Why *Rite Aid* Was Right

by Lawrence M. Axelrod

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In this article, Axelrod responds to critics of the Federal Circuit's 2001 decision in *Rite Aid*, which invalidated a portion of the loss disallowance regulations, and he explains why Congress ratified the result. The author is grateful to Helena Klumpp and Patrick Smith of Ivins, Phillips & Barker for their thoughtful comments on earlier drafts.

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In a February *Tax Notes* report,[1] Jasper L. Cummings, Jr., revisited the Federal Circuit's 2001 decision in *Rite Aid*.[2] That decision invalidated one factor of the infamous consolidated return loss disallowance regulations, the "duplicated loss" provision. The case, like the regulation it invalidated, remains highly controversial.[3] Cummings is hardly the first to challenge the court's reasoning and result, although other critics have been more equivocal in their analysis.[4] On the other side, many in the tax community applauded the decision.[5] Cummings's report reviewed prior case law upholding or striking down a consolidated return regulation, but it did not describe the *Rite Aid* case. It correctly concluded that none of the cases establishes a clear standard for invalidating a consolidated return regulation, but the report's failure to discuss the specific facts presented may account for its misguided characterization of the result.

This article takes the position that the result in *Rite Aid* was correct, although the Federal Circuit could certainly have provided a better articulation of a rationale to support its decision. To the court's credit, it came to the commonsense conclusion that a regulation that disallows a deduction for a true economic loss distorts rather than reflects taxable income and tax liability. The results produced by the loss disallowance regulations were simply too bad to be true. The lesson for regulation writers and practitioners entangled in technical tax rules is to be wary of consolidated

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[1] Jasper L. Cummings, Jr., "Invalidating Consolidated Return Regulations," *Tax Notes*, Feb. 13, 2017, p. 849.

[2] *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001).

[3] The principal drafters of the regulations noted shortly after the regulations were made final that "the loss disallowance regulations are among the most controversial regulations issued in recent years." Andrew J. Dubroff and John Broadbent, "Consolidated Returns: Evolving Single and Separate Entity Themes," 72 *Taxes* 743, 751 (1994).

[4] *See, e.g.*, Don Leatherman, "Why *Rite Aid* Is Wrong," 52 *Am. U.L. Rev.* 811, 814 (2003), in which the author concludes "that although the question is perhaps close, the Federal Circuit should have found the regulation valid." That article, however, was written before the 2004 legislation amending section 1502, and the author did not have the benefit of the amendment and its legislative history.

[5] *See* Christian M. McBurney, "The Consolidated Return Regs.' Loss Disallowance Rule — When Is it Vulnerable?" 90 *J. Tax'n* 20 (Jan. 1999); Stephen J. Joffe and Michael G. Brandt, "Loss Disallowance Regulations Act III — Has the Final Curtain Fallen?" 70 *Taxes* 69 (Feb. 1992); Mark J. Silverman, Kevin M. Keyes, and McBurney, "Maximizing Allowable Losses and Minimizing Problems Under the Consolidated Return Regs.," 76 *J. Tax'n* ___ (1992); Irving Salem, "Judicial Deference, Consolidated Returns, and Loss Disallowance: Could LDR Survive a Court Challenge?" 43 *Tax Exec.* 167 (1991); Lawrence M. Axelrod, "The Final Loss Disallowance Regulations: Not the Last Word," *Tax Notes*, Oct. 7, 1991, p. 121; Bryan P. Collins, P. Anthony Nissley, and Ross S. Friedman, "Friday the 13th, Part III: The Final Loss Disallowance Rules," *Tax Notes*, Sept. 30, 1991, p. 1627; Bowen, "Loss Disallowance," 68 *Taxes* 918 (1990); and Louis S. Freeman, "Response to Loss Disallowance Rule: Partial Deconsolidation," *Tax Notes*, June 1, 1990, p. 1349.

return mumbo jumbo, like single-entity treatment, that obfuscates the economics. This article also examines misconceptions regarding the breadth of Treasury's consolidated return regulatory authority, the duplicated loss concept, and the single-entity versus separate-company approach to consolidated groups.

Statutory Authority and Congressional Action

The code contains very little guidance for an affiliated group that avails itself of the "privilege" of filing a consolidated return.[6] Section 1503 comprises a few special rules, but the real guidance is almost entirely regulatory. Section 1502 reads:

> The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed collected, and adjusted, in such manner as clearly to reflect the income tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such liability.

In 2004, out of fear that the *Rite Aid* decision could spark a wave of challenges to a broad range of consolidated return regulations, Congress added a second sentence to the end of section 1502: "In carrying out the preceding sentence, the Secretary may prescribe rules that are different from the provisions of chapter 1 that would apply if such corporations filed separate returns."[7] Discussions of the amendment too often ignore the six key prefatory words, which reference the preceding sentence and require the regulations to produce results that clearly reflect tax liability.

Also ignored by some commentators, the conference report accompanying the legislation goes out of its way to preserve the *Rite Aid* result:

> The provision nevertheless allows the result of the *Rite Aid* case to stand with respect to the type of factual situation presented in the case. That is, the bill provides for the override of the regulatory provision that took the approach of denying a loss on a deconsolidating disposition of stock of a consolidated subsidiary to the extent the subsidiary had net operating losses or built-in losses that could be used later outside the group. Retaining the result in the *Rite Aid* case with respect to the particular regulation section 1.1502-20(c)(1)(iii) as applied to the factual situation of the case does not in any way prevent or invalidate the various approaches Treasury has announced it will apply or that it intends to consider in lieu of the approach of that regulation, including, for example, the denial of a loss on a stock sale if inside losses of a subsidiary may also be used by the consolidated group, and the possible requirement that inside attributes be adjusted when a subsidiary leaves a group.[8]

The *Rite Aid* Facts

From the legislative history, we can surmise that although Congress intended to affirm Treasury's consolidated return regulation authority, it also agreed with the Federal Circuit that the factual situation presented in *Rite Aid* justified the result. Accordingly, understanding the particular facts is highly instructive.

The story begins with Rite Aid's ill-fated foray into the retail book business with its 1984 purchase of 80 percent of the stock of Penn Encore (Encore), a small discount bookstore chain. Rite Aid later acquired the remaining 20 percent of Encore's stock and in 1994, immediately before Rite Aid's sale of the Encore stock, Rite Aid contributed approximately $45 million of intercompany debt to Encore's capital. Net losses

[6] Section 1501.

[7] Section 844(a) of the American Jobs Creation Act of 2004, P.L 108-357.

[8] H. Rep. No. 108-755, at 433-434 (conf. rep. to H.R. 4520). *Compare* section 1503(e), enacted by section 10222(a)(1) of the Technical and Miscellaneous Revenue Act of 1987, expressly to override the result of the Tax Court's decision in *Woods Investment Co. v. Commissioner*, 85 T.C. 274 (1985).

generated by Encore that were used by the group during Encore's 10-year period of affiliation totaled approximately $11 million, which resulted in a stock basis reduction under reg. section 1.1502-32. After taking into account all appropriate basis adjustments, Rite Aid realized an undisputed loss of approximately $22 million on the stock sale.

Encore, however, had assets with a built-in loss of more than $28 million. The loss disallowance regulations regarded the loss claimed by Rite Aid on the sale of Encore's stock, coupled with the potential for Encore to claim a loss on the sale of its assets after it left the group, as a "duplicated loss." In addition to other loss disallowance factors, reg. section 1.1502-20(c)(1)(iii) required an owning member's loss on the disposition of a subsidiary's stock in a consolidated group to be disallowed to the extent of the subsidiary's duplicated loss. Despite the regulations, Rite Aid claimed a deduction on its return for the $22 million loss that the parent company incurred on the sale of Encore's stock.[9] Because Encore's built-in loss exceeded Rite Aid's stock loss, the IRS disallowed the entire deduction.

Rite Aid paid the tax and filed for a refund in the Court of Federal Claims, challenging the validity of the regulations. In its brief, the taxpayer argued that section 165 allowed a taxpayer a deduction for a loss, which it indisputably suffered. The government responded that although the loss would have been allowed if members of the group had not filed a consolidated return, section 1502 gave the Treasury secretary the authority to prescribe a regulation that disallowed the loss. After losing at the trial court, Rite Aid appealed to the Federal Circuit, which reversed, invalidated the regulation, and remanded the case to the trial court.

Limits on Consolidated Return Reg Authority

The consolidated return regulations are the epitome of legislative regulations. Section 1502 provides scant guidance on what the regulations should address other than to clearly reflect the tax liability of the group and of members, both during and after the period of affiliation, and to prevent tax avoidance. Legislative regulations, as opposed to interpretive regulations, had generally been thought to demand greater judicial deference, but the Supreme Court's decision in *Mayo Foundation*[10] has cast doubt on whether the distinction is meaningful.

Despite the broad grant of regulatory authority, the secretary cannot ignore the code. As the claims court held in *Union Carbide*[11]:

> Though there may be many reasonable methods to determine a group's liability and the Secretary's authority is absolute when it represents a choice between such methods, the statute does not authorize the Secretary to choose a method that imposes a tax on income that would not otherwise be taxed.

Similarly, in *American Standard*,[12] the claims court held:

> Income tax liability is not imposed by the Secretary's regulations, but by the Internal Revenue Code. Though there may be many reasonable methods to determine a group's tax liability and the Secretary's authority is absolute when it represents a choice between such methods, the statute does not authorize the Secretary to choose a method that imposes a tax on income that would not otherwise be taxed.

Even the most ardent defender of the secretary's power concedes that "section 1502 is not a roving commission to rewrite the tax law *in ways having nothing to do with* consolidated filing," and "that Treasury cannot write a section 1502 regulation completely denying the section 162 deductions to consolidated groups simply because of section 1502."[13]

[9] To avoid a penalty for the intentional disregard of a regulation, Rite Aid attached Form 8275-R to its consolidated return, disclosing that it was taking a position contrary to the regulations.

[10] *Mayo Foundation for Medical Education and Research v. United States*, 562 U.S. 44 (2011).

[11] *Union Carbide Corp. v. United States*, 615 F.2d 558, 563 (Ct. Cl. 1979).

[12] *American Standard Inc. v. United States*, 602 F.2d 256 (Ct. Cl. 1979).

[13] Cummings, *supra* note 1 (emphasis in original).

Presumably, the same should hold true for a deduction under section 165, which was the basis of the taxpayer's argument in *Rite Aid*. In *Rite Aid*, however, the loss was on subsidiary stock, which arguably is a completely different kettle of fish. One commentator maintains that courts have uniformly approved denial of a deduction for a group's economic loss in subsidiary stock, but the cases cited as support concern liquidating distributions based on a long-defunct regulation.[14] Subsidiary stock, of course, poses the potential for the dreaded double deduction emphatically condemned by the Supreme Court in *Ilfeld*,[15] and more recently applied by the Tax Court in *Thrifty Oil*[16] and *Duquesne Light Holdings*.[17] The purpose of the investment adjustment rules in reg. section 1.1502-32 is to treat an owning member and a subsidiary as a single entity to prevent a subsidiary's income or loss from being taken into account a second time by the group upon a disposition of the subsidiary's stock.[18] These rules, however, are a far cry from disregarding the subsidiary's stock as an asset of the group, as would be the case, for example, for an interest in a disregarded entity. The secretary is not authorized to write any rule he pleases regarding subsidiary stock.

The double deduction problem addressed in *Ilfeld* is too often confused with the duplicated loss issue that was the subject of *Rite Aid* and is now "cured" by the uniform loss rules in reg. section 1.1502-36(d). A double deduction refers to a consolidated group's attempt to claim two deductions for one economic loss, one on a subsidiary's stock and one on the subsidiary's assets in the same group. By contrast, a duplicated loss arises from our double-level corporate tax system, which allows a shareholder to claim a loss on the sale of a corporation's stock and allows the corporation to claim a loss on the sale of its assets after the corporation has left the group. To prevent loss trafficking, section 382 may limit the use of a loss by a corporation following an ownership change. As the *Rite Aid* court correctly pointed out, Congress enacted section 382 to limit the deduction of built-in losses on the sale of a corporation's assets following a sale of its stock, whereas the regulations disallowed the stock loss to the seller. Thus, instead of allowing two losses within the system, the combined effect of the statute and the regulations would have been to allow little or no loss at all. Whether duplicated losses are even a problem when a member of a consolidated group disposes of a subsidiary's stock at a loss depends on whether the regulation writers choose to adopt a single-entity or separate-company model for consolidated groups. Before 1991, the separate-company model prevailed, but since then the single-entity concept has taken hold. Consider the following thought experiment:

> P, a stand-alone, calendar-year corporation, forms S for $100 on January 1, 2017. S uses the $100 to buy a tract of raw land. During 2017, the land declines in value to $60, but P does not elect to file a consolidated return for 2017. On January 1, 2018, P sells S's stock for $60 and recognizes a $40 loss on the stock sale. On October 15, 2019, when P files its extended 2018 return, it can elect to file a consolidated return, or not. If P makes no election and P and S each file a separate return, S's basis in the land remains at $100. If, however, the P group files a consolidated return for 2018, S's $100 basis in the land will be reduced by the $40 duplicated loss to $60.[19]

Clearly, the economic loss suffered by P and S because of the decline in the value of S's land is not a problem caused by P filing or failing to file a consolidated return. The hit to the basis of the land in S's hands if a consolidated return is filed is not a detriment that reflects some benefit that the group achieved by filing a consolidated return; there was none.[20] Rather, the basis reduction is

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[14] Leatherman, *supra* note 4, at 825, in which he cites Reg. 75.

[15] *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62, 65 (1934).

[16] *Thrifty Oil Co. v. Commissioner*, 139 T.C. 198 (2012).

[17] *Duquesne Light Holdings Inc. v. Commissioner*, T.C. Memo. 2013-216.

[18] Reg. section 1.1502-32(a)(1).

[19] Reg. section 1.1502-36(d). A well-advised purchaser of S's stock may require P to guarantee that it will not file a consolidated return for 2018, or that it will waive the stock loss. For the first year for which an affiliated group elects to file a consolidated return, reg. section 1.1502-75(b)(1) requires each member to execute Form 1122 consenting to the regulations and appointing the common parent as its agent for all dealings with the IRS during its membership in the group.

justified under some amorous notion of a "single entity," which treats the consolidated return rules as a separate system and requires an electing group "to take the bitter with the sweet."[21] The mere inclusion of S in the P group return, no matter how brief and regardless of whether any tax benefit was achieved, is sufficient to justify the reduction to S's post-affiliation asset basis.[22] In *Rite Aid*, the Federal Circuit held that "in the absence of a problem created from the filing of consolidated returns," the secretary was not authorized to change the way the code applied. The court's conclusion, in 2001, before the legislative history accompanying the 2004 amendment, was perfectly reasonable. In the conference report to the 2004 amendment to section 1502, however, Congress made clear that it viewed the secretary's authority as not so limited. But even if P files a consolidated return under the facts of the above example, only one loss would be reported by the group. This is not the classic *Ilfeld* double-deduction scenario. Before 1991, before the promulgation of reg. section 1.1502-20T, the deduction of a loss by P on the stock sale and the deduction of a loss by S upon a subsequent sale of the land in its post-affiliation separate return year was viewed simply as the natural consequence of the corporate double tax system.

Separate-company treatment is by no means unusual. Reg. section 1.1502-80(a)(1) states the general rule that "the Code, or other law, shall be applicable to the group to the extent the regulations do not exclude its application." Accordingly, the regulations treat the members of the group as separate companies except when they don't. Consider a few examples:

1. Members of a consolidated group may be the only partners in a partnership. If the regulations treated the members as divisions of a single corporation, the partnership would fail for lack of partners.
2. If two members of a group each own 6 percent of the stock of a foreign corporation, neither member is eligible to claim a deemed paid foreign tax credit under section 902.[23] If the members were treated as divisions of a single corporation, their aggregate stock ownership would meet the 10 percent ownership requirement. Reg. section 1.1502-34 aggregates stock ownership of members only for purposes of the specified provisions (sections 165(g), 332, 351, and 732(f)).
3. If a subsidiary is insolvent because of outstanding debt owed to its parent, the subsidiary's dissolution will not qualify as a liquidation under section 332. If the members were treated as divisions of a single corporation, the intercompany debt would be disregarded, the subsidiary would be solvent, and section 332 would apply to the liquidation.
4. Reg. section 1.1502-17 allows each member to elect its own accounting method.
5. If two members of a group each own 50 percent of a solvent subsidiary's stock and the subsidiary liquidates, section 332 will apply to eliminate any gain or loss to the owning members. The members' stock ownership, however, is not aggregated for other purposes, which results in the distribution failing to qualify for nonrecognition treatment to the subsidiary under section 337(a).[24] If the owning members were treated as divisions of a single corporation, their

[20] *Compare* with the basis reduction rules of reg. section 1.1502-36(c), which limit the amount of reduction to the basis of a transferred loss share to the amount of its basis increase on account of its "net positive adjustment," a basis increase that would not be obtained but for the filing of a consolidated return.

[21] *Garvey Inc. v. United States*, 1 Cl. Ct. 108 (1983).

[22] Under the current regulations, the attribute reduction rules in reg. section 1.1502-36(d) can serve as a backstop when the mechanical rules for stock basis reduction under reg. section 1.1502-36(c) allow the deduction for a noneconomic loss on a stock sale. Assume P buys S stock for $100, when S has a built-in gain asset with a zero basis and a value of $100, and a built-in loss asset with a basis of $100 and a value of zero. If S sells the built-in gain asset for $100 and P then sells S's stock for $100, P is allowed a loss on the stock sale. Reg. section 1.1502-36(c) requires a reduction to the basis of a transferred loss share by the lesser of the net positive adjustments ($100) or the inside-outside basis disconformity amount ($0). Although P is allowed a loss on the stock sale, S's basis in the built-in loss asset is reduced to zero.

[23] *First Chicago Corp. v. Commissioner*, 88 T.C. 663 (1987); and Rev. Rul. 85-3, 1985-1 C.B. 222.

[24] Section 337(c), second sentence. *Compare* reg. section 1.1502-13(j)(9), examples 6 and 7.

stock ownership would be aggregated and a distribution of property to each would qualify for nonrecognition treatment under the 80 percent ownership test in section 337(a). On the contrary, the subsidiary must recognize gain or loss on its assets as if the assets were sold.[25]

Single-entity or separate-company treatment is a result, not a reason. For examples 1 through 4, the regulation writers, if they chose, could promulgate a regulation that would apply a single-entity concept and change the answers. In many cases, the decision to apply one approach over the other is arbitrary, but given two reasonable approaches, the decision of the regulation writers is generally sustained. In other cases, the chosen approach is necessary to achieve a clear policy objective. Separate-company treatment for purposes of section 337(a), described in Example 5, besides being statutory and not subject to regulatory interpretation, is designed to stop bust-up transactions. Regarding the treatment of duplicated losses at issue in *Rite Aid*, the legislative history to the 2004 amendment indicates that Congress believed a single-entity approach is acceptable to cause a reduction to the basis of assets in S's hands after S leaves. That approach is now enshrined in reg. section 1.1502-36(d). P, however, is allowed its loss on the stock sale.

The statutory authority is undeniable for allowing regulations that require a reduction to the basis of the land in S's hands as a result of P's recognition of a loss on S's stock. Section 1502 authorizes regulations governing the taxation "of each corporation in the group, both during and after the period of affiliation." Unlike the *Rite Aid* scenario, a purchaser of a subsidiary's stock from a consolidated group today is forewarned of the potential for a reduction to the basis of the subsidiary's assets and can negotiate for P to waive the stock loss and S keep its asset basis.[26] But whether a single-entity or separate-company model is adopted, absent an express waiver, P's true economic loss on the sale of S's stock is allowed. If P and S are treated as divisions of a single corporation, P's loss on the sale of S's stock may result in a write-down of the basis of the assets in S's hands, as now required by reg. section 1.1502-36(d). If a separate company approach were used, only section 382 would limit the use of S's built-in loss. In either case, P is entitled to deduct its economic loss. Denying a loss to the P group cannot be justified under either a single-entity or separate-company model and would fail to clearly reflect the group's income tax liability.

Conclusion

The statutory authority to promulgate consolidated return regulations that differ from the separate return rules is broader than merely fixing problems created by consolidated filing. To that extent, the *Rite Aid* opinion overstated the limitations on the secretary's authority. In many cases, consolidated return regulation writers have the option to apply a code section on either a single-entity or separate-company basis. Nevertheless, the regulation struck down by the *Rite Aid* court failed even under that broad standard. Disallowing the group's economic loss on the sale of its subsidiary stock distorted, rather than reflected, the group's tax liability, and the *Rite Aid* court rightly relegated the regulation to the dustbin of history. ■

[25] Section 336(a).

[26] The regulations contain various elections by which the selling group can waive the loss and have the subsidiary retain its asset basis. Also, a reattribution election is available, as an alternative to the stock loss, by which S's loss carryover is transferred to the common parent to the extent of the loss that would otherwise be allowed on the subsidiary's stock. Reg. section 1.1502-36(d)(6).