

## LIMITATIONS ON IMPORTATION AND TRANSFER OF BUILT-IN LOSSES: UNTANGLING THE NEW BASIS ADJUSTMENT RULES

By Andrew M. Eisenberg

Andrew M. Eisenberg is a partner in the Washington National Tax-Corporate Tax Practice of KPMG LLP and an adjunct professor of corporate taxation at Georgetown University Law Center. The author acknowledges the helpful comments of Christine W. Booth, a director in the Washington National Tax-Corporate Tax practice of KPMG LLP.

Eisenberg asserts that new provisions in the American Jobs Creation Act of 2004, which are effective for transactions on or after October 22, 2004, alter the general transferred basis rules of sections 362(a) and (b), and 334(b) for certain transactions that involve built-in loss property. Although the new provisions might be characterized as rules that substitute a lower, fair market value basis for transferred basis, they are in fact more complicated according to Eisenberg. He finds three separate new provisions, each triggered by distinct conditions and each yielding consequences different from the others. Moreover, he thinks the new provisions do not resolve some important issues, such as whether transfers are to be evaluated in the aggregate or transferor-by-transferor. This article discusses the three new provisions and evaluates some areas that require further clarification.

The information contained in this article is general in nature and based on authorities that are subject to change. Applicability to specific situations is to be determined through consultation with a tax adviser. The views and opinions expressed in this article are those of the author and do not necessarily represent the views and opinions of KPMG LLP.

Copyright 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative.

All rights reserved.

### Table of Contents

I. Background	869
II. Statutory Language and Paradigm Examples	870
A. Nonliquidating Importations	870
B. Liquidating Importations	872
C. Anti-Loss-Duplications	872

III. Other Issues	874
A. Property Not Subject to U.S. Tax	874
B. Aggregate or Transferor-by-Transferor	875
C. Other Section 362(e) Issues	877
IV. Conclusion	879

### I. Background

Under sections 362(a) and (b), and 334(b) of the Internal Revenue Code, the basis of property in the hands of a receiving corporation — whether transferred from domestic or foreign transferors — in a transfer to which section 337,<sup>1</sup> 351,<sup>2</sup> or 361<sup>3</sup> applies, is generally the same as the adjusted basis of that property in the hands of the transferor, increased by gain recognized by the transferor.<sup>4</sup> That general basis rule, which is colloquially referred to as “carryover basis” and which the code describes as “transferred basis,”<sup>5</sup> is a cornerstone of the

<sup>1</sup>Section 337(a) provides that no gain or loss shall be recognized to a liquidating corporation on the distribution to an 80 percent distributee of any property in a complete liquidation to which section 332 applies.

<sup>2</sup>Section 351 provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in that corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. See section 351(b) for determination of gain when property other than transferee stock is received by a transferor.

<sup>3</sup>Section 361 provides that no gain or loss shall be recognized to a corporation if that corporation is a party to a reorganization and exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation that is a party to the reorganization. See section 361(b) for determination of gain when property other than transferee stock is received by the transferor. In addition to transactions described in section 361, the section 362(b) basis rule also applies to certain reorganizations involving stock-for-stock exchanges.

<sup>4</sup>If the transferor recognizes gain in a transaction to which section 351 or 361 applies (or in certain stock-for-stock exchanges), the basis of property received by the transferee in that transaction is increased by the amount of that gain (sections 362(a) and (b)). If the distributor recognizes gain or loss on the distribution of its property in a complete liquidation, then the basis of such property received by the distributee in that distribution is the FMV of the property (section 334(b)(1)).

<sup>5</sup>Section 7701(a)(43).

**COMMENTARY / SPECIAL REPORT**

so-called tax-free corporate provisions. The code provides that certain transactions (for example, tax-free incorporations and contributions to capital, tax-free reorganizations, and tax-free subsidiary liquidations) can be effected without a *current* tax, but only at the price of retaining old asset bases in lieu of what would otherwise be new fair market value bases. Therefore, in a situation involving a transfer of built-in gain property, the built-in gain is simply assigned to the transferee (represented by the low basis the transferee has in the transferred asset) to be recognized later. Similarly, in a situation involving a transfer of built-in loss property (in which the transferor's basis in the asset exceeds the asset's FMV), a transferee would take the high basis in the transferred asset, thus preserving the loss to be recognized later.

New provisions in the American Jobs Creation Act of 2004, which are effective for transactions occurring on or after October 22, 2004,<sup>6</sup> change that transferred basis regime for certain transactions that involve property with built-in losses (that is, adjusted bases that exceeds FMV). The affected transactions fall into three broad categories:

- (1) importations of certain net built-in loss properties into the U.S. tax system that are subject to section 362 (that is, section 351 exchanges, contributions to capital, and most section 368 reorganizations)<sup>7</sup> (section 362(e)(1) Non-Liquidating Importations);
- (2) upstream importations of net built-in loss property subject to section 334(b) from foreign distributors to domestic distributees (that is, tax-free subsidiary liquidations) (section 334(b) Liquidating Importations); and
- (3) transfers of built-in loss properties in certain section 351 transfers not covered by section 362(e)(1) (section 362(e)(2) Anti-Loss Duplications).

This last category is really an anti-loss-duplication rule, because it attempts to prevent a single economic loss from being reflected in both the basis of the transferred property and the basis of the successor asset (the stock of the transferee corporation received in exchange for the property).

In general, the new law provides that for the first two of those three categories, the basis of the property in the hands of the transferee is not transferred basis, but rather is a basis equal to the FMV of some or all of the transferred property immediately after the transfer. Those rules are sometimes referred to as "mark-to-market" rules. Regarding the third category, the new law replaces transferred basis with an alternative basis reduction regime. Although those new rules might simply be thought of as rules that substitute a lower, FMV basis for transferred basis, they are more complicated. In fact, what is interesting about the three new provisions is that the precise conditions that trigger each of them is differ-

ent from the others and the precise consequences of each is different from the others. Thus, what might appear to be a simple change in the transferred basis regime masks a host of more complicated issues raised by the new legislation. In Part II, this article analyzes the statutory language of the three provisions to highlight the different conditions that trigger each of them, and then sets forth a paradigm case for each provision to highlight the different basis consequences that result from the application of each of them. In Part III, this article considers a number of issues raised, but not resolved, by the three provisions.

**II. Statutory Language and Paradigm Examples**

**A. Nonliquidating Importations**

Section 362(e)(1) applies if three conditions are satisfied:

1. The transaction under consideration is either a contribution to capital, a section 351 exchange, or a section 361 exchange (or a section 368 stock-for-stock exchange)<sup>8</sup> (section 362(e)(1)(A));
2. The transaction involves *property* defined in section 362(e)(1)(B); and
3. The transaction involves an *importation of a net built-in loss* defined in section 362(e)(1)(C).

If those three conditions are satisfied, the basis of each asset (both gain and loss asset) satisfying the section 362(e)(1)(B) definition is given an FMV basis (marked to market) in the hands of the transferee.

Section 362(e)(1)(B) defines property as any property "if gain or loss with respect to such property is not subject to tax under [subtitle A] in the hands of the transferor immediately before the transfer, and gain or loss with respect to such property is subject to such tax in the hands of the transferee immediately after the transfer." That definition has led to the general observation that foreign persons and tax-exempt transferors are the primary type of transferors that own such property. As the examples below will demonstrate, however, that observation is too simplistic. For example, foreign and tax-exempt transferors might own (and transfer) property that is already subject to U.S. tax, such as property used by a foreign person in a U.S. trade or business<sup>9</sup> or property that is unrelated to the business of a tax-exempt person.<sup>10</sup> Moreover, it is not clear whether the section 362(e)(1)(B) definition of property requires the transferor to actually be liable for the tax on any built-in gain (or receive a deduction on any built-in loss), or whether instead the definition requires the disposition of the property to have U.S. tax consequences to a U.S. taxpayer.

Partnerships can also be transferors of property in section 351 transactions,<sup>11</sup> and as transferors of property, would seem to satisfy the requirement that gain or loss on the disposition of that property be "not subject to tax

<sup>6</sup>H.R. 4520, section 836(c).

<sup>7</sup>Section 362(e)(1) references all transactions described in sections 362(a) (section 351 transactions and contributions to capital) and 362(b) ("property acquired by a corporation in connection with a reorganization . . .").

<sup>8</sup>See *supra* note 3.

<sup>9</sup>See, e.g., section 861.

<sup>10</sup>See, e.g., section 511; section 512.

<sup>11</sup>See, e.g., Rev. Rul. 84-111, 1984-2 C.B. 88.

in the hands of the transferor [the partnership].” Thus, the drafters of the legislation provided in section 362(e)(1)(B) that if the transferor is a partnership, the determination of whether gain or loss on the property is subject to tax in the hands of the transferor will be made by treating each partner as holding a proportionate share of the partnership property. Neither the statute nor the legislative history gives guidance on whether the proportionate share is based on a capital or a profits interest in the partnership. When regulatory guidance on that rule is issued, it should specify whether a profits interest or capital interest should be designated as the appropriate measure for this allocation rule.<sup>12</sup>

There are other types of entities, similar to partnerships, whose gains (and sometimes losses) flow through (directly or indirectly) to their owners. Those include entities such as S corporations,<sup>13</sup> regulated investment companies,<sup>14</sup> real estate investment trusts,<sup>15</sup> and controlled foreign corporations.<sup>16</sup> As discussed below, property owned by those types of entities might be treated in one of three ways: (1) it might be subject to the section 362(e)(1) rule in the same manner as other property exempt from U.S. tax in the hands of the transferor, (2) it might be treated as held and transferred by the entity’s owners, if the IRS and Treasury issue guidance treating those entities the way they treat partnerships (applying an aggregate approach), or (3) it might be viewed as not defined in section 362(e)(1) at all, because property transferred by such entity is treated as subject to U.S. tax in the entity’s hands.

Finally, section 362(e)(1)(C) defines an *importation of net built-in loss* as a transaction in which the *transferee’s* aggregate adjusted basis in the properties transferred would (but for the adjustment required by the new rules) exceed the total FMV of these properties immediately after the transfer. In applying the section 362(e)(1) (importation) rule, the properties counted in computing aggregate basis include only those properties that are described in section 362(e)(1)(B). Notice that this rule requires net built-in loss status to be tested by reference to the transferee’s basis in the transferred property after the general basis adjustments of section 362(a) have been

<sup>12</sup>The IRS and Treasury have acknowledged that there could be a difference between a partner’s capital and profits interest in the context of a section 355 active trade or business inquiry (Rev. Rul. 2002-49, 2002-2 C.B. 49, *Doc 2002-16962, 2002 TNT 140-17*), and in the context of determining allowable losses on transactions between related persons, one or more of which are partnerships (Treas. reg. section 1.267(a)-2T(c)).

<sup>13</sup>See section 1361 *et seq.* In the case of an S corporation, items of income, deductions, gains, and losses flow through to the S corporation’s shareholders; therefore, except for the possibility of gain tax under section 1374, an S corporation is not subject to tax on gain or loss on the disposition of its property.

<sup>14</sup>See section 851 for definition of RICs.

<sup>15</sup>See section 856 for definition of REITs.

<sup>16</sup>See section 957 for definition of CFCs. Although grantor trusts are another type of flow-through entity, Rev. Rul. 85-13, 1985-1 C.B. 325, concludes that the grantor would be treated as the transferor of property transferred by a grantor trust to a transferee corporation in a section 351 exchange.

applied (providing for an increase in basis for gain recognized by the transferor).

#### Section 362(e)(1) Example

In the paradigm section 362(e)(1) case, a single foreign/tax-exempt transferor (FT) transfers property not already subject to U.S. tax to a U.S. corporation (or other corporation that will hold the property in such a way that it is subject to U.S. tax) (Sub) in a section 351 transaction. Assume the property transferred by FT consists of a \$100 built-in gain asset (Asset 1: basis \$50, FMV \$150) and a \$300 built-in loss asset (Asset 2: basis \$400, FMV \$100). Applying the historical rules of section 362, Sub would take a \$50 transferred basis in Asset 1 and a \$400 transferred basis in Asset 2. Under the new regime, because FT is transferring property not subject to U.S. tax in the hands of FT to a corporation in whose hands the property will be subject to U.S. tax, the transferred property satisfies the section 362(e)(1)(B) definition of *property*. And, because Sub’s aggregate adjusted basis in the transferred *property* (\$450, determined without application of section 362(e)(1)) would exceed its \$250 FMV by \$200, there has been an *importation of a net built-in loss*. The result is that the new rule in section 362(e)(1) will apply and Sub will hold each asset described in section 362(e)(1)(B) (Asset 1 and Asset 2) with a basis equal to its FMV. Thus, Sub will hold Asset 1 with a basis of \$150 and Asset 2 with a basis of \$100. Note that even though only one built-in loss asset has been transferred, new section 362(e)(1) assigns an FMV basis to both of the assets received by Sub.

Although section 362(e)(1) refers to property received in “any transaction” that would involve an importation of a net built-in loss, not all property received from a foreign transferor will be subject to the basis reduction rule of section 362(e)(1), because section 362(e)(1)(C) provides for basis reduction only for property satisfying the section 362(e)(1)(B) definition. For example, if the facts were the same as those above, except that the \$100 built-in gain asset (Asset 1) was already subject to U.S. tax (for example, Asset 1 was a U.S. trade or business asset), one might conclude that section 362(e)(1) should apply to all of the property transferred in the section 351 exchange (both Asset 1 and Asset 2), because Sub’s aggregate adjusted basis (\$450, determined without application of section 362(e)(1)) exceeds the \$250 FMV of the property received in the “transaction” and there was a foreign transferor involved. Applying the rules of section 362(e)(1), however, Asset 1 does not constitute *property* under section 362(e)(1)(B), and thus only Asset 2 (the only property satisfying the definition of section 362(e)(1)(B)) is subject to the basis reduction rule of section 362(e)(1). Therefore Asset 1 takes a transferred basis in the hands of Sub, because, as discussed below, the transfer of the \$100 built-in gain property is not subject to section 362(e)(2), and Asset 2 will take an FMV basis of \$100 in the hands of Sub.

Notice that if Asset 2 (the \$300 built-in loss asset) were already subject to U.S. tax, there would be no *importation of a net built-in loss* under section 362(e)(1)(C). And, because the only loss property transferred would already have been subject to U.S. tax (and therefore would not satisfy the section 362(e)(1)(B) definition of *property*),

**COMMENTARY / SPECIAL REPORT**

section 362(e)(1) would not apply to the transfer of Asset 2. As will be discussed below, however, section 362(e)(2) should apply, because that rule does not require that the property be exempt from U.S. tax before the transfer.

Part III of this article will consider questions raised by the definition of property in section 362(e)(1)(B) and will also evaluate section 362(e)(1) situations involving multiple transferors.

**B. Liquidating Importations**

Section 334(b)(1)(B) applies if two conditions are satisfied:

1. There is a distribution of property from a *foreign corporation* to an 80 percent domestic corporate distributee in a complete liquidation qualifying under section 332 (including a deemed liquidation under the check-the-box regulations).<sup>17</sup>
2. The 80 percent corporate distributee's aggregate basis in *property* (defined in section 362(e)(1)(B)) received in the liquidation would (but for the adjustment required by the new rule) exceed the *property's* aggregate FMV immediately after the liquidation.

If those two conditions are satisfied, *all* of the property received by the domestic corporate distributee in the liquidation is given an FMV basis in the hands of the distributee, rather than a transferred basis. Note that for purposes of section 362(e)(1) (importation rule), the property that receives an FMV basis is limited to property described in section 362(e)(1)(B) (that is, property not subject to U.S. tax before the importation and subject to U.S. tax after the importation). For purposes of section 334(b)(1)(B), by contrast, *all* of the transferred property receives an FMV basis if the provision applies. That is true even though, as with section 362(e)(1), only properties described in section 362(e)(1)(B) are counted for purposes of determining whether the transferee has an aggregate built-in loss in the property received.

**Section 334(b) Example**

In the paradigm section 334(b)(1)(B) case, assume U.S. parent (P) owns 100 percent of a foreign subsidiary (FS). FS holds two properties, one with a \$100 built-in gain (Asset 1: basis \$50, FMV \$150), and another with a \$300 built-in loss (Asset 2: basis \$400, FMV \$100). Assume further that both Asset 1 and Asset 2 are *property* within the meaning of section 362(e)(1)(B) (that is, property not subject to U.S. tax before the importation and subject to U.S. tax after the importation). In a complete liquidation under sections 332 and 337, FS liquidates and distributes its assets to P. Applying the historical section 334(b)(1) rule, P would take a \$50 transferred basis in Asset 1 and a \$400 transferred basis in Asset 2. Under amended section 334(b)(1), P will take a \$150 FMV basis in Asset 1 and a \$100 FMV basis in Asset 2.

Now suppose that FS also owns another asset with a \$400 built-in gain (Asset 3: basis \$100, FMV \$500), used in a U.S. trade or business, and subject to U.S. tax in the hands of FS. Taking Asset 3 into account, the aggregate

FMV of all distributed property (Assets 1, 2, and 3) would exceed the aggregate adjusted basis of that property, such that one might believe no basis adjustment is required (together, Assets 1 and 3 have a built-in gain of \$500, and Asset 2 has a built-in loss of \$300, for an aggregate net built-in gain of \$200). Nevertheless, the test to determine whether the distributed property is subject to the basis reduction rule of section 334(b)(1)(B) takes into account only property meeting the requirements of section 362(e)(1)(B) (that is, only Asset 1 and Asset 2). If that test is satisfied, *all* of the properties received by the distributee will be marked to market. Thus, in this case section 334(b)(1)(B) applies, and each of Assets 1, 2, and 3 will take an FMV basis in the hands of P after the liquidation (or deemed liquidation) of FS (Asset 1 would take a basis of \$150, Asset 2 would take a basis of \$100, and Asset 3 would take a basis of \$500). It is unlikely that Congress intended that result, and therefore some practitioners anticipate that this anomaly will be the subject of a technical correction. It is unclear whether such a technical correction can be retroactive to the October 22, 2004, original enactment date.

Part III of this article will consider questions raised by the definition of property in section 362(e)(1)(B) that are relevant to section 334(b)(1)(B) importations.

**C. Anti-Loss-Duplications**

Section 362(e)(2) applies if three conditions are satisfied:

1. The transaction under consideration is either a section 351 exchange or a capital contribution;
2. Section 362(e)(1) does not apply to the property transferred (for example, in general, net built-in loss property received in a section 351 transfer from a foreign/tax-exempt transferor to a domestic transferee will be subject to the section 362(e)(1) rule and not this rule); and
3. The transferee's aggregate basis in the property received would (but for the adjustment required by the new rule) exceed the aggregate FMV of the property immediately after the transaction.

If those three conditions are satisfied, the new rule provides that the basis of the transferred properties in the transferee's hands "shall not exceed the fair market value of such property immediately after such transaction." Note that unlike section 362(e)(1), this consequence does not assign an FMV basis to each implicated asset. In other words, this basis adjustment rule is not a true "mark-to-market" rule. Rather, section 362(e)(2) states merely that the transferee's aggregate basis must not exceed FMV. Thus, section 362(e)(2) effects its limitation on basis by requiring an adjustment only to the basis of built-in loss assets, with no adjustment to the basis of any transferred built-in gain assets. As a result of that adjustment, section 362(e)(2) permits a built-in loss to be preserved, but only to the extent that built-in gain is preserved.

There are several other differences between this provision and section 362(e)(1) (importations). First, this provision does not invoke the section 362(e)(1)(B) definition of *property*, and thus does not require an inquiry into whether the property would be subject to U.S. tax in the transferee's hands, but not in the transferor's hands.

<sup>17</sup>Treas. reg. section 301.7701-3.

Differences Summarized			
	362(e)(1)	334(b)	362(e)(2)
Relevant tax-free provision	118, 351, 361, stock-for-stock reorganizations	332	118, 351, not 362(e)(1)
Property/transferor requirements	362(e)(1)(B) property	Transferor foreign	None
Property tested to determine if net BIL	362(e)(1)(B) property	362(e)(1)(B) property	All (except 362(e)(1)(B) property)
Property subject to basis adjustment	362(e)(1)(B) property	All	All BIL property
Nature of basis adjustment	FMV for each asset	FMV for each asset	Make BIL=BIG subject to election

Thus, this provision does not look to that definition to determine which property is measured to determine net built-in loss, nor does it look to that definition to determine which property is subject to a basis adjustment. Second, section 362(e)(2) provides two special rules not available in section 362(e)(1). Those are the section 362(e)(2)(B) allocation rule and the section 362(e)(2)(C) election. The allocation rule allocates the total amount of basis reduction among the built-in loss assets received in proportion to their respective built-in loss immediately before the transaction. The election permits the transferor and the transferee to jointly elect to reduce the basis of the transferee stock received in the exchange, in lieu of reducing the basis of the property transferred (thus permitting the transferee to receive a full transferred basis in the properties). The election requires the transferor to reduce the basis of the transferee stock received in the exchange to an amount not greater than the FMV of that stock.

Finally, as a result of the new section 362(e)(2) rule, a single transferor of property to his wholly owned corporation now needs to undertake a formal valuation of the assets that are transferred. That is because if the transfer is of net built-in loss property, then absent an election, a basis adjustment would be necessary.<sup>18</sup>

#### Section 362(e)(2) Example

In the paradigm section 362(e)(2) case, a U.S. transferor (T) forms a U.S. corporation (Newco), by transferring to Newco a \$100 built-in gain asset (Asset 1: basis \$0, FMV \$100) and a \$200 built-in loss asset (Asset 2: basis \$300, FMV \$100) in exchange for all of the 100 shares of Newco stock. Section 362(e)(2) applies to the exchange, because it is a section 351 transfer involving aggregate net built-in loss property (net built-in loss is \$100), and section 362(e)(1) does not apply, because the transfer does not involve *property* within the meaning of section 362(e)(1)(B). Assuming no election is made, section 362(e)(2) requires a basis reduction in built-in loss assets received by Newco. Thus, section 362(e)(2) requires a basis adjustment in Asset 2 only. The amount of that basis reduction would be an amount sufficient to assure that Newco's aggregate basis in the property received will not

exceed the aggregate FMV of that property. Newco must reduce its basis in Asset 2 by \$100, so that the resulting aggregate \$200 basis (\$0 + \$200) equals the aggregate \$200 FMV (\$100 + \$100). Thus, applying section 362(e)(2), Newco would take a \$0 transferred basis in Asset 1 and a \$200 basis in Asset 2, and T would take a \$300 basis in the Newco stock.

To illustrate how the section 362(e)(2) basis reduction rule works when there are multiple built-in loss assets (that is, how the net built-in loss is allocated), assume that in addition to Assets 1 and 2, above, T transfers an additional asset with a \$300 built-in loss (Asset 3: basis \$500, FMV \$200). The net built-in loss is now \$400, and it must be allocated to the basis of Assets 2 and 3 (the built-in loss properties). Thus, Asset 2 is allocated \$160 of basis reduction (\$200 (Asset 2 built-in loss)/\$500 (aggregate built-in loss) x \$400 (net built-in loss)), reducing Asset 2's basis to \$140 (\$300-\$160). And, Asset 3 is allocated \$240 of basis reduction (\$300 (Asset 3 built-in loss)/\$500 (aggregate built-in loss) x \$400 (net built-in loss)), reducing Asset 3's basis to \$260 (\$500-\$240).

Part III of this article will consider how to calculate basis adjustments when there are multiple transferors, the consequences of the section 362(e)(2)(C) stock basis reduction election, the calculation of net built-in loss when there is boot in a section 351 transaction, and traps for the unwary in certain overlap transactions involving section 368 transactions.

The three relatively simple paradigm examples set forth above are sufficient to demonstrate the differences in the conditions that trigger each of the three provisions and the differences in the consequences of each. As the examples demonstrate, those differences fall into five categories: (1) the transactions that invoke each provision, (2) the transferor or property subject to each provision, (3) the property that is counted for purposes of determining if the transferee's basis would exceed FMV in the absence of the new rule, (4) the property that is subject to basis adjustment, and (5) the nature of the basis adjustment. Those differences are summarized in the table above.

The new basis reduction regimes, and the differences among them, add additional complexity to an already complex area of the tax law. As noted above, it is not even clear that all of those differences were intended (for example, the adjustment to the basis of *all* properties received in distributions described in section 334(b)). But, the complexity introduced by those differences is just the

<sup>18</sup>In lieu of a valuation, some taxpayers may opt for including a "protective election" with their returns, although there is no guarantee that such "protective election" is satisfactory.

**COMMENTARY / SPECIAL REPORT**

beginning. The new statutory language raises other problems. First, it is not clear what constitutes *property* as defined in section 362(e)(1)(B) (“gain or loss with respect to such property is not subject to U.S. tax . . . immediately before the transfer and . . . is subject to U.S. tax . . . immediately after”), particularly in cases involving CFCs. Second, it is not clear whether transfers are to be evaluated on an aggregate (all transferors included in the control group in a section 351 exchange) or a transferor-by-transferor approach. Third, a number of other examples involving section 362(e) (calculation of built-in loss in section 351 transactions with boot and overlap transactions) further demonstrate the complexity of the new basis rules. The remainder of this article will focus on those three subjects.

**III. Other Issues**

**A. Property Not Subject to U.S. Tax**

**1. Foreign transferors and transferees, including CFCs.** As noted above, the section 362(e)(1)(B) definition of *property* is relevant to transactions subject to section 362(e)(1) and in a slightly different manner to transactions subject to section 334(b)(1)(B). Recall that the first part of section 362(e)(1)(B) requires that the transferor hold property gain or loss which is not subject to U.S. tax in the hands of the transferor. The problem with this definition is that there are many cases in which it is not clear whether that requirement has been satisfied. For example, it seems that assets held by a foreign person (whether a CFC or otherwise) that are used in a U.S. trade or business or that are U.S. real property interests do not satisfy that definition (that is, they are subject to U.S. tax in the hands of the transferor), at least insofar as those assets are concerned.<sup>19</sup> And, it appears that passive investment assets (subpart F-type assets), could be treated as subject to U.S. tax in the hands of a CFC, even though they are not so treated in the hands of a non-CFC.<sup>20</sup> Moreover, it is not clear whether the section 362(e)(1)(B) definition of *property* requires the transferor to actually be able to use the loss created when the built-in loss asset is disposed of as an offset for its gains that are subject to U.S. tax, or whether instead it requires a U.S. taxpayer (generally its U.S. shareholder) to incur a current tax liability (or offset an otherwise includible deemed dividend under the subpart F rules) as a result of a disposition of the property by its actual owner.

As illustrated above, the issue of greatest uncertainty involves property transferred or received by a CFC. Suppose the facts are the same as in the original section 362(e)(1) example (a single transferor who transfers two pieces of property), except that the transferor is a CFC. Is gain or loss on property held by a CFC exempt from U.S. tax in the CFC’s hands immediately before the transfer? If it is not (in other words, if it is already subject to U.S. tax),

the property will not satisfy the section 362(e)(1)(B) definition, and it will not be included in the test to determine whether there has been “an importation of a net built-in loss.” The result will be that the property will be subject to the basis reduction regime of section 362(e)(2), if at all.

Using the original example (Asset 1: basis \$50, FMV \$150, and Asset 2: basis \$400 FMV \$100), assume that section 362(e)(1) does apply, because gain or loss on each of Asset 1 and Asset 2 was not subject to U.S. tax in the hands of the CFC. In that case, each of Assets 1 and 2 would take an FMV basis in the hands of the U.S. transferee (Asset 1 would take a \$150 basis and Asset 2 would take a \$100 basis). If, on the other hand, section 362(e)(1) does not apply (because gain or loss on each of Asset 1 and Asset 2 was viewed as subject to U.S. tax in the hands of the CFC), Asset 1 would receive a normal transferred basis of \$50 and Asset 2 would be subject to a basis reduction under section 362(e)(2) (Asset 2 would take a reduced basis of \$200).

At least insofar as CFCs are concerned, the juxtaposition of section 334(b)(1)(B) and the definition of *property* in section 362(e)(1)(B) strongly suggests that CFCs should be treated as holding at least some property that is not subject to U.S. tax. From a technical point of view, section 334(b)(1)(B) necessarily applies only to CFCs, because it requires an 80 percent domestic owner of a foreign corporation. If CFCs could not be treated as holding property exempt from U.S. tax, then section 334(b)(1)(B) could never apply, because it is triggered by a distribution of property defined in section 362(e)(1)(B). Thus, from a purely technical reading of the statute, a CFC can own property that is defined in section 362(e)(1)(B), because if no property of a CFC could satisfy the definition of section 362(e)(1)(B), section 334(b)(1)(B) would never apply.

Although that argument is helpful in determining that non-U.S. trade or business property is described in section 362(e)(1)(B), it remains unclear whether property subject to subpart F is included in that definition. Taking a practical approach, property described in subpart F (that is, property giving rise to passive income) should be treated as described in section 362(e)(1)(B). If the disposal of built-in loss property by a CFC creates a U.S. tax attribute useable by the CFC (generally by either creating a U.S. net operating loss carryover, or by offsetting gains on U.S. built-in gain property), the transaction should not be treated as an importation of the property’s built-in loss, because that property was already subject to U.S. tax. Conversely, if the disposal of built-in loss property by a CFC does not create a U.S. tax attribute useable by the CFC (such as foreign trade or business assets or even property giving rise to passive income), the transaction should be treated as an importation of the property’s built-in loss. Although disposal of that property could reduce the CFC’s earnings and profits account (and thus have an effect on the taxability of distributions from the CFC or on subpart F inclusions), the property is simply not otherwise subject to U.S. tax. The mere fact that the disposal has an impact on CFC earnings and profits should not mean that the property is subject to U.S. tax. At best, subpart F operates merely to adjust the timing of

<sup>19</sup>See sections 861, 897 (certain property used in a U.S. trade or business is subject to U.S. tax on any gain or loss).

<sup>20</sup>In the hands of the CFC, gain on the sale of subpart F type assets result in current inclusion of income to the U.S. shareholders of that CFC. See section 951(a).

income inclusion. Generally, the disposition of appreciated foreign trade or business property increases the earnings and profits of the CFC but does not result in current inclusion in income by the U.S. shareholders.<sup>21</sup> The disposition of appreciated foreign passive investment property increases the earnings and profits of the CFC and results in current inclusion in income by the U.S. shareholders under the Subpart F regime.<sup>22</sup> Thus, but for the timing of inclusion of earnings and profits by the U.S. shareholder, property designated as subpart F property is no more subject to U.S. tax than is foreign trade or business property. Therefore, the two types of property should be treated in the same manner under section 362(e)(1)(B).

**2. Domestic flowthrough entities.** As noted above, section 362(e)(1) provides a special rule for transfers by partnerships. Suppose a partnership (PRS) has historically owned only two properties, a \$100 gain asset (Asset 1: basis of \$50, FMV of \$150) and a \$300 loss asset (Asset 2: basis of \$400, FMV of \$100). Suppose further that PRS has two equal partners, FP (a non-resident alien) and USP (a U.S. citizen), each of which owns a 50 percent capital and profits interest in PRS. If PRS transfers all of its property to a U.S. corporation (SUB) in a section 351 exchange, section 362(e)(1)(B) will be applied as if the PRS transfers were made by FP and USP, individually. The property treated as transferred by FP will be an undivided one-half interest in Asset 1 and an undivided one-half interest in Asset 2. Thus, SUB will take half of Asset 1 and half of Asset 2 with FMV bases of \$75 and \$50, respectively (and presumably a fresh holding period, because section 1223 does not apply to the receipt by SUB of the property). The property treated as transferred by USP (the remaining one-half interest in each of Assets 1 and 2) will not be subject to section 362(e)(1), because neither of those half interests is *property* within the meaning of section 362(e)(1)(B). Thus, the half interest in Asset 1 that is treated as transferred by USP will receive a normal transferred basis of \$25 (FMV \$75), preserving \$50 of built-in gain. The half interest in Asset 2 treated as transferred by USP will take a reduced basis under section 362(e)(2) of \$100 (FMV \$50), preserving \$50 of built-in loss.

If Asset 1 (gain property) and Asset 2 (loss property) were received by PRS from USP and FP, respectively, within the last seven years and had their current built-in gains and losses at the time they were received by PRS, disposal of that property by PRS would ordinarily result in all of the built-in gain or loss being allocated to the transferring partner under section 704(c). In such a case, section 362(e)(1)(B) should treat that asset as having been transferred by the partner to whom the loss and the gain were allocated. Any other allocation could allow a loss that is not available for purposes of calculating U.S. tax to be used by SUB after the exchange.

Although new section 362(e)(1) contains a special rule for evaluating transfers from partnerships, no such rule

was included for S corporations, RICs, REITs, or other passthrough-type entities. Presumably, the special partnership rule was required because Congress acknowledged that gain or loss on the disposition of the transferred property would not be subject to U.S. tax in the hands of the partnership. In other words, the partners, but not the partnership, are liable for the tax resulting from the disposition. Thus, absent a special rule for other flow-through entities, property transferred by such entities might technically satisfy the definition of *property* set forth in section 362(e)(1)(B). A “look-through” rule is thus necessary to exempt from section 362(e)(1)(B) treatment, certain property, if gain or loss on that property would be subject to tax via the flow-through rules of regimes similar to that of subchapter K.

Property transferred by a corporation with a valid subchapter S election in effect could, but for a look-through rule similar to the one for partnerships, be treated as defined in section 362(e)(1)(B). Although it may be possible to distinguish partnerships from S corporations, in that partnerships can have foreign partners and S corporations cannot have foreign shareholders, S corporations can have tax-exempt shareholders.<sup>23</sup> Thus, there is probably a need for a “look-through” rule for S corporations, with some exception for property subject to section 1374 built-in gain tax.

Regarding RICs and REITs, it seems that gain or loss on property owned by these entities is subject to tax in the hands of the RIC or REIT, because absent a dividends paid deduction,<sup>24</sup> the RIC or REIT is subject to tax resulting from the gain or loss recognized on the disposition of that property, similar to any other corporation. Therefore, property transfers by those types of entities should not be included within the definition of section 362(e)(1)(B).

## B. Aggregate or Transferor-by-Transferor

**1. Section 362(e)(1) transactions.** Suppose that the facts are the same as in the original section 362(e)(1) example (Asset 1: basis \$50, FMV \$150 and Asset 2: basis \$400, FMV \$100), except that Asset 1 is transferred by one foreign/tax-exempt transferor and Asset 2 is transferred by a second, unrelated foreign/tax-exempt transferor. Given those facts, all of the transferred property should satisfy the section 362(e)(1)(B) definition of *property*. And, it looks like Sub’s aggregate adjusted basis of *property* received in the transaction (\$450) exceeds the \$250 FMV of the transferred property, such that there has been an *importation of a net built-in loss*. Thus, one could argue that this example has the same basis results as in the original example. That argument is supported by section 362(e)(1)(C), which references property received by the transferee in the “transaction” as the property that is subject to the basis reduction rules of section 362(e)(1)(A). It is not clear, however, whether in this case involving multiple transferors, there has been one transaction or

<sup>21</sup>See section 954(c)(1)(B)(iii); Treas. reg. section 1.954-2(e)(3)(ii).

<sup>22</sup>See section 951(a); section 954(c)(1)(B)(i).

<sup>23</sup>See section 1361(b)(1)(B); section 1361(c)(6).

<sup>24</sup>See section 561 (providing for the amount of deduction allowed); section 857 (providing for a deduction against real estate investment trust taxable income).

**COMMENTARY / SPECIAL REPORT**

two. If there have been two transactions and the basis rules are applied transferor-by-transferor, arguably Sub would take an FMV basis of \$100 in Asset 2 (the loss asset) and a transferred basis of \$50 in Asset 1 (the gain asset). That is because the gain asset, viewed by itself, would not satisfy the definition of an *importation of a net built-in loss*, leaving that portion of the transaction subject to the old transferred basis rule and not the new marked-to-market basis rule. That view seems to be supported by the section 362(e)(1)(B) rule, which focuses on each transferor, and whether gain or loss on dispositions of each transferor's property is subject to U.S. tax in each transferor's hands. If it is correct to analyze section 362(e)(1)(B) using a transferor-by-transferor approach, the same approach should apply for section 362(e)(1)(C), because that section determines net built-in loss based on the property described in section 362(e)(1)(B).

If, on the other hand, the term "transaction" as used in section 362(e)(1)(C) is viewed as the overall section 351 exchange, the built-in gain asset transferred by a person unrelated to the transferor of the built-in loss asset will take an increased basis (equal to the property's FMV). IRS and Treasury guidance is necessary to resolve this uncertainty.

**2. Section 362(e)(2) transactions.** The question about whether to use a transferor-by-transferor versus an aggregate approach leads to an equal, but different, uncertainty when applied to section 362(e)(2) transactions. Suppose Parent, a U.S. corporation, owns two U.S. subsidiaries, Sub 1 and Sub 2. Sub 1 and Sub 2 create a newly formed U.S. subsidiary (Newco) and transfer property to it in a section 351 exchange. In the exchange, Sub 1 transfers Asset 1 (basis \$0, FMV \$100), and Sub 2 transfers Asset 2 (basis \$250, FMV \$100), and each receives 50 shares of Newco stock. Section 362(e)(2) clearly applies to the exchange, because it is a section 351 transfer involving aggregate built-in loss property, and section 362(e)(1) does not apply (because the transfer does not involve *property* within the meaning of section 362(e)(1)(B)). It is also clear that section 362(e)(2) requires a basis reduction in Asset 2 only. What is not so clear is the amount of that required basis reduction. If the section 362(e)(2) basis reduction rule is applied using an aggregate approach, taking into account all assets transferred in the entire section 351 transaction, Newco will take a basis in Asset 2 of \$200 (\$250 less \$50 aggregate net built-in loss in all of the property transferred). If, on the other hand, the section 362(e)(2) basis reduction rule is applied using a transferor-by-transferor approach, taking into account only the built-in loss asset transferred by Sub 2 in the transaction, then Newco will take a basis in Asset 2 of \$100 (\$250 less \$150 net built-in loss in Asset 2).

The lack of clarity comes not so much from the statutory language in section 362(e)(2)(A) (which, as described below, seems to adopt a transferor-by-transferor approach), but instead from an apparent contradiction between the statutory language and the legislative history. The legislative history to the Senate amendment to the House bill strongly suggests that Congress intended an aggregate approach. It states "if 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 aggregate fair market

value of the property transferred in a tax-free incorporation, the transferee's aggregate basis of the properties is limited to the aggregate fair market value of the transferred property." In contrast, the statute seems relatively clear that the only property used to measure the amount of required basis reduction is property transferred by a transferor of built-in loss property. Section 362(e)(2)(A)(i) refers to property transferred by "a transferor" and goes on in section 362(e)(2)(A)(ii) to require that "such property" have a net built-in loss. Clearly guidance is needed in that regard as well.

**3. Election to reduce stock basis.** Recall that even if section 362(e)(2) results in a basis reduction by the transferee, that reduction can be avoided if the transferor and the transferee make a joint election under section 362(e)(2)(C) (election) to have the transferor reduce the basis in its transferee stock received in the exchange. Such an election could lead to strange consequences if the aggregate approach is adopted and one transferor has both a gain asset and a loss asset, and another transferor has only a loss asset. For example, assume A and B (both U.S. persons) are the transferors. A owns a \$20 gain asset (basis \$80, FMV \$100) and a \$10 loss asset (basis \$60, FMV \$50). In the aggregate, A's property has a net gain of \$10. B owns a single \$30 loss asset (basis \$100, FMV \$70). A and B will contribute those three assets to a newly formed corporation (Newco) solely for stock in Newco; A will receive 150 shares with a value of \$150 and B will receive 70 shares with a value of \$70.

If the transferor-by-transferor approach is adopted (the transfers by A and B are treated as separate transactions for purposes of section 362(e)(2)), the only basis adjustment will be a \$30 reduction to the basis of the loss property contributed by B, which will then take a \$70 basis in Newco's hands. If B and Newco make the election, the basis of B's property in Newco's hands will remain \$100, but B will take a \$70 basis in the Newco stock (the Newco stock's FMV). Either way (with or without the election), the basis reduction will be \$30. There will be no adjustment to the basis of the loss property transferred by A, because A's transferred property does not have an aggregate built-in loss.

If, on the other hand, the aggregate approach is adopted and A's and B's transfers are aggregated, there will be an aggregate loss of \$20 (total basis of \$240 and total FMV of \$220). If neither A nor B makes the election with Newco, the two loss assets, one belonging to A and the other to B, will suffer a \$5 and \$15 basis reduction, respectively, in Newco's hands (\$10 (built-in loss of A's property)/\$40 (aggregate built-in loss) x \$20 (net built-in loss), and \$30 (built-in loss of B's property)/\$40 (aggregate built-in loss) x \$20 (net built-in loss)). The language in section 362(e)(2)(C) seems to allow each transferor in the transferor group to independently make (or refrain from making) an election to reduce the transferor's basis in the transferee stock received. There is no suggestion in the legislative history that the election must be made by the entire transferor group. Thus, if B, but not A, makes the election with Newco, the asset transferred by B will not be subject to the section 362(e)(2)(A) rules (that is, Newco will keep its \$100 basis in the property received from B) and B will take a basis of \$70 in its Newco stock. But more importantly, B's election should cause A's



transfer to stand alone for purposes of applying the section 362(e)(2)(A) rule; and standing alone, A's transfer will not be subject to the section 362(e)(2) rule, because there will be no net built-in loss in A's transferred property. This example illustrates a fundamental problem with adopting an aggregate approach. Under such an approach, there is a \$30 basis reduction if the election is made, but only a \$20 reduction if the election is not made. The election should result in only timing and location differences, and not an absolute difference in the amount of basis reduction.

If both A and B make the election, none of the assets transferred by A and B will be subject to the section 362(e)(2)(A) rules. Newco will take a basis in the assets equal to their basis in the hands of A and B. Regarding each transferor's basis in his stock, A will have no adjustment, because the basis of the stock received by A does not exceed the FMV of that stock, but B will be required to reduce his basis in the Newco stock to \$70 (a \$30 basis reduction). Reducing basis (either Newco's basis in the B property or B's basis in the Newco stock) by \$30 seems to be consistent with the statute, but inconsistent with an aggregate approach.

If the facts were changed so that both A and B had net built-in loss property, under each scenario above (transferor-by-transferor and aggregate) the total asset and stock basis adjustments would be identical.<sup>25</sup> Thus, it is only when some of the transferors have net built-in loss property and others have net built-in gain property that the aggregate approach (versus the transferor-by-transferor approach) produces inconsistencies. It is difficult to believe that it was the intent of Congress to create disparate reductions in basis depending on whether transferors elect to reduce asset or stock basis. The only reason to allow transferors to make those elections is to allow the transferor of the property to bear all of the basis reduction, rather than having the basis reduction imposed on a transferee who bargained for a full basis. As can be seen from the discussion above, if an aggregate approach is adopted for purposes of section 362(e)(2)(A) (and absent an election by any of the transferors in the control group), some *net* gain of one transferor will be used to allow duplication of loss by another transferor. Thus, the aggregate approach, when coupled with the section 362(e)(2)(C) election regime applied on a transferor-by-transferor basis, seems to be inconsistent with the intent of Congress in enacting section 362(e)(2).

### C. Other Section 362(e) Issues

A few additional issues arise under section 362(e) that do not involve either the aggregate versus transferor-by-transferor problem or the definition of *property* in section 362(e)(1)(B).

**1. Sections 362(e) transactions with boot.** An important, but easily overlooked, aspect of the new rules is that net built-in loss is tested after the transferee has received

property and after the section 362 rules (except 362(e)) have been applied. There is no better illustration of that concept than a section 351 exchange that involves a receipt of boot by the transferor.<sup>26</sup> The example that follows involves a section 362(e)(2) transaction, although it applies equally to a section 362(e)(1) transaction. Suppose Parent, a U.S. corporation, owned all of the stock of a U.S. subsidiary (SUB) and transferred to SUB Asset 1 with a \$100 built-in gain (basis \$0, FMV \$100) and Asset 2 with a \$100 built-in loss (basis \$200, FMV \$100), solely in exchange for \$100 of Sub stock (constructively issued or actually issued) and \$100 of boot (cash or SUB note). At first glance, it would seem that section 362(e)(2) would not apply to this transaction, because the aggregate basis of the property transferred (\$200) does not exceed the aggregate FMV of that property (\$200) (that is, there has been no transfer of net built-in loss property). However, the section 362(e)(2) basis reduction rule (as well as the section 362(e)(1) rule) tests whether the property transferred has an aggregate built-in loss in the hands of the transferee, before application of the section 362(e)(2) basis reduction rule (or the section 362(e)(1) rule). Following that approach, this transaction involves a greater amount of duplicated built-in loss than duplicated built-in gain. That is because when property is contributed in a section 351 exchange, and in addition to stock of the transferee other property is given to the transferor, gain (but not loss) is recognized by the transferor on the exchange. In those types of "boot" section 351 exchanges, the gain recognized on each transferred asset is equal to the lesser of the gain realized on that asset or the value the other property allocated to that asset.<sup>27</sup>

Applying the rationale in Rev. Rul. 68-55,<sup>28</sup> the proper calculation of gain recognition requires that each category of consideration (that is, stock, property, and money) be allocated pro rata (based on FMV) to each individual asset transferred by the transferor. Thus, in this case, only \$50 of the cash would be allocated to each of Assets 1 and 2. As a result, Parent will recognize gain of \$50 on Asset 1, but will not recognize loss on Asset 2. As a result of the \$50 gain recognized on Asset 1, SUB will increase its basis under section 362(a) in Asset 1 to \$50. After application of that section 362(a) step-up of \$50, there is a net built-in loss of \$50 in Assets 1 and 2 (aggregate basis of \$250 and FMV of \$200). In this example, the section 362(e)(2) basis reduction rule will cause the basis of Asset 2 to be reduced by \$50 to \$150 (reducing the amount of duplicated built-in loss (\$50) so that it equals the amount of duplicated built-in gain (\$50)). Notice that the boot received in a section 351 exchange reduces the amount of built-in gain that is duplicated in the exchange, without reducing the amount of built-in loss that is duplicated in the exchange.

**2. Section 362(e)(2) overlaps.** Similar unanticipated results occur in situations involving transactions that qualify as two different types of tax-free transactions. For

<sup>25</sup>There could be differences in the amount of basis reduction allocated to each built-in loss asset (depending on whether the transferor-by-transferor or aggregate approach is adopted) in cases in which each transferor transfers multiple gain and multiple loss assets.

<sup>26</sup>This issue also arises when section 357(b) applies to liabilities assumed in the section 351 exchange.

<sup>27</sup>See section 351(b).

<sup>28</sup>1968-1 C.B. 140.

**COMMENTARY / SPECIAL REPORT**

example, suppose a U.S. corporation (Acquiring), with 200 shares of a single class of stock outstanding, agrees to acquire all of the property of a second U.S. corporation (Target) solely in exchange for 800 newly issued shares of that same single class of stock (in other words, Target is four times more valuable than Acquiring). Suppose further that the aggregate bases of the assets of Target exceed their FMV, and that following the exchange, Target will dissolve and distribute all of its property (the 800 shares of Acquiring stock) to its shareholders in cancellation of their Target stock. That transaction satisfies the requirements of sections 368(a)(1)(C) and (D),<sup>29</sup> such that under sections 361, 354, and 1032, no party to the transaction recognizes gain or loss. And, under section 362(b), Acquiring should receive a transferred basis in the Target assets it receives. But, a section 361 exchange that results in the transferor receiving an amount of stock that constitutes section 368(c) control is also a section 351 exchange.<sup>30</sup> Thus, in the example above, the property transfer from Target to Acquiring is not only a section 361 exchange, but also a section 351 exchange. Therefore, this transaction would be subject to section 362(e)(2). Without a stock basis reduction election under section 362(e)(2)(C), Acquiring will be required to reduce the basis of Target's assets so that any aggregate built-in loss is eliminated.

Although that result might be anticipated (because the section 368(c) control test applicable to section 351 exchanges is satisfied in the transaction) it might not be anticipated when Acquiring and Target are members of the same consolidated group, and Target is not four times more valuable than Acquiring. Suppose instead of having 200 shares of Acquiring stock outstanding, there were 2,000 shares outstanding, and Acquiring and Target were members of the same consolidated group. Although Target's receipt of 800 shares of Acquiring stock does not appear to satisfy the section 368(c) control requirement, section 1.1502-34 of the consolidated return regulations renders that fact immaterial, because that section treats Target as owning all the Acquiring stock owned by other members of the consolidated group. What that means is that almost all intragroup reorganizations will also be section 351 exchanges and section 362(e)(2) has the possibility of applying to each of those overlaps. Absent a section 362(e)(2)(C) stock basis reduction election (that election will cause Target to reduce its basis in the Acquiring stock received in exchange for the Target assets, but has little consequence as those shares are generally distributed without gain or loss recognition under section 361(c)), Acquiring will be required to adjust

the basis of the assets received from Target, to the extent of the excess of aggregate built-in losses over aggregate built-in gains.<sup>31</sup>

That outcome could lead to serious repercussions if the consolidated group's generally accepted accounting principles financial statements reflect a deferred tax asset associated with Target's built-in loss property (reflecting the future benefit of the loss or deduction). In such a case, that deferred tax asset may need to be reduced to the extent the basis reduction eliminates all or a portion of the future expected asset loss.

Two other overlap transactions deserve attention. The first is a section 304(a)(1) transaction, in which the seller of the issuing corporation stock (the stock of the company sold to the acquiring company) receives property that is treated as a distribution under section 301. The Tax Reform Act of 1997 amended section 304(a)(1) to provide that all "dividend" section 304(a)(1) transactions are treated as (1) a transfer of the issuing corporation stock to the acquiring company solely for stock of the acquiring company in a transaction to which section 351 applies, followed by (2) a redemption of the acquiring company stock deemed issued in (1). The statute treats the transfer of the issuing corporation stock as a section 351 exchange,<sup>32</sup> thus section 362(e)(2) seems to apply to that contribution if the issuing corporation stock (the property) has a basis that exceeds value. If so, the acquiring corporation must reduce the basis of the property it received from the seller (issuing corporation stock) so that it no longer reflects a net built-in loss. Alternatively, if the section 362(e)(2)(C) stock basis reduction election is made, the reduction in basis probably is made to the stock deemed issued, then redeemed, in the section 304 transaction. When that stock is treated as redeemed and the basis (assuming the section 362(e)(2)(C) election is not made) exceeds the dividend amount and any basis adjustment required under section 301(c)(2), the remaining basis in the redeemed shares will be allocated to the other shares that the seller owns in the acquiring company.<sup>33</sup>

The second overlap occurs in reorganizations in which the target corporation survives: reorganizations described in section 368(a)(1)(A) by reason of section 368(a)(2)(E) (reverse subsidiary mergers) and section 368(a)(1)(B) (certain stock acquisitions). Each could constitute a section 351 exchange if the transferring shareholders acquire the requisite amount of stock of the acquiring company to satisfy the section 368(c) control requirement. Absent a section 362(e)(2)(C) stock basis

<sup>29</sup>Under section 368(a)(2)(A), transactions described in both (C) and (D) of section 368(a)(1) will be treated as described only in (D).

<sup>30</sup>*Cf.* Rev. Rul. 68-357, 1968-2 C.B. 144; Rev. Rul. 76-123, 1976-1 C.B. 94. Notice in each of these rulings, the target corporation did not receive the requisite amount of stock to satisfy the section 368(e) control test. Instead, the target corporation was a cotransferor with another party that together acquired control of the transferee.

<sup>31</sup>Section 362(e) raises other issues under the consolidated return regulations (notably the section 1.1502-32 investment adjustment rules), but those are beyond the scope of this article.

<sup>32</sup>Before its amendment by the Taxpayer Relief Act of 1997 (P.L. 105-34), section 304 treated this transfer to the acquiring corporation as a contribution to capital instead of a section 351 transfer. The underlying regulation, Treas. reg. section 1.304-2(a), still refers to the transfer as a contribution to capital, and references section 362(a) for a determination of basis.

<sup>33</sup>*See* Treas. reg. section 1.302-2(c) and prop. reg. section 1.302-5 (requiring a "proper adjustment" to the basis of the remaining shares).

reduction election, those overlaps might require the transferee of the target stock to adjust the basis of the target stock to the extent any shareholder transfers target stock having a net built-in loss.<sup>34</sup>

**3. Failure to submit timely election.** Finally, regarding the section 362(e)(2)(C) election, suppose a transferor should have made a section 362(e)(2)(C) stock basis reduction election but neglected to do so. There is some uncertainty as to whether the transferor has the ability to petition the IRS for an extension of the time to file, under section 9100. Ordinarily that question is resolved by reference to whether the time for filing the election is defined by statute or regulation. For the former, it is generally not possible to have the time for filing extended, but for the latter, the Service generally may grant the extension. Section 362(e)(2)(C) seems to define the time for filing the election as the date of the filing of the tax return for the year of the transaction, suggesting that no extension is possible.<sup>35</sup>

---

<sup>34</sup>Query whether section 362(e)(2) would apply (and therefore require the election) regardless of the basis option the acquiring corporation chose pursuant to Treas. reg. section 1.358-6(c)(2)(ii).

<sup>35</sup>See Treas. reg. section 301.9100-2 for automatic six-month extension (from initial due date), provided the taxpayer has timely filed its tax return before the extended due date.

#### IV. Conclusion

Although the new rules governing importations and transfers of net built-in losses might be thought of simply as rules that substitute a lower, FMV basis for transferred basis, they are more complicated. Each of the three new provisions is triggered by distinct conditions and each leads to consequences different from the others. Moreover, the new provisions do not resolve crucial issues such as whether transfers are to be evaluated in the aggregate or transferor-by-transferor, and how the notion of property not subject to U.S. tax is to be interpreted.

Undoubtedly other questions will surface as the new provisions are applied. As is often the case, new law designed to clarify, simplify, or protect the integrity of existing rules leads to additional confusion and complexity.