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Gather (and Harvest) Your Losses While You May

By Robert W. Wood • Wood & Porter • San Francisco

It is axiomatic that taxpayers want to realize their losses and to deduct them. Conversely, generally speaking, they want to defer and not recognize their gains. Although arguably more of the tax law focuses on accretions to wealth and on systematic methods to ensure that taxpayers pay their fair share on those accretions, the flip side of the coin is that deductions and exclusions must be scrutinized. Triggering losses (which after all, are attractive precisely because they can offset gains) is thus fundamental.

One of the corporate changes made by the American Jobs Creation Act of 2004 [P.L. 108-357] was a new Code Sec. 362(e), designed to limit the ability of taxpayers to duplicate net built-in losses in certain nonrecognition transactions. Notwithstanding Code Sec. 362(a) and (b), which can import net built-in losses, Code Sec. 362(e)(1)(A) now provides that the basis of certain property acquired in such a transaction will be its fair market value immediately after the transaction. Property is subject to this rule if its gain or loss is not subject to tax in the hands of the transferor immediately before the transfer, and if its gain or loss is subject to tax in the hands of the transferee immediately after the transfer. There is an importation of net built-in loss in a transaction where the transferee's aggregate adjusted basis in the property would (but for Code Sec. 362(e)(1)) exceed the aggregate fair market value of the property immediately after the transaction.

The idea of all of this, of course, is to prevent the importation of a net built-in loss in a tax-free deal. The rule limits the recipient's basis in the property to fair market value, thus foreclosing a later realization of an ostensibly larger loss. In essence, where the basis limitation kicks in, the aggregate reduction in basis of the transferred property must be allocated among the properties in proportion to their respective built-in losses immediately before the transaction. Code Sec. 362(e)(2)(B). As

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an alternative to incurring this basis reduction, though, the transferor and transferee can jointly elect not to have this provision apply. See Code Sec. 362(e)(2)(C). Instead, upon such a joint election, the transferor's basis in the stock of the transferee (received in exchange for the property that would otherwise be subject to basis reduction) will not exceed its fair market value. Thus, you can take the hit on your stock rather than on assets.

Second, if property is transferred by a transferor to a transferee in a Code Sec. 362(a) transaction that is not described in Code Sec. 362(e)(1), and if the transferree's aggregate adjusted basis in the transferred property would (but for Code Sec. 362(e)(2)) exceed its aggregate fair market value immediately after the transfer, then the transferee's aggregate adjusted basis in the transferred property will not exceed the fair market value of the property immediately after the transfer. [Code Sec. 362(e)(2)(A).]

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Proposed regulations were just issued to provide guidance on the determination of the bases of assets and stock. [*See* REG-110405-05.] These proposed regulations apply to transfers of net built-in loss property within the U.S. tax system,in which the Code would otherwise duplicate the net built-in asset loss in the stock of the transferee. Notably, these proposed regulations do not apply to transfers subject to Code Sec. 362(e)(1). That provision covers loss importation transactions. Again, loss importation occurs where losses are brought into the U.S. tax system.

Nevertheless, the proposed regulations recognize that there can be overlap. If part of a transaction is subject to the rule of Code Sec. 362(e)(1), Code Sec. 362(e)(2) can still apply to the portion of the transaction that isn't covered by Code Sec. 362(e)(1).

Miscellaneous Clarifications

The proposed regulations give a grab bag of guidance, including the following:

- In determining whether the transferred property has a net built-in loss in the hands of the transferee, the basis of the property must first be increased for any gain recognized by the transferor on the transfer.
- Where there are multiple transferors, Code Sec. 362(e)(2) applies separately to each transferor.
- If assets are transferred in a transaction potentially subject to Code Sec. 362(e)(2) more than two years before entering the U.S. tax system, then (solely for purposes of Code Sec. 362(e)(2)), it is generally presumed that the aggregate fair market value of the transferred assets equals their adjusted basis in the hands of the transferee immediately after the transfer.
- Code Sec. 362(e)(2) won't apply to transactions to the extent that loss duplication is prevented or eliminated where the transferor distributes the transferee's stock and/or securities received in the transaction without recognizing gain or loss, and upon completion of the transaction, no person holds any asset with a basis determined (in whole or in part) by reference to the transferor's basis in the transferee's stock and/or securities.

- Transfers in exchange for both stock and securities are covered by Code Sec. 362(e)(2) to the extent necessary to eliminate loss duplication. In other words, these rules must be considered not only where there is a transfer for stock, but also for securities.
- When it comes to the joint election, the amount of reduction in the basis of the transferee's stock (and securities) as a result of the election will be equal to the net built-in loss in the transferred assets in the hands of the transferee. Regarding mechanics, Notice 2005-70, IRB 2005-41, 694, gave initial instructions to taxpayers how to make the election. The proposed regulations provide additional election detail. Notably, a "protective election" can be made, since at the time of the transaction, whether Code Sec. 362(e)(2) applies may not be clear.
- If the transferor is a partnership and the Code Sec. 362(e)(2) election is made, any reduction to the partnership's basis in the transferee's stock received will be treated as an expenditure of the partnership. There is a similar rule for S corporations that make the election.

Conclusion

Code Sec. 362(e)(2) is only one little piece of the regulation of recognizing (and carrying over) built-in losses. The proposed regulations (which are scheduled to go into effect only after they are published as final regulations) are one piece of the continuing—and continually more complicated—loss puzzle.