

Part III. Administrative, Procedural, and Miscellaneous

SRLY NOTICE

Notice 98-38

In 1991, the Treasury Department and the Internal Revenue Service issued proposed regulations concerning the application of the separate return limitation year (SRLY) rules to net operating loss and capital loss carryovers and carrybacks, and built-in deductions. On June 27, 1996, these regulations, substantially unchanged, were re-proposed and issued as temporary regulations in T.D. 8677, 1996-2 C.B. 119. On January 12, 1998 in T.D. 8751, 1998-10 I.R.B. 23, (modified only as to effective date on March 16, 1998 in T.D. 8766, 1998-16 I.R.B. 17) the Treasury Department and the Service published regulations extending the principles of the new temporary regulations to certain tax credits and related attributes. In addition, T.D. 8751 eliminated the application of the SRLY rules to foreign tax credits and overall foreign losses.

Comments have been received in response to each set of proposed regulations. The preamble to the temporary regulations stated that all of the comments would be considered in finalizing the temporary SRLY regulations. Many of the comments asserted that the amendment to §382 of the Internal Revenue Code in 1986 adequately addressed Congressional concerns regarding loss trafficking. Therefore, some commentators argued, the SRLY rules should be eliminated in whole or in part because the SRLY rules have become superfluous, add unwarranted complexity to the consolidated return system, and are easily avoided. Other commentators have argued that the SRLY rules should be retained.

Treasury and the Service have considered these arguments and believe that limitations on the extent to which a consolidated group can use attributes arising in a separate return limitation year remain necessary to protect the integrity of both the separate return system and the consolidated return system. Treasury and the Service, however, are concerned about any complexity in applying the current SRLY rules, particularly with respect to situations where both the SRLY rules and § 382 apply.

Accordingly, Treasury and the Service are considering, inter alia, an approach that would replace the current SRLY limitation with an approach modeled on § 382. While the temporary regulations base the SRLY limitation on the income actually generated by the SRLY member (or SRLY subgroup), the approach under consideration would base the limitation on an expectation of the amount of income to be generated. In other words, applying the methodology of § 382, the limitation would be determined based on the value of the member's or subgroup's stock at the time it joins the consolidated group, with appropriate adjustments (such as adjustments for recognized built-in gains) to reflect adjustments that would be made under § 382.

Most instances in which a corporation becomes a member of a consolidated group involve an ownership change as defined in § 382(g). In those cases, current law requires taxpayers to calculate two separate loss limitations -- the SRLY limitation and the § 382 limitation. By making the SRLY limitation the same as the § 382 limitation, the proposed approach would remove the

need to make two sets of calculations, thereby greatly simplifying the loss limitation rules applicable to consolidated groups.

In addition, adoption of this approach would address concerns raised that the SRLY rules are easily avoided through the use of stuffing transactions (e.g., transferring income producing assets to the SRLY member).

Treasury and the Service request comments about the advisability of adopting this approach. In particular, comments are requested with respect to the following:

1. Possible approaches to limit the use of loss carrybacks;
2. The application of this approach to credits (including foreign tax credits) and overall foreign losses arising in separate return limitation years;
3. The interaction of this approach with the operation of § 382(l)(5) (relating to corporations in a Title 11 or similar case);
4. Determination of the effect on an ongoing SRLY subgroup limitation when a member of the subgroup leaves the consolidated group;
5. Whether special valuation rules will be required to apply the § 382 mechanism in situations where there is no § 382 ownership change; and
6. Possible transition rules for corporations that joined a consolidated group before the effective date of any new regulations adopting this proposed approach.

Any regulations adopting a new method of determining the SRLY limitation would be initially issued as a notice of proposed rulemaking. Treasury and the Service would provide taxpayers and their representatives another comment period before regulations adopting such an approach are finalized. The existing temporary regulations will apply at least to taxable years ending on or before December 31, 1998.

Comments should be sent to: CC:DOM:CORP:R (Notice 98-38), room 5228, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, comments may be hand delivered to CC:DOM:CORP:R (Notice 98-38), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may transmit comments electronically via the IRS Internet site at <http://www.irs.ustreas.gov/prod/tax-regs/comments.html>. To be considered, comments should be received by November 15, 1998.

FOR FURTHER INFORMATION CONTACT: David Kessler or Roy Hirschhorn, of the Office of the Assistant Chief Counsel (Corporate), at (202) 622-7770 (not a toll-free number).