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Conformity: California
Rules Taxpayer May Disregard Treas.
Reg. §1.337(d)-2



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I.R.C. Conformity

While California currently conforms to the Internal Revenue Code as of Jan. 1, 2009, that conformity may come with some unintended consequences. For example, stock losses partially deductible at the federal level could be completely disallowed for state income tax purposes pursuant to the application of Treas. Reg. § 1.337(d)-2 if an affirmative statement is not attached to the return. The California Franchise Tax Board recently addressed this potential trap, ruling that the federal regulation does not apply to members of a California combined reporting group. This article explains the regulation in question and the FTB's reasoning.

Unintended Consequence of I.R.C. Conformity: California Rules Taxpayer May Disregard Treas. Reg. § 1.337(d)-2

BY BRIAN J. SULLIVAN AND MICHAEL F. PAXTON

In the spirit of consistency and ease of administration, most states that impose corporate income taxes begin their computation of taxable income with federal taxable income. One method adopted by states to accomplish this objective is to require a corporation to use the amount reported on its federal tax return as the starting point. The majority of states, however, have enacted legislation to conform to the Internal Revenue

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Code ("I.R.C.")¹ in some respect, either through rolling conformity or static conformity.² Moreover, it has been quite common for states in the recent past to opt out of certain federal tax provisions that states may view as either unfavorable or inconsistent with their income tax policies. For example, some states opt out of bonus depreciation (I.R.C. § 168(k)), the expensing of depreciable business assets (I.R.C. § 179), the domestic production activities deduction (I.R.C. § 199), and the deferral of certain cancellation of debt income provided by I.R.C. § 108(i). But, it is also possible that the general

¹ Statutory and regulatory references to the "Code" or "I.R.C. §" are to the Internal Revenue Code of 1986, as amended, and all "Treas. Reg. §" references are to the Treasury regulations thereunder.

² Rolling (or "moving date") conformity refers to a state conformity statute that automatically adopts any changes to the federal law while static (or "fixed date") conformity refers to a state conformity statute that adopts the federal law on a certain date, such as Jan. 1, 2009, and does not include any federal law changes enacted after that date. Note that California conforms to the I.R.C. as of Jan. 1, 2009. See, Cal. Rev. & Tax. Code §§ 23051.5(a)(1) and 17024.5(a).

conformity to the I.R.C. provisions may have other unintended consequences.

Potential Trap

In this article, we discuss one potential trap for the unwary related to a state's general adoption of the I.R.C. and, as part of that adoption, the application of Treas. Reg. § 1.337(d)-2. Generally speaking, before the promulgation of Treas. Reg. § 1.1502-36, Treas. Reg. § 1.337(d)-2 prevented taxpayers from using the federal consolidated return regulations to sell assets without paying a corporate tax while the buyer obtained a stepped-up tax basis in those assets.³ A potential trap may arise under circumstances where this Treasury regulation operates to permanently disallow stock losses for state income tax purposes that are permitted for federal income tax purposes unless the taxpayer affirmatively attaches a statement to its return to apply certain safe harbor provisions. In its recent Chief Counsel Ruling 2012-06, the California Franchise Tax Board ("FTB") addressed this potential unintended consequence, ruling that Treas. Reg. § 1.337(d)-2 was not applicable for California purposes with respect to a worthless stock loss attributable to members of a combined reporting group despite California's specific conformity to the I.R.C.⁴ We summarize the approach taken by the FTB in Chief Counsel Ruling 2012-06 to resolve this issue and address the potential implications in other states.

California Chief Counsel Ruling 2012-06

In the ruling, the FTB was asked to address whether Treas. Reg. § 1.337(d)-2 would operate to disallow worthless stock deductions by insolvent corporations converting to disregarded limited liability companies pursuant to a court ordered bankruptcy reorganization pursuant to Chapter 11 of the Bankruptcy Code (11 U.S.C.). The worthless stock deductions were allowable for federal income tax purposes pursuant to I.R.C. § 165(g), subject to the limitations provided by Treas. Reg. § 1.1502-36. But because it is clear that California does not adopt the limitations imposed by Treas. Reg. § 1.1502-36, the question presented was whether California's adoption of Subchapter C of the I.R.C. would include the application of Treas. Reg. § 1.337(d)-2 to disallow the stock loss deductions.⁵

One of the purposes of Treas. Reg. § 1.1502-36 is to prevent perceived problems that occur through the application of the consolidated return investment adjustment rules under Treas. Reg. § 1.1502-32.⁶ Promulgated in September 2008, to apply a single integrated approach that had previously applied separately under Treas. Reg. §§ 1.337(d)-2 and 1.1502-35 (related to duplicated losses), Treas. Reg. § 1.1502-36 adjusts stock basis to eliminate non-economic losses or reduces attri-

butes to prevent duplicated losses. Although Treas. Reg. §§ 1.337(d)-2 and 1.1502-35 are currently still active regulations, they generally no longer apply to transactions after September 17, 2008, where Treas. Reg. § 1.1502-36 applies.

Treas. Reg. § 1.337(d)-2(a)(1) provides:

No deduction is allowed for any loss recognized by a member of a consolidated group with respect to the disposition of stock of a subsidiary. However, for transactions involving loss shares of subsidiary stock occurring on or after September 17, 2008, see § 1.1502-36. Further, this section does not apply to a transaction that is subject to § 1.1502-36.⁷

On its face, Treas. Reg. § 1.337(d)-2 is inapplicable to transactions occurring on or after Sept. 17, 2008. Taxpayers executing transactions after this date are directed to apply the loss limitation rules of Treas. Reg. § 1.1502-36, a federal consolidated return regulation that does not apply for California franchise tax purposes. Treas. Reg. § 1.337(d)-2 provides that the section does not apply to a transaction that is subject to Treas. Reg. § 1.1502-36.

California specifically adopts by reference Subchapter C of Chapter 1 of Subtitle A of the I.R.C. ("Subchapter C").⁸ This adoption encompasses I.R.C. §§ 301 through 385 and, therefore, includes I.R.C. § 337. Furthermore, California provides that the federal Treasury regulations are controlling when California statutes conform to federal statutes, unless otherwise provided.⁹ California does not provide specific statutory or regulatory guidance that indicates that I.R.C. § 337 or its underlying regulations, including Treas. Reg. § 1.337(d)-2, would not apply. Further, California provides that federal terminology may be replaced by California terminology when applying the I.R.C. or Treasury regulations.¹⁰

Therefore, because Treas. Reg. § 1.1502-36 applied to the taxpayer's transaction for federal income tax purposes, Treas. Reg. § 1.337(d)-2 was not applicable. In California Chief Counsel Ruling 2012-06, the taxpayer sought to deduct certain stock losses pursuant to I.R.C. § 165(g)(3), *i.e.*, worthless stock deductions, which were triggered by the liquidation of its insolvent subsidiaries in accordance with the taxpayer's court-approved bankruptcy plan governed by Chapter 11 of Title 11 of the United States Code. However, because Treas. Reg. § 1.1502-36 does not apply for California franchise tax

⁷ It should be noted that Treas. Reg. § 1.337(d)-2(c) provides exceptions to the general disallowance of a stock loss; however, those exceptions are available only if the taxpayer includes a separate and affirmative statement with its return of its intent to invoke those exceptions. Because Treas. Reg. § 1.337(d)-2 does not apply for federal income tax purposes with respect to transactions occurring after Sept. 17, 2008, the statement would not generally be included with a taxpayer's federal return, thus creating further ambiguity for taxpayers trying to avoid the application of the general rule provided in subsection (a)(1). For such taxpayers, the question becomes whether the statement should be attached to the federal return or attached to each state return in which a taxpayer claims a stock loss pursuant to I.R.C. § 165(g) or any other federal provision.

⁸ Cal. Rev. & Tax. Code §§ 17321 and 24451.

⁹ Cal. Rev. & Tax. Code § 23051.5(d).

¹⁰ Cal. Rev. & Tax. Code § 23051.5(h).

³ This transaction came to be known as the "Son of Mirrors Transaction."

⁴ California Chief Counsel Ruling 2012-06 (Oct. 25, 2012).

⁵ California does not follow the federal consolidated return regulations except for its specific and limited conformity to Treas. Reg. § 1.1502-13 with modifications as provided by California Code of Regulations, title 18 ("CCR") § 25106.5-1.

⁶ Note that Treas. Reg. § 1.1502-36 also addresses duplicated losses which are unrelated to the investment adjustment system and not pertinent to the analysis in this article.

purposes, it would appear that Treas. Reg. § 1.337(d)-2 ostensibly applies in California by default.¹¹

The FTB ruled that Treas. Reg. § 1.337(d)-2 is not applicable to taxpayers filing a California combined franchise tax return because such a return is not a consolidated return, and the regulation “is only applicable for taxpayers that file consolidated returns.”¹² Although the analysis in the Chief Counsel Ruling is relatively brief, it hinges on California’s adoption of certain I.R.C. terms and its case law history. Except in very limited circumstances, California does not provide for “consolidated” returns.¹³ Instead, California requires combined returns for taxpayers that meet the unitary requirements.¹⁴ California’s case law and history of published guidance have consistently held that a unitary combined return is not the same as a consolidated return.¹⁵ Therefore, without a California consolidated return, Treas. Reg. § 1.337(d)-2 is not operable for California franchise tax purposes.

Application Outside California

In essence, Treas. Reg. § 1.337(d)-2 is a misplaced federal consolidated return regulation, promulgated outside the authority granted by I.R.C. § 1502. Its origin dates back to the 1986 Tax Reform Act, which repealed the *General Utilities* doctrine.¹⁶ In that Act, Congress not only overturned that doctrine by providing that gain must be recognized upon a distribution of appreciated property, but also specifically tasked the Internal Revenue Service (the “Service”) to prescribe regulations that would prevent the circumvention of the *General Utilities* repeal through the use of the consolidated return regulations.¹⁷

The Service issued final regulations under Treas. Reg. §§ 1.1502-20, 1.337(d)-1, and 1.337(d)-2 on Sept. 13, 1991. The approach that Treas. Reg. § 1.1502-20 took was widely criticized and was subsequently litigated because it disallowed economic losses that would otherwise be deductible in a separate return context. In *Rite Aid Corp. v. U.S.*, the Court of Appeals for the Federal Circuit held that the government’s attempt to disallow losses capable of duplication was invalid.¹⁸ The court concluded that disallowing a loss that would otherwise be deductible under I.R.C. § 165 amounts to an imposition of tax on income that would otherwise not be taxed.¹⁹

¹¹ See footnote 4 of California Chief Counsel Ruling 2012-06 (Oct. 15, 2012).

¹² California Chief Counsel Ruling 2012-06 (Oct. 15, 2012).

¹³ California allows consolidated return filings only in limited situations, such as when there is an affiliated group of railroad corporations connected through stock ownership with a common parent corporation. Cal. Rev. & Tax. Code § 23362.

¹⁴ Cal. Rev. & Tax. Code § 25102.

¹⁵ See *Appeal of NIF Liquidating Company*, Cal. SBE, 80-SBE-118 (Oct. 28, 1980). See also FTB Publication 1061.

¹⁶ The *General Utilities* doctrine refers to the holding in *General Utilities and Operating Co. v. Helvering*, 296 U.S. 200 (1935). In that case, the Supreme Court held that a corporation does not recognize gain upon the distribution of appreciated property to its shareholders.

¹⁷ See I.R.C. § 337(d)(1); H.R. Rep. No. 426, 99th Cong., 1st Sess. 282 (1985). The gain recognition treatment was accomplished through the amendment of I.R.C. § 311(b).

¹⁸ *Rite Aid Corp. v. U.S.*, 255 F.3d 1357, 1360 (Fed. Cir. 2001).

¹⁹ *Id.*

After *Rite Aid*, the Service replaced Treas. Reg. § 1.1502-20 in its entirety with interim regulations based on Treas. Reg. § 1.337(d)-2. The interim regulations, issued under Treas. Reg. § 1.337(d)-2T, became final on March 3, 2005, and applied to stock dispositions on or after that date. The “new” Treas. Reg. § 1.337(d)-2 largely employed the same rules that were in former Treas. Reg. § 1.337(d)-2 in that losses on subsidiary stock are disallowed except to the extent that the parent establishes that the loss is not attributable to built-in gain on the disposition of an asset. It is important to note that, although the regulation is clearly a consolidated return regulation, the Service promulgated this regulation under I.R.C. § 337 under the authority granted by Congress to protect the purposes of the *General Utilities* repeal and ensure against any attempt to circumvent that purpose.

As discussed above, Treas. Reg. § 1.1502-36, also known as the Unified Loss Rule, replaced Treas. Reg. § 1.337(d)-2 in 2008 (although Treas. Reg. § 1.337(d)-2 was not repealed). Both regulations serve to prevent members of a federal consolidated group from recognizing non-economic losses on subsidiary stock that may be created by the application of the consolidated return investment adjustment rules under Treas. Reg. § 1.1502-32. Most states do not adopt the federal consolidated return regulations promulgated under I.R.C. § 1502. Therefore, if a state doesn’t apply the investment adjustment rules provided by Treas. Reg. § 1.1502-32, neither Treas. Reg. § 1.1502-36 nor Treas. Reg. § 1.337(d)-2 seem necessary from a policy standpoint. However, while determining the applicability of Treas. Reg. § 1.1502-36 in most states is a straightforward exercise of determining conformity or non-conformity to the federal consolidated return regulations, how many states will ostensibly apply Treas. Reg. § 1.337(d)-2 if Treas. Reg. § 1.1502-36 does not apply? Based on the FTB’s analysis in California Chief Counsel Ruling 2012-06, taxpayers deducting stock losses should consider this issue.

Because the general rule found in Treas. Reg. § 1.337(d)-2 is to disallow the entire stock loss and not simply mirror the limitations now found in Treas. Reg. § 1.1502-36, the potential exists for a situation in which a stock loss partially deductible for federal income tax purposes is completely disallowed for state income tax purposes pursuant to Treas. Reg. § 1.337(d)-2(a)(1), absent an affirmative statement attached to the return. Clearly, such a result would not be consistent with a state’s desire to adopt the I.R.C. for purposes of consistency and ease of administration.

Conclusion

Taxpayers and tax practitioners should be wary of potential traps created by a state’s desire to adopt federal tax rules by generally conforming to the I.R.C., or even specific Code sections. California Chief Counsel Ruling 2012-06 points out only one such trap for the unwary based on differences between combined and consolidated returns and California’s ostensible conformity to the I.R.C. while failing to conform to most of the federal consolidated return regulations. Other traps can result from the ambiguity and even potential conflict of law created by general state conformity to the I.R.C. without guidance as to how to reconcile that conformity to state concepts not found in the I.R.C., such as combined reporting, apportionment, and the unitary busi-

ness principle. Presumably, the goal of such general I.R.C. conformity is to make the administration of a state income tax easier by using federal taxable income as a starting point and only making certain state modifications that effectuate state taxing policies. However, general conformity to the I.R.C. by states can create situations where a technical reading of the law produces potentially unintended results not contemplated by state tax policy makers.

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