable year ending after the acquisition, consistent with treatment of NOL carryforwards under Treas. Reg. §§ 1.381(c)(1)-1 and -2.
- Disallowed business interest expense carryforwards are potentially subject to limitation under §382 and SRLY.
- A C corporation's E&P is determined without regard to business interest expense disallowance (i.e., a C corporation generally reduces its E&P by disallowed business interest expense).
- The §163(j) limitation applies at the consolidated group level, with the consolidated group having a single limitation that is applied to a member's business interest expense.

New §163(j) Depreciation

- The Proposed Regulations contain a number of provisions modifying ATI to account for §163(j)(8)(A)'s requirement that ATI be computed without regard to any deduction allowable for depreciation.
  - For taxable years beginning before January 1, 2022, any deduction for depreciation under §167 or 168 is added to taxable income to determine ATI. Prop. Treas. Reg. § 1.163(j)-1(b)(1)(i)(D).
  - With respect to the sale or other disposition of property, ATI is reduced by the **lesser** of (1) any gain recognized on the sale or other disposition of such property, and (2) any depreciation, amortization, or depletion deductions for the tax years beginning after December 31, 2017, and before January 1, 2022, with respect to such property. Prop. Treas. Reg. § 1.163(j)-1(b)(1)(ii)(C). This rule sometimes is referred to as the "Anti-Double Counting Subtraction" rule.
  - Depreciation, amortization, and depletion capitalized to inventory under section 263A are not treated as deductions, and are not adjustments, in computing ATI. In some industries, most depreciation is converted to cost of goods sold, and the Proposed Regulations prohibit any benefit for depreciation—even pre-2022.
  - With respect to the sale or other disposition of stock of a member of a consolidated group that includes the selling member, ATI is reduced by the investment adjustments with respect to such stock that are attributable to deductions taken for depreciation. Prop. Treas. Reg. § 1.163(j)-1(b)(1)(ii)(D).

New §163(j) Depreciation (cont'd)

Example 1



Facts

1. On Date 1, X transfers $100 to Y in exchange for Asset A, a depreciable asset.
2. Between Date 1 and Date 2, X depreciates Asset A's adjusted basis to $0.
3. On Date 2, X transfers Asset A to Z in exchange for $40.

U.S. Federal Income Tax Considerations

For taxable years beginning before January 1, 2022, as Asset A is depreciated, the depreciation reduces X's taxable income but does not impact X's ATI for purposes of §163(j).

On the disposition of Asset A, the Proposed Regulations would reduce ATI for the $40 of gain recognized on the sale of Asset A.

New §163(j) Depreciation (cont'd)

Example 2 – Anti-Double Counting Subtraction applies without regard to any benefit from initial add-back

Facts

- In 2020, corporation A has ATI of $500 (including $50 of depreciation deductions from asset X added back to ATI), and $100 current-year business interest expense. Corporation A can deduct up to $150 of it business interest expense based on its ATI and so can deduct the full $100 of current-year business interest expense. If there were no depreciation add-back, based on ATI of $450, corporation A would have been able to deduct up to $135 of business interest expense.
- In 2021, corporation A sells asset X for a gain of greater than $50 and has business interest expense of $90. Without the Anti-Double Counting Subtraction, corporation A would have ATI of $300 in 2021 (allowing a deduction of the full $90 of business interest expense).

US Federal Income Tax Considerations

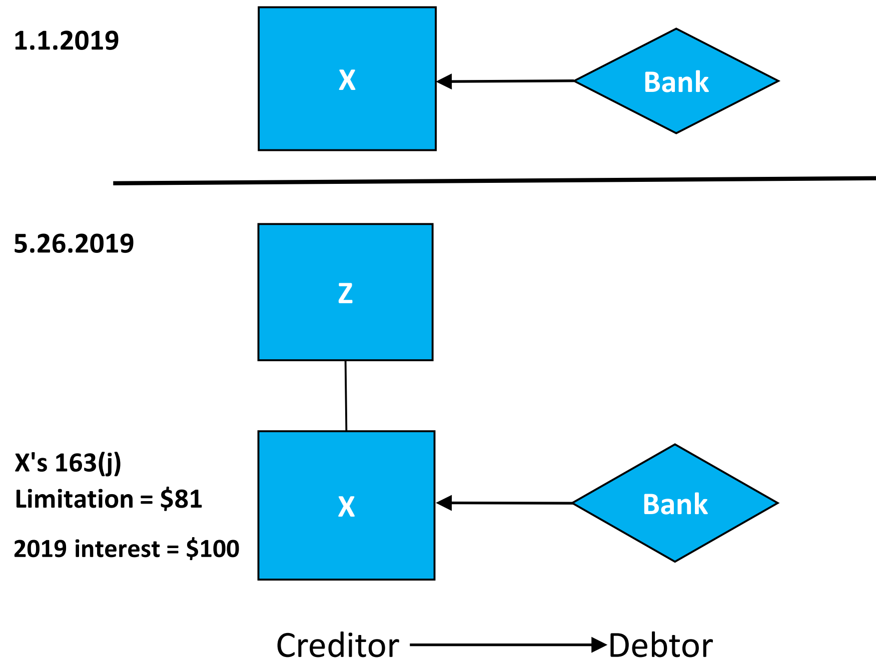
- Corporation A's 2021 ATI is reduced by $50 to $250, meaning that A can only deduct $75 of its $90 of business interest expense. This would result in an expected $3.15 increase in 2021 tax and $15 of disallowed business interest expense carryforward.
- Thus, the Anti-Double Counting Subtraction arguably does more than eliminate a purported double benefit; it places the taxpayer in a worse position than if the depreciation were not added back in the first place.

New §163(j) §382 Aspects

- §382(d)(3) treats a disallowed business interest expense carryforward as a "pre-change loss" subject to §382.
- The Proposed Regulations clarify the term "§382 disallowed business interest expense carryforward" of a loss corporation consists of –
  - The loss corporation's disallowed business interest expense carryforwards, including disallowed disqualified interest, as of the ownership change, and
  - The carryforward of the loss corporation's disallowed business interest expense paid or accrued in the pre-change period is determined by using a daily proration method, regardless of whether the loss corporation has made a closing-of-the-books election under Treas. Reg. § 1.382-6(b)(2).
    - Treas. Reg. § 1.382-6(d) provides that, if Treas. Reg. § 1.1502-76 applies (relating to the tax year of members of a consolidated group), an allocation of items is determined after applying Treas. Reg. § 1.1502-76.
    - Thus, if a short year under Treas. Reg. § 1.1502-76 is a change year for which an allocation under this section is to be made, the allocation under this section applies only to the items allocated to that short taxable year under Treas. Reg. § 1.1502-76.
  - Regulations modified to require pre-change losses for disallowed business interest expense to be absorbed before NOLs, and losses subject to a §382 limitation are absorbed before non-limited losses of the same type from the same tax year.

New §163(j) §382 Aspects (cont'd)

Example – Allocation of Business Interest Expense for Purposes of §382 (Prop. Treas. Reg. § 1.382-6(b)(4)(ii), Ex.)

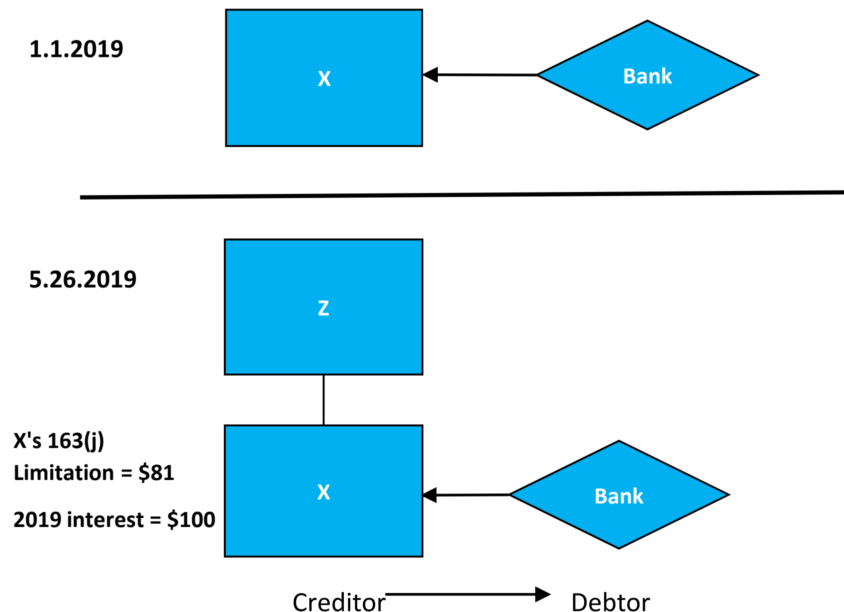


Facts

- In 2019, X was a calendar year corporation that was not a member of a consolidated group.
- On May 26, 2019, X was acquired by Z (an unrelated third party), in a transaction that qualified as an ownership change under §382(g).
  - In 2019, X had $100 of business interest expense and an $81 §163(j) limitation.

New §163(j) §382 Aspects (cont'd)

Example (cont'd)



US Federal Income Tax Considerations

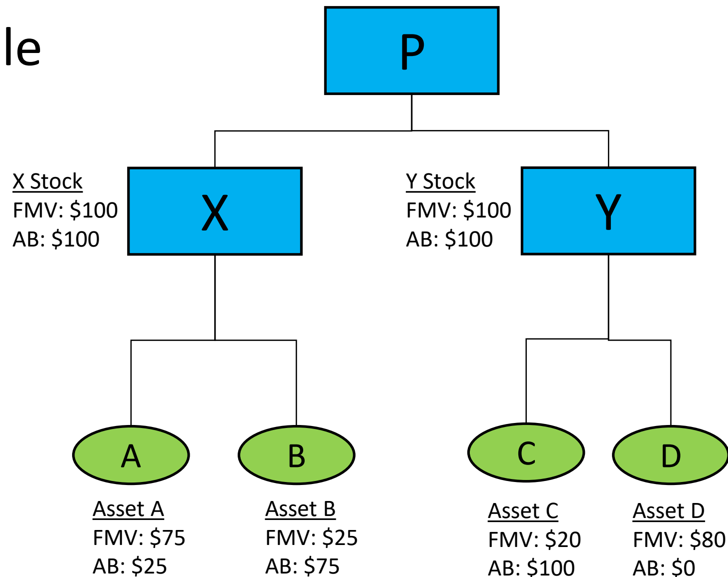
- X's business interest expense deduction is ratably allocated between the pre-change and post-change periods.
  - X may deduct $81 of its business interest expense of which $32.4 ($81 x (146 days/365 days) = $32.4) is allocable to the pre-change period.
  - The remaining $19 of interest is disallowed business interest expense, of which $7.6 ($19 x (146 days/365 days) = $7.6) is allocable to the pre-change period.
  - The $7.6 of disallowed business interest expense is treated as a §382 disallowed business interest expense carryforward, and thus is a pre-change loss within the meaning of Treas. Reg. § 1.382-2(a)(2).
- What if X joined Z's consolidated group for the remainder of 2019?
  - This allocation applies only to the items allocated to the short taxable year under Treas. Reg. § 1.1502-76.

New §163(j) Allocation of Interest

- Prop. Treas. Reg. § 1.163(j)-10 sets forth rules for determining the amount of interest expense, interest income, and other tax items of a taxpayer that is properly allocable to excepted and non-excepted trades or businesses for purposes of §163(j).
- A taxpayer's interest expense and interest income is generally allocated to a taxpayer's excepted and non-excepted trades or businesses under the Proposed Regulations based on the relative amounts of the taxpayer's adjusted basis in the assets.
- A shareholder must look through to the assets of a non-consolidated domestic C corporation for purposes of allocating the shareholder's basis in its stock in the corporation between excepted and non-excepted trades or businesses if the shareholder's direct and indirect interest in the corporation satisfies the ownership requirements of §1504(a)(2).
- For purposes of Prop. Treas. Reg. § 1.163(j)-10, a consolidated group is treated as a single corporation. Consequently, the consolidated group, as opposed to a single member, is treated as engaged in excepted or non-excepted trades or businesses.

New §163(j) Allocation of Interest (cont'd)

Example



Facts

P is a pure holding company that wholly owns both X and Y, but does not file a consolidated return with X or Y.

Assets A and C are used in **excepted** businesses by X and Y, respectively. Assets B and D are used in **non-excepted** businesses, by X and Y, respectively.

P has $100 of interest expense in Year 1.

U.S. Federal Income Tax Considerations

25% ($25 basis in Asset A/$100 total asset basis) of the X stock owned by P is allocated to excepted businesses and 100% ($100 basis in Asset C/$100 total asset basis) of the Y stock owned by P is allocated to excepted businesses. The remaining 75% ($75 basis in Asset B/$100 total asset basis) of P's X stock is allocated to non-excepted businesses.

62.5% ($125 excepted stock basis/$200 total stock basis) of P's interest expense is therefore allocated to excepted businesses and 37.5% ($75 non-excepted stock basis/$200 total stock basis) of P's interest expense is allocated to non-excepted businesses.

The result here is the same as it would be in consolidation, but it would be different if the stock basis in X or Y did not conform to inside asset basis or if there were liabilities at X or Y, such that one had higher stock basis than the other, even if there were conformity.

Other Consolidated Return Considerations

- A departing member may retain its current year BIE (through the date of departure) and disallowed BIE carryforwards, to the extent not used by the consolidated group for the taxable year including the departure date, or otherwise reduced (e.g., under the unified loss rule of Treas. Reg. § 1.1502-36). The member's remaining current year BIE and disallowed BIE carryforwards would be carried to the member's first separate return year
- In general, stock basis adjustments apply under Treas. Reg. § 1.1502-32, at time disallowed BIE is absorbed by the group.
- The Proposed Regulations provide a transition rule for members joining a consolidated group, in which the status of the acquiring group controls the application of section 163(j) to the joining member for the period of membership
- Effective Date
  - Generally prospective, although taxpayers may elect to adopt proposed regulations retroactively
  - Taxpayers and related parties (within the meaning of Sections 267(b) and 707(b)(1)) may elect to apply the proposed rules to taxable years beginning after December 31, 2017, provided all of the rules are applied on a consistent basis

SRLY Rules

- NOL carryovers may be used to offset current year CTI to the extent the member’s loss did not arise in a separate return year
- A SRLY NOL may be applied against CTI only to the extent of the loss member's cumulative contribution to the CTI
- Proposed 163(j) regulations provide SRLY rules to disallowed business interest expense carryforwards from separate return years

Prop. Treas. Reg. Section 1.163(j)-5(d)

- Disallowed business interest expense carryforwards of a member arising in a SRLY that are included in the consolidated group’s business interest expense deduction may not exceed the group’s section 163(j) limit for that year, determined by reference only to the member’s items of income, gain, deduction and loss for that year
- Deduction of SRLY carryforward interest expense is only available if the group has any remaining section 163(j) limitation for the current year after the deduction of current year business interest expense and only to the extent that section 163(j) SRLY limitation for the current year exceeds the amount of the member’s business interest expense already deducted by the group
  - In contrast to the SRLY NOL rules which apply the losses to the cumulative register, the SRLY 163(j) rules are applied on an annual basis
- SRLY limited disallowed business interest expense carryforwards are deducted on a pro rata basis with non-SRLY limited disallowed business interest expense carryforwards in year’s where both exist

SRLY/382 Overlap

- A SRLY limitation generally does not apply if the affiliation event overlaps with a Section 382 ownership change under Treas. Reg. Section 1.1502-21(g)
- An overlap occurs if a corporation becomes a member of a consolidated group (the SRLY event) within six months of an ownership change date that gives rise to a Section 382 limitation
- Prop. Treas. Reg. Section 1.163(j)-5(f) confirms that the principals of Treas. Reg. Section 1.1502-21(g) apply to disallowed business interest expense carryforwards when the application of the SRLY limitation results in a 382 overlap

SRLY Example

- In 2020, T joins P group with a SRLY $100 excess business interest carryforward
- In 2020, T has no income or loss and P has $200 of income
- T cannot use the $100 SRLY excess business interest carryforward to offset the $200 income

See Prop. Treas. Reg. Section 1.163(j)-5(d)(3)

(Assumes no Section 382 limit and small business exceptions don’t apply)

SRLY 2nd Example

- In 2020, T joins P group with a SRLY $100 excess business interest carryforward
- In 2020, T has no income or loss and P has $200 of income
- In 2021, T has $100 of income and P has $100 of loss, no CTI
- In 2022, T has $0 income and P has $300 of income, T cannot use the $100 SRLY excess business interest carryforward to offset the $300 income
- Contrast with cumulative register rules for SRLY NOLs

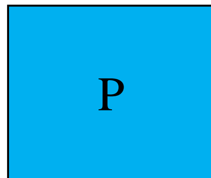
See Prop. Treas. Reg. Section 1.163(j)-5(d)(3)

(Assumes no Section 382 limit and small business exceptions don't apply)

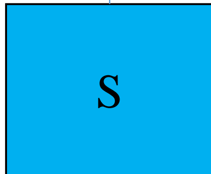
The "Anti-Double Counting Subtraction"

- Section 163(j)(8): the term adjusted taxable income ("ATI") means the taxable income of the taxpayer (A) computed without regard to…(v) in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion…
- Prop Reg § 1.163(j)-1(b)(1)(ii) (the "ADC Subtraction"): "The amounts of the following items (if any) are subtracted from taxable income to determine ATI…
- (C) With respect to the sale or other disposition of property, the lesser of: (1) Any gain recognized on the sale or other disposition of such property; and (2) Any depreciation, amortization, or depletion deductions ["DAD deductions"] for the taxable years beginning after December 31, 2017, and before January 1, 2022, with respect to such property;
- (D) With respect to the sale or other disposition of stock of a member of a consolidated group that includes the selling member, the investment adjustments, as defined under §1.1502-32, with respect to such stock that are attributable to deductions described in paragraph (b)(1)(ii)(C) of this section;

The ADC Subtraction - Asymmetry



2019: (1) P forms S with $200 cash contribution and (2) P's basis in S reduced by $50 to $150.



2019 – S purchases asset X for $50 and immediately expenses

Asymmetry between asset and stock sales

Facts:

- P (parent of P group) forms S in 2019 with $200 cash contribution. S uses $50 to purchase asset X that is immediately expensed and results in a reduction in P's basis in S of $50
- S generates no net taxable income in 2019 or 2020 (and there are no other adjustments to P's basis in S).
- S sells all of its assets to an unrelated buyer in 2021, with $25 of the purchase price allocated to asset X, and no other gain or loss on the sale

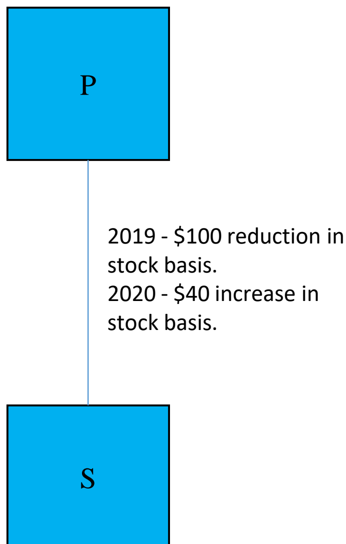
Results:

- The P group has an ADC Subtraction of $25.
- If, in contrast, P sold the stock of S (no 338 election), ADC Subtraction of $50, even if the same amount of gain with respect to the sale of the stock was recognized (reflecting the same gain in asset X)

The ADC Subtraction – Interpretation

- What is the scope of “sale or other disposition?” Does it include transactions between members of a consolidated group?
  - Does not seem appropriate to trigger ADC Subtraction on either (1) non-recognition exchange between group members or (2) where gain or loss deferred under the intercompany transaction rules.
- What is the scope of “attributable to” DAD Deductions (part 1)?
  - Example: P owns S1, and S1 purchases asset X for $100 and immediately expenses it. P’s basis in S1 is reduced by $100. P then transfers stock of S1 to consolidated subsidiary S2 in 351 exchange, and subsequently sells S2
  - If the intercompany transfer of the stock of S1 by P to S2 in a 351 transaction is not a “sale or other disposition,” have any “investment adjustments, as defined under §1.1502-32,” been made with respect to the stock of S2?

The ADC Subtraction – Interpretation (cont.)



2019 – S purchases asset X for $100 and immediately expenses

2020 – S sells asset X for $40

What is the scope of "attributable to" DAD Deductions (part 2)?

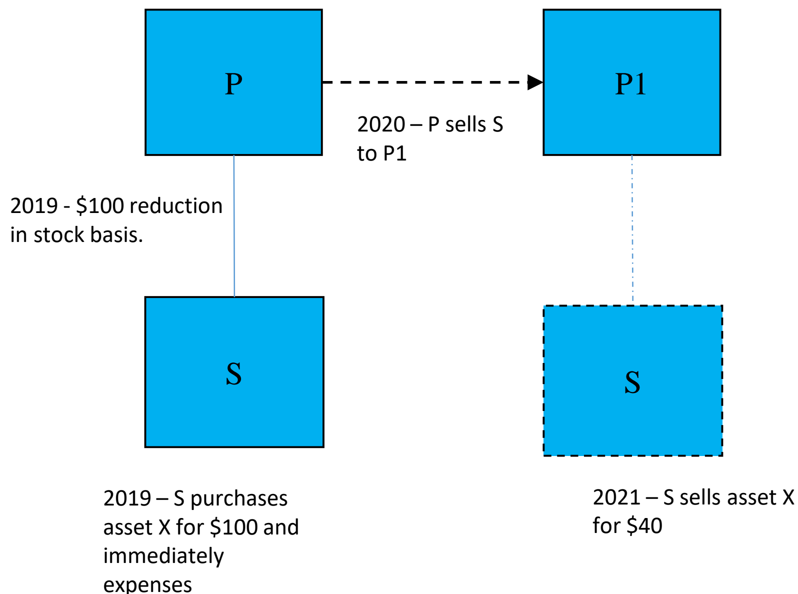
Facts:

- P and S are members of a consolidated group.
- In 2019, S purchases asset X for $100 and immediately expenses. P's basis in S is reduced by $100 under Reg. 1.1502-32.
- In 2020, S sells asset X for $40, resulting in $40 of gain, an increase in P's basis in S by $40 under Reg. 1.1502-32, and a subtraction of $40 from ATI (lesser of gain ($40) or prior depreciation deductions ($100)).
- In 2021, P sells the stock of S to an unrelated party (no 338 election).

Question: What is the amount of the ADC Subtraction from ATI for P's sale of the stock of S?

- Is it $100 (because the only investment adjustment "attributable to" the depreciation deduction is the depreciation deduction)? Or is it $60 (because the gain of $40 on the subsequent sale is also "attributable to" the depreciation deduction)?
- The latter answer results in a total ADC Subtraction of $100, while the former would result in $140 of ADC Subtraction.

The ADC Subtraction – Duplication



Sale of member followed by sale of asset

Facts:

P and S compose a consolidated group.

In 2019, S purchases asset X for $100 and immediately expenses. P's basis in S is reduced by $100 under Reg. 1.1502-32.

In 2020, P sells the stock of S to corporation P1, the parent of an unrelated consolidated group (no 338 election).

In 2021, S sells asset X for $40, resulting in $40 of gain.

Results:

P has an ADC Subtraction of $100.

When S sells asset X, there does not appear to be anything that would prevent an ADC Subtraction of $40 from the ATI of the P1 group.

Note: If P owns S1, which owns S2, etc., and S8 purchases asset X, potential for duplicative adjustments increases.