The Consolidated Return Investment Basis Adjustment Rules Study Problems
(Handout)

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THE CONSOLIDATED RETURN INVESTMENT BASIS ADJUSTMENT RULES - STUDY PROBLEMS

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INTRODUCTION

• The purpose of the investment adjustment system is “to treat P and S as a single entity so that consolidated income reflects the group’s income.” Reg. § 1.1502-32(a)(1).
  – Ambiguities and oversights are governed by a rule of reason.
  – Adjustments may not be made “in a manner that has the effect of duplicating an adjustment.” Reg. § 1.1502-32(a)(2).
• The current regulations, unlike the prior regulations, de-link stock basis adjustments and earnings and profits (“E&P”).
  – The current stock basis adjustment system is analogous to the systems for adjusting the basis of partnership interests and of S corporation stock.
  – For most subsidiaries, the net investment adjustment when the subsidiary is disposed of should be the difference between the subsidiary’s net inside tax basis at the time it was acquired and its net inside tax basis at the time of the disposition (assuming no change in its capital structure).
INTRODUCTION (cont.)

• Basis in subsidiary stock is increased under Reg. § 1.1502-32(b) by positive adjustments and decreased by negative adjustments, as described below. The adjustments required are comprised of two component parts (treating income and gain items as increases and treating loss and deduction items and distributions as decreases):
  – Net Residual Adjustment consisting of: taxable income or tax loss, tax-exempt income, and noncapital, nondeductible expenses, and
  – Distributions.
• After computing the potential stock basis adjustment amount (i.e., distributions and the net residual adjustment), Reg. § 1.1502-32(c) requires an allocation of that amount among:
  – Different classes of stock, and
  – Equally within classes of stock to each share, unless shares have differing excess loss accounts ("ELAs"). Reg. §§ 1.1502-19(d), -32(c)(2)(i).