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Application of Proposed CERT Regulations to Acquisitions by Consolidated Groups

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INTRODUCTION

On September 17, 2012, the Internal Revenue Service (IRS) issued proposed regulations (the "Proposed Regulations") that would provide rules relating to the treatment of corporate equity reduction transactions (CERTs) under §172.[1] The Proposed Regulations would be the first major guidance issued by the IRS since the CERT rules were enacted in 1989.

The remainder of this article is divided into two parts. The first part discusses the CERT rules in general. The second part discusses the Proposed Regulations, focusing on the application of the Proposed Regulations to acquisitions by consolidated groups.

OVERVIEW OF CERT RULES

Background and Enactment

Section 172 provides rules relating to carrybacks and carryovers of net operating losses (NOLs). Under §172(b)(1)(A), taxpayers may carry back an NOL to each of the two years preceding the taxable year of the loss and carry over the NOL to each of the 20 years following the taxable year of the loss.

In general, §172(b)(1)(E) and (h) (the "CERT rules") limit the NOL carrybacks of a C corporation involved in a CERT to the extent the NOL carryback is attributable to interest deductions that are (1) allocable to a CERT and (2) incurred in (a) the taxable year in which the CERT occurs or (b) either of the two succeeding taxable years. The CERT provisions were added to the Code by the Omnibus Budget Reconciliation Act of 1989.[2] Congress believed that the ability of corporations to carry back NOLs incurred as a result of leveraged buyouts and distributions is contrary to the purpose of the NOL carryback rules. The House Committee on Ways and Means explained the reasons for enacting the CERT rules as follows:

> The committee believes that the ability of corporations to carry back NOLs that are created by certain debt-financed transactions is contrary to the purpose of the NOL carryback rule. Specifically, the purpose of the rule is to allow corporations to smooth out the swings in taxable income that result from business cycle fluctuations and unexpected financial reverses. The committee believes that when a corporation is involved in certain debt-financed transactions, the underlying nature of the corporation is substantially altered. In addition, the committee believes that the interest expense associated with such transactions does not have a sufficient nexus with prior period operations to justify a carryback of NOLs attributable to such expense. Therefore, the committee believes that it is

[1] REG-140668-07, 77 Fed. Reg. 57452 (9/17/01). Unless otherwise stated, all section references are to the Internal Revenue Code, as amended, and the regulations promulgated thereunder.

[2] P.L. 101-239.

inappropriate to permit a corporation to carry back an NOL generated by such a transaction to a year prior to the year in which such transaction occurred.[3]

Statutory Definition of a CERT

Section 172(h)(3)(A) defines a CERT as a ''major stock acquisition'' or an ''excess distribution.'' Section 172(h)(3)(B) defines a major stock acquisition as the acquisition by a corporation (or any group of persons acting in concert with such corporation) of stock in another corporation representing 50% or more (by vote or value) of the stock of another corporation. A major stock acquisition does not include a qualified stock purchase to which a §338 election applies.

Section 172(h)(3)(C) defines an excess distribution as the excess (if any) of the aggregate distributions (including redemptions) made during a taxable year by a corporation with respect to its stock over the greater of: (1) 150% of the average of such distributions during the three taxable years immediately preceding such taxable year, or (2) 10% of the fair market value of the stock of the corporation at the beginning of such taxable year. The amount of distributions and redemptions made by a corporation during a taxable year are reduced by stock issued by the corporation during the applicable period in exchange for money or property other than stock in the corporation.

The Proposed Regulations would clarify that multistep transactions are tested as CERTs, including typical leveraged buyout structures:

> *Example 1: Leveraged Buyout as CERT*
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> *Facts.* T is a publicly traded, widely held corporation with a single class of stock outstanding with a fair market value of $100. As part of an integrated plan, the following steps are undertaken: Corporation A acquires 10% of the outstanding stock of T for $10. A forms a new corporation, S, with a contribution of $25. S obtains a loan of $65 from an unrelated lender, and then merges with and into T, with T surviving. In the merger, all shareholders of T except A receive cash in exchange for their shares, and as a consequence, A owns all of the outstanding stock of T. As a result of the merger, T becomes liable for S's $65 loan.
>
> *Analysis.* A's direct acquisition of 10% of T's outstanding stock and the steps culminating with the merger are part of an integrated plan. Therefore, the multiple steps are tested together as a potential major stock acquisition. Because the steps of the integrated plan resulted in A's acquisition of 100% of T, the transaction is treated as a single major stock acquisition. Furthermore, because the $65 redemption is part of a major stock acquisition, it is treated solely as part of the major stock acquisition and is not tested as a potential excess distribution.[4]

As discussed below, the Proposed Regulations also would apply the CERT rules to acquisitions (such as tax-free reorganizations) that are far beyond the intended scope of the provisions.

Operation of CERT Limitations

If a major stock acquisition or an excess distribution occurs, §172(b)(1)(E) and (h) limit the carryback of the portion of an NOL that constitutes a ''corporate equity reduction interest loss'' of an ''applicable corporation'' in any ''loss limitation year.''

Section 172(b)(1)(E)(iii) defines an ''applicable corporation'' as a C corporation that: (1) acquires stock, or the stock of which is acquired, in a major stock acquisition; (2) makes distributions with respect to, or redeems, its stock in connection with an excess distribution; or (3) is a successor to one of the other types of applicable corporations.

Section 172(b)(1)(E)(ii) defines a ''loss limitation year'' as the taxable year in which a CERT occurs and each of the two succeeding taxable years.

Section 172(h)(1) defines a ''corporate equity reduction interest loss'' (CERIL) as the excess of (1) the total NOL for a loss limitation year, over (2) the NOL for the loss limitation year computed without regard to the ''allocable interest deductions'' that are otherwise taken into account in computing the NOL. Section 172(h)(2)(A) defines ''allocable interest deductions'' as deductions allowed on the portion of any indebtedness ''allocable'' to a CERT.

One of the most critical (and taxpayer adverse) aspects of the CERT rules is the manner in which debt is allocable to a CERT. Section 172(h)(2)(B) provides that, in general, debt is allocable to a CERT under the ''avoided cost'' method of §263A(f)(2)(A) (without regard to paragraph (i) thereof (relating to traced debt)). Thus, the amount of debt treated as incurred to finance the CERT is based on the amount of interest expense that (in theory) would have been avoided if the CERT had not been undertaken and no new debt was incurred or, in the case of existing debt, the amounts expended for the CERT were instead used to

[3] H.R. Rep. No. 101-247 at 1250 (1989).

[4] *See* Prop. Regs. §1.172(h)-1(d)(2), (3), *Ex. 2*.

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repay the debt. While §172(h)(2)(B) grants the IRS the authority to prescribe a different manner of allocating debt to a CERT, unfortunately, the IRS did not do so in the Proposed Regulations.

In a simple scenario where a CERT is financed solely by new borrowing, the avoided cost method applies in a straightforward fashion that is consistent with the purposes of the statute:

> *Example 2: CERT Funded Solely by New Borrowing*
>
> *Facts.* Corporation P is a calendar-year corporation. At the end of Year 4, P has no debt. P had taxable income of $2 million in each of Years 3 and 4. P had no debt in Years 2–4.[5] On January 1, Year 5, P borrows $50 million and uses the funds to purchase all of the stock of unrelated corporation T. P's acquisition of T is a CERT. P incurs no further debt during Year 5. In Year 5, P's total interest expense is $5 million. Apart from P's interest expense, P generates $1 million in taxable income. Thus, taking into account P's $5 million of interest expense, P incurs an NOL of $4 million. P desires to carry back the $4 million NOL to offset $2 million of income in each of Years 3 and 4.
>
> *Analysis.* Year 5 is a loss limitation year with respect to the CERT. All $5 million of P's interest expense in Year 5 is allocable to the CERT under the avoided cost method because, in the absence of the CERT, P could have avoided borrowing the $50 million. Thus, P's CERIL is (1) $4 million (the total NOL for Year 5), over (2) $0 (the NOL for Year 5 computed without regard to the $5 million interest deductions allocable to the CERT), or $4 million. As a result of the CERT rules, P may not carry back any portion of the $4 million NOL incurred in Year 5. Instead, P must carry forward the $4 million NOL.

The adverse impact of the avoided cost method is tempered somewhat by §172(h)(2)(C), which limits the amount of allocable interest deductions for any loss limitation year to (1) the corporation's interest deduction, less (2) the corporation's average interest deductions for the three taxable years preceding the taxable year in which the CERT occurred (the ''lookback period''). Thus, the allocable interest deductions are limited to the increase in interest deductions over the lookback period.

> *Example 3: Three-Year Average Limitation*
>
> *Facts.* Corporation P is a calendar-year corporation. P had taxable income of $2 million in each of Years 3 and 4. In each of Years 2–4, P had $50 million of debt outstanding and in each of those years P's total interest expense was $5 million. On January 1, Year 5, P purchases all of the stock of unrelated corporation T for $50 million, using cash on hand (i.e., P incurred no further borrowing to make the acquisition). P's acquisition of T is a CERT. P incurs no further debt during Year 5. In Year 5, P's total interest expense is $5 million. Apart from P's interest expense, P generates $1 million in taxable income. Thus, taking into account P's $5 million of interest expense, P incurs an NOL of $4 million. P desires to carry back the $4 million NOL to offset $2 million of income in each of Years 3 and 4.
>
> *Analysis.* Year 5 is a loss limitation year with respect to the CERT. Under the general rule of §172(h)(2)(B), all $5 million of P's interest expense in Year 5 would be allocable to the CERT under the avoided cost method because, in the absence of the CERT, P could have used the $50 million of cash on hand to repay its outstanding debt. However, §172(h)(2)(C) limits the allocable interest deduction to the excess of: (1) P's interest expense ($5 million), over (2) P's average interest expense for Years 2–4 (the three years preceding the year of the CERT) (also $5 million). Thus, because P's interest deduction in the Year 5 did not exceed its average deductions over the three-year lookback period, no portion of the interest is allocable to the CERT and P can carry back the entire $4 million NOL to Years 3 and 4.

The legislative history to the CERT rules states that Congress expected the IRS to write rules that provide that increases in interest expenses attributable solely to fluctuations in interest rates would not be taken into account for purposes of applying the three-year average limitation. The Proposed Regulations do not include any such rules. In the preamble to the Proposed Regulations, the IRS mentioned it is considering a rule that, for purposes of applying the three-year average limitation, would factor out interest deductions that are attributable to increases in the taxpayer's interest rate that occur after the date of a CERT. The rule would take into account the fact that a CERT will often decrease a taxpayer's creditworthiness and increase its average cost of borrowing. The IRS re-

[5] The significance of P not having debt in the two years prior to the CERT is explained below.

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quested comments on whether such a baseline would effectively account for fluctuations in interest rates or whether an alternative measure would be more appropriate.

There are two other limitations on the CERT rules. First, §172(h)(2)(D) provides a *de minimis* rule under which an interest deduction of less than $1 million is not allocated to a CERT. Second, §172(h)(2)(E) requires that the allocation of interest to a CERT be reduced if an ''unforeseeable extraordinary adverse event'' occurs during a loss limitation year but after the CERT. In such case, the corporation's debt first is allocated to unreimbursed costs paid or incurred in connection with the event, in the same manner as debt is allocated to a CERT. Any remaining debt is then allocable to the CERT. In addition, interest expense on debt allocated to such an event is not taken into account for purposes of determining whether the corporation's interest expense in the loss limitation year exceeds the average for the three-year period prior to the CERT. The Proposed Regulations do not provide guidance regarding unforeseeable extraordinary adverse events. However, the IRS requested comments regarding whether rules are necessary and, if so, what type of events should constitute unforeseeable extraordinary adverse events.

The limitations provided in §172(h)(2) do not always prevent debt from being allocated to CERT, even when the debt clearly has no relation to the CERT.

Example 4: Interest Allocable to Pre-existing Debt

Facts. Corporation P is a calendar-year corporation. At the end of Year 4, P has no debt. P had taxable income of $2 million in each of Years 3 and 4. P had no debt in Years 2–4. On January 1, Year 5, P borrows $50 million and uses the funds to purchase a new factory. On December 1, Year 5, P purchases all of the stock of unrelated corporation T for $50 million, using cash on hand (i.e., P incurred no further borrowing to make the acquisition). P's acquisition of T is a CERT. P incurs no further debt during Year 5. In Year 5, P's total interest expense is $5 million. Apart from P's interest expense, P generates $1 million in taxable income. Thus, taking into account P's $5 million of interest expense, P incurs an NOL of $4 million. P desires to carry back the $4 million NOL to offset $2 million of income in each of Years 3 and 4.

Analysis. Year 5 is a loss limitation year with respect to the CERT. All $5 million of P's interest expense in Year 5 is allocable to the CERT under the avoided cost method because, in the absence of the CERT, P could have used the $50 million to repay its outstanding debt incurred to purchase the factory. Thus, P's CERIL is (1) $4 million (the total NOL for Year 5), over (2) $0 (the NOL for Year 5 computed without regard to the $5 million interest deductions allocable to the CERT), or $4 million. The three year-average limitation does not apply because P had no interest expense in the lookback period (Years 2–4). Thus, as a result of the CERT rules, P may not carry back any portion of the $4 million NOL incurred in Year 5. Instead, P must carry forward the $4 million NOL.

The foregoing example demonstrates the harshness of the avoided cost method when a tracing method could mitigate the application of the CERT limitations in those instances where the debt bears no relation to the CERT. An even more egregious case would occur if in Example 3, P first acquired the stock of T with $50 million of cash on hand at the beginning of Year 5 and then subsequently borrowed $50 million to purchase the factory.[6]

Even putting harshness aside, the complexities and uncertainties of applying the avoided cost method to taxpayers with multiple tranches of existing debt are staggering.[7] Nevertheless, the IRS did not redress the harsh results, or address the complexities and uncertainties, of the avoided cost method in the Proposed Regulations. In fact, the Proposed Regulations would substantially increase the complexity and harshness of the avoided cost method by allocating interest deductions not merely to the CERT itself (i.e., the value of the stock acquired in a major stock acquisition, or the amount of the excess distribution), but also to what the Proposed Regulations refer to as ''CERT costs.''[8] These costs would include amounts paid or incurred to facilitate the acquisition or distribution to the extent that those amounts are required to be capitalized under §263(a) or disallowed as a deduction under §162(k). By increasing the scope of the costs to which interest can be allocated, the Proposed Regulations would increase the amount of a CERIL.

Another harsh result of the CERT rules, related to the avoided cost method, is the treatment of tax-free transactions as CERTs. Consider the facts of the following example:

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[6] *See* Ginsburg et al., *Mergers, Acquisitions, and Buyouts* ¶1208.1.4 (2012).

[7] *See* Carrington, *Tax Accounting in Mergers and Acquisitions* ¶1003 (2012).

[8] Prop. Regs. §1.172-2(b)(3).

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Example 5: Tax-Free Reorganization as CERT

Facts. Corporation P is a calendar-year corporation. At the end of Year 4, P has no debt. P had taxable income of $2 million in each of Years 3 and 4. P had no debt in Years 2–4. On January 1, Year 5, P borrows $50 million and uses the funds to purchase a new factory. On December 1, Year 5, P acquires all of the stock of unrelated corporation T in exchange for P voting stock worth $50 million in a §368(a)(1)(B) reorganization. P incurs no further debt during Year 5. In Year 5, P's total interest expense is $5 million. Apart from P's interest expense, P generates $1 million in taxable income. Thus, taking into account P's $5 million of interest expense, P incurs an NOL of $4 million. P desires to carryback the $4 million NOL to offset $2 million of income in each of Years 3 and 4.

The IRS's view in the Proposed Regulations is that tax-free transactions can be CERTs, either in the form of a major stock acquisition (as in Example 4 above) or an excess distribution (e.g., the distribution of the stock of a subsidiary qualifying under §355).[9] In the preamble to the Proposed Regulations, the IRS states that ''the concerns targeted by Congress in enacting [the CERT rules] can exist in the context of both taxable and tax-free transactions.'' This statement is dubious. In the example, P did not expend any borrowed money to acquire the T stock, nor did P reduce its equity.[10] The application of the avoided cost method seems entirely misplaced. It strains reasoning to think that P could have issued $50 million of stock (i.e., the consideration issued in the CERT) to repay the debt used to purchase the factory. Further, while it is theoretically possible that P could issue $50 million of stock for cash and use the cash to repay the debt, such a hypothetical transaction (when combined with P's acquisition of T stock for P stock) would not merely prevent a reduction in P's equity — it would require P to issue new equity to replace existing debt. Such favoring of equity over debt is vastly beyond the scope of the CERT rules. In enacting the CERT rules, Congress authorized the IRS ''to prescribe regulations that would exempt transactions from application of the provision where corporate equity has not been replaced by debt.''[11] For that reason, the IRS should reconsider its position that tax-free transactions can be CERTs.

Application of CERT Rules to Consolidated Groups

Section 172(h)(4)(C) states that, except as provided by regulation, all members of a consolidated group are treated as a single taxpayer for purposes of the CERT rules. As discussed in detail below, the Proposed Regulations would provide significant guidance on the application of the single-entity principle espoused in the statute.

PROPOSED REGULATIONS

Overview

Currently, there are no regulations addressing the CERT rules. Section 172(h)(5) grants the IRS the authority to prescribe such regulations as may be necessary to carry out the purposes of §172(h). The Proposed Regulations provide general rules addressing (1) whether a CERT has occurred; (2) the computation of a CERIL; (3) the treatment of successors; and (4) the application of CERT rules to consolidated groups.

The following discussion focuses on the most significant aspects of the Proposed Regulations affecting acquisitions by consolidated groups, specifically: (1) treatment of the consolidated group as a single taxpayer; (2) apportionment of a CERIL to members of a consolidated group for carryback to separate return years; and (3) determination of the group's three-year average limitation under §172(h)(2)(C).

Treatment of Consolidated Group as a Single Taxpayer

The Proposed Regulations would provide, as a general rule, that all members of a consolidated group are treated as a single taxpayer for purposes of the CERT rules.[12] For example, if multiple members of a group acquire in total 50% or more (by vote or value) of the stock of another corporation, the group has engaged in a major stock acquisition.

The Proposed Regulations also would provide that the computation of a consolidated group's CERIL under §172(h)(1) includes the debt and interest expense

[9] Prop. Regs. §1.172(h)-1(d).

[10] *See* Ginsburg et al., above note 6 at ¶1208.1.4; Carrington, above note 7 at ¶1002.1.1.

[11] H.R. Rep. No 101-247 at 1252 (1989).

[12] Prop. Regs. §1.1502-72(a)(2)(i).

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of all members.[13] This rule would apply regardless of whether any particular debt or interest expense is directly related to the CERT, whether any particular member was included in the group on the date of the CERT, or whether any particular debt would not exist in the group if the group had not engaged in the CERT. The Proposed Regulations also would provide that, in applying the CERT rules with respect to a corporation that joins a consolidated group, any debt of the acquired corporation is treated as debt of the acquiring group for purposes of applying the avoided cost method.[14] For example, if a target corporation acquired by a consolidated group has debt outstanding prior to the acquisition, the group takes into account interest incurred by the group that is attributable to the target's pre-existing debt, notwithstanding the fact that the group would have had no reason to satisfy the target's debt if the acquisition had not occurred. These rules are demonstrated in the following example:

> *Example 6: Acquisition Debt of Consolidated Group*
>
> *Facts.* Corporation T is a calendar-year taxpayer that has significant debt outstanding, which was incurred to fund operations. Unrelated P is the common parent of a calendar-year consolidated group. The following steps occur pursuant to an integrated plan. On May 1, Year 5, P acquires 10% of the T stock for $100. On June 30, Year 5, T borrows $700 and immediately thereafter uses the money to redeem some of its shares from its shareholders. On the same day, the P group acquires all of the remaining T stock in exchange for $200. The steps of the integrated plan (including the redemption of the former T shareholders) constitute a major stock acquisition by which T becomes a member of the P group.
>
> *Analysis.* The P group's consolidated return Year 5 is the taxable year of the CERT for the group. For purposes of allocating the interest paid or accrued during the P group's loss limitation years (Years 5, 6, and 7) to the CERT, the P group takes into account the debt of all members, including the $700 loan and all of T's other debt.[15]

[13] Prop. Regs. §1.1502-72(a)(2)(ii)(A).

[14] Prop. Regs. §1.1502-72(a)(2)(ii)(B).

[15] Prop. Regs. §1.1502-72(b)(3), *Ex. 1*.

Apportionment of a CERIL to Members of a Consolidated Group for Carry Back to Separate Return Years

The Proposed Regulations would provide rules regarding the apportionment of CNOLs that contain a CERIL.[16] Under these rules, a CERIL is apportioned to each group member under the method provided in Regs. §1.1502-21(b)(2)(iv)(B), which apportions a CNOL pro rata according to the relative sizes of the separate NOLs of the members. This apportionment would occur without regard to whether a particular member actually incurred the interest expense. These rules are demonstrated in the following example:

> *Example 7: Apportionment of CERIL for Carry Back Purposes*
>
> *Facts.* P is the parent of a calendar-year consolidated group that includes S. S has been a member of the P group for all relevant years. On December 31, Year 3, P acquires all of the stock of T, an unrelated corporation, in a CERT and T becomes a member of the P group. In Year 4, the P group has a CNOL of $1,200, of which $300 constitutes a CERIL. Assume that under the pro rata method of Regs. §1.1502-21(b)(2)(iv)(B), $800 (⅔) of the CNOL is attributable to T and the remaining $400 (⅓) of the CNOL is attributable to S.
>
> *Analysis.* Under Prop. Regs. §1.1502-21(b)(2)(iv)(C), the CNOL is divided into its CERIL component and its non-CERIL component. Because T has separate return year carryback years, each component of the CNOL is apportioned pro rata under Regs. §1.1502-21(b)(2)(iv)(B). Under that apportionment rule, 23 of each amount is apportioned to T, and the remainder of the CNOL is attributable to S and can be carried back to prior P group years. Therefore, $200 of the $300 CERIL is apportioned to T, and $600 of the $900 non-CERIL component is apportioned to T. As a result, the $200 CERIL cannot be carried back to T's separate return years. The remaining $100 of the $300 CERIL is apportioned to S, as is $300 of the $900 non-CERIL component. The $100 CERIL cannot be carried back to the P

[16] Prop. Regs. §1.1502-21(b)(2)(iv)(C). The apportionment rules would also apply to portions of an NOL subject to special carryback or carryover rules (such as specified liability losses in §172(f)(1)).

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group's consolidated return taxable Years 2 or 3.[17]

The apportionment of a pro rata portion of the CERIL to T in the above example occurs whether T actually incurred any interest expense. This is the same conclusion the IRS reached in an earlier Chief Counsel Memorandum.[18] The IRS noted that while it might be argued that the CERIL component of the CNOL should be apportioned only to those members that incurred the interest expense directly, such an argument ignores the single-entity principle of §172(h)(4)(C).

A related rule in the Proposed Regulations would modify the election to waive CNOL carrybacks by consolidated groups. Under current Regs. §1.1502-21(b)(3)(ii)(B), if one or more members of a selling consolidated group becomes a member of another consolidated group, the acquiring group may make an election to relinquish, with respect to the CNOLs attributable to the acquired member, the portion of the carryback period for which the acquired member was a member of the selling group. The election is often advantageous to selling consolidated groups insofar as it prevents having to file amended returns for taxable years preceding the sale. The Proposed Regulations recognize that a carryback waiver also could be advantageous to an acquiring consolidated group if the carryback would be substantially limited by the CERT rules. The Proposed Regulations would also increase the utility of such an election by making two significant modifications. First, the current waiver rule does not allow a group to waive a carryback of an acquired corporation that was not a member of a consolidated group (i.e., a corporation that filed a separate return). The Proposed Regulations would make the election available to any acquiring consolidated group that acquires a corporation, regardless of whether such corporation was acquired from another group.[19] Second, the current election is a one-time election for all carryback years of the acquired member. The Proposed Regulations would allow the acquiring consolidated group to make a one-time election or make the election on an annual basis with regard to the CNOL of a particular consolidated return year.

Determination of Consolidated Group's Three-Year Average Limitation

As discussed above, §172(h)(2)(C) provides a three-year average limitation under which the interest deductions that are allocable to a CERT are limited to the excess of the interest paid or accrued in the loss limitation year and the average of the interest paid or accrued in the three years preceding the year of the CERT. The Proposed Regulations would adopt single-entity concepts in applying the three-year average limitation to consolidated groups. Specifically, the Proposed Regulations would provide that the interest history of a corporation joining a consolidated group is combined with the interest history of the acquiring group.[20] These rules are demonstrated in the following examples.

Example 8: Acquired Member's Interest History, End of Year Acquisition

Facts. P is the common parent of a calendar-year consolidated group that includes S on all relevant dates. On December 31, Year 5, S acquires the stock of T in a CERT, and T is first included in the P group on January 1, Year 6. Membership in the P group is otherwise stable for all relevant years. Prior to joining the P group, T does not join in the filing of a consolidated return and maintains a calendar taxable year. T's amounts of interest paid or accrued in Years 2, 3, and 4, respectively, are $600, $200, and $400. The P group's amounts of interest paid or accrued in Years 2, 3, and 4, respectively, are $1,400, $1,000, and $1,200.

Analysis. The P group's loss limitation years are calendar Years 5, 6, and 7. The P group's lookback period with regard to the CERT is calendar Years 2, 3, and 4. For purposes of computing the three-year average limitation of the P group for its lookback period with respect to the acquisition of T, the interest history of T is combined with the interest history of the P group. However, because T is not a member of the P group on any date during the P group's consolidated return Year 5, the computation of the P group's three-year average limitation with respect to Year 5 will not include any of T's interest paid or accrued during the lookback period. Thus, the P group's three-year average limitation for Year 5 is $1,200 ([$1,400 + $1,000 + 1,200]/3). Because T is a member of the P group during each day of Years 6 and 7, T's history of interest paid or accrued during the lookback period is included in the P group's computation of its three-year average limitation with respect to Years 6 and 7. Thus, the

[17] Prop. Regs. §1.1502-21(b)(2)(iv)(C)(2), *Ex.*

[18] CCA 200305019.

[19] Prop. Regs. §1.1502-21(b)(3)(ii)(B).

[20] Prop. Regs. §1.1502-72(d)(3).

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P group's three-year average for loss limitation Years 6 and 7 is $1,600 ([$1,400 + $1,000 + 1,200 + $600 + $200 + $400]/3).[21]

Example 9: Acquired Member's Interest History, Mid-Year Acquisition

Facts. The facts are the same as Example 8, except that S acquires the stock of T on March 31, Year 5, and T is included in the P group for 275 days of Year 5.

Analysis. Because T is a partial-year member of the P group during loss limitation Year 5, the computation of the three-year average relevant to loss limitation Year 5 includes a prorated portion of T's interest for the lookback period. Because T is in the P group for 275 days during Year 5, the computation of the P group's three-year average relevant to Year 5 takes into account an amount of T's interest history equal to T's actual amount of interest paid or accrued for each year of the lookback period, multiplied by a fraction equal to 275/365 (number of days of the loss limitation year during which T is a member of the P group divided by the number of days in the loss limitation year), or $452 ($600 × [275/365]), $151 ($200 × [275/365]), and $301 ($400 × [275/365]) for Years 2, 3, and 4, respectively.[22]

The approach taken in the Proposed Regulations whereby T's pre-CERT interest is combined with the P group's pre-CERT interest provides symmetry with the rules that would include interest allocable to T's existing debt in computing the group's CERIL. The approach also is consistent with the IRS's conclusion in an earlier Technical Advice Memorandum.[23]

The Proposed Regulations also would provide rules relating to the calculation of a consolidated group's three-year average limitation when a member departs the group.[24] Specifically, a portion of the group's interest history is apportioned to the deconsolidating member for purposes of the CERT rules. The apportionment is based on the relative fair market values of the deconsolidating member (immediately after its deconsolidation) and the entire group (immediately before the deconsolidation). Thus, consistent with the Proposed Regulation's single-entity treatment and the rejection of a tracing regime, the interest allocated to a particular deconsolidating member is not tied to that member's actual interest history. Once the interest history is allocated and apportioned to the departing member, the history is subtracted from the group's interest history and is unavailable to the group with regard to any loss limitation year of the group after the year of deconsolidation. These rules are demonstrated in the following example:

Example 10: Interest History and Deconsolidation

Facts. P is the common parent of a calendar-year consolidated group that includes S. P acquires the stock of unrelated corporation T in a CERT on December 27, Year 5. S deconsolidates from the P group on December 31, Year 5. S was not a party to the CERT and throughout its history in the P group, S neither paid nor accrued any interest. Upon its deconsolidation, S does not elect to waive the carryback of any post-consolidation losses to the P group under Prop. Regs. §1.1502-72(e)(1) (as discussed below). S's value immediately after its deconsolidation is $4,000. The P group's value immediately before S's deconsolidation is $10,000.

Analysis. Because the CERT occurs during the P group's calendar consolidated return Year 5, Years 5, 6, and 7 are the P group's loss limitation years. Under Prop. Regs. §1.1502-72(d)(3)(ii), the interest history of the P group during the period of S's consolidation and any preceding years is allocated to S and the remaining members of the P group. The amount of the P group's interest for each year that is allocated to S is the amount of interest paid or accrued by the P group in the relevant consolidated return year multiplied by a fraction equal to 4,000 divided by 10,000 (the value of the deconsolidating corporation immediately after its deconsolidation divided by the value of the entire group immediately prior to the deconsolidation), or 25. The interest allocated to S is subtracted from the interest history of the group and is unavailable to the P group for purposes of computing a three-year average with regard to any loss limitation year of the P group after the year of the deconsolidation, including Years 6 and 7. This is true even though S was not a party to the CERT and neither paid nor accrued interest in the P group. The interest history allocated to S will be maintained by S to be used in the computation of any CERIL of S, or any

[21] Prop. Regs. §1.1502-72(d)(5), *Ex. 1*.

[22] *Id.*, Ex. 1(iii).

[23] TAM 200432014.

[24] Prop. Regs. §1.1502-72(d)(3)(ii).

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CERIL of any group of which S becomes a member.[25]

The Proposed Regulations would provide a departing member a one-time election to elect out of the rules governing the apportionment of the group's interest history to the departing member.[26] The rules also would apply for purposes of electing out of the apportionment of CERT costs.[27] The election would result in the departing member waiving all carrybacks of post-consolidation losses to prior consolidated return years. The effect of the election is demonstrated in the following example:

Example 11: Interest History and Deconsolidation with Carry Back Waiver

Facts. The facts are the same as Example 10, except that S elects to waive the carryback of any post-consolidation NOLs to the prior consolidated return years of the P group under Prop. Regs. §1.1502-72(e)(1).

Analysis. As a result of the election, none of the interest history of the P group is allocated to S. Therefore, in any post-deconsolidation year, for purposes of computing a CERIL in connection with any CERT with regard to which S (or of any group of which S is later a member) is an applicable corporation, S is treated as having paid or accrued zero interest for the period of its inclusion in the P group. The P group will retain the interest history that would otherwise be allocated to S.

The Proposed Regulations also would provide rules for computing the three-year average if a consolidated group is not in existence for three taxable years prior to the consolidated return year in which the CERT occurred. This is frequently the face in leveraged buyouts where the acquiring corporation is newly formed. In those instances, where a group was not in existence on the date of the CERT, for purposes of determining the lookback period, the group's taxable years would be deemed to include the taxable years of the group's original common parent.[28] If the original common parent was not in existence on the date of the CERT, or it does not have three taxable years that precede its taxable year that includes the date of the CERT, the group would be deemed to have additional 12-month taxable periods that end on the calendar date that is one day prior to the date of the original common parent's organization. These rules are demonstrated in the following example:

Example 12: Interest History Where Acquiring Group is Newly Formed

Facts. Corporation P is formed on January 1, Year 4. On the same day, P organizes wholly-owned, special-purpose corporation S. T is an unrelated, calendar-year corporation with a significant tax history. On February 1, Year 4, S merges into T, with T surviving. In the merger, all of T's historic shareholders receive cash in exchange for their shares. Following the merger, P owns all of the outstanding stock of T, and P is treated as acquiring all the stock of T in a major stock acquisition. The P group files consolidated returns beginning in Year 4 and maintains a calendar taxable year. T is first included in the P group on February 2, Year 4.

Analysis. Neither P nor the P group is in existence before the year that includes the date of the CERT (calendar Year 4). Therefore, for purposes of applying the interest allocation limitation of §172(h)(2)(C), the P group's lookback period is deemed to include three additional taxable periods (January 1 through December 31 for Years 1, 2, and 3). In computing the three-year average limitation, P is treated as having paid or accrued zero interest during the deemed years (January 1, Year 1 through December 30, Year 3). However, the interest history of T is combined with the interest history of the P group. Because T is not a member of the P group for each day of Year 4, the computation of the three-year average applicable to Year 4 will include only a pro rata portion of the interest of T for the lookback period, as calculated in Example 9.

CONCLUSION

The Proposed Regulations provide much welcome guidance on the application of the CERT rules, coming 23 years after Congress added the rules to the Code. In particular, the Proposed Regulations would provide detailed and comprehensive guidance on the application of the CERT rules to acquisitions by consolidated groups. Nevertheless, the Proposed Regulations' application of the CERT rules to tax-free transactions, and the lack of any guidance on the application of the avoided cost method, should be reconsidered.

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[25] *See* Prop. Regs. §1.1502-72(d)(5), *Ex. 3(ii)*.

[26] *See* Prop. Regs. §1.1502-72(e)(1).

[27] *See* Prop. Regs. §1.1502-72(c)(4).

[28] Prop. Regs. §1.1502-72(d)(4).

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