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"Rite Aid": Consolidated Return Loss Disallowance Held Invalid

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Corporate taxpayers are generally allowed a deduction for "any loss sustained during the taxable year and not compensated for by insurance or otherwise." There are of course some significant statutory limitations on this rule. For example, a corporation's losses from sales or exchanges of capital assets are allowed only to the extent of gains from such sales or exchanges. Also, losses from the sale or exchange of property between corporations which are members of the same affiliated group filing consolidated returns ("consolidated group") or "controlled group" may be deferred and not allowed until some later time (such as when the property is disposed of to a nonmember of the group).

Commencing with temporary regulations issued in 1990, the Treasury Department has tried, without apparent statutory support, to impose yet another limitation on the ability of corporations to claim deductions for losses, by denying deductions for many losses recognized by a member of a consolidated group with respect to the disposition of stock of a subsidiary member of that group. The Treasury articulated two reasons for denying such deductions: first, to prevent use of the "investment adjustment" rules under the consolidated return regulations to offset a subsidiary's gains on the disposition of its assets with the parent's loss on the sale of the subsidiary's stock and, second, to prevent losses of the subsidiary from being "duplicated" as losses of the parent when the parent disposes of the subsidiary's stock.

The "loss disallowance rule" has been very controversial and it had been widely expected that it would be challenged as contrary to the basic rule of the Internal Revenue Code (the "Code") that a realized loss is allowable as a deduction in computing income. In *Rite Aid Corp. v. United States*, Docket No. 00-5098 (July 6, 2001), the Court of Appeals for the Federal Circuit concluded that the loss disallowance rule was invalid as "manifestly contrary" to the Code and allowed a refund claim relating to a sale of the stock of a subsidiary.

Facts in 'Rite Aid'

Rite Aid Corp. ("Rite Aid"), the common parent of an consolidated group, acquired 80% of the stock of Penn Encore, Inc. ("Encore") during 1984. This acquisition was treated as a purchase of the assets of Encore pursuant to Code section 338. In 1988, Rite Aid acquired the remaining 20% of the stock of Encore.

Rite Aid lent approximately $45 million to Encore over a 10-year period beginning in 1985. Encore was marginally profitable in some of those years, but incurred a $5.2 million loss in its final year of ownership by Rite Aid. Encore experienced a net negative adjustment to its earnings and profits of approximately $11 million over the same 10-year period.

In 1994, Rite Aid determined to sell Encore and asked prospective bidders for the stock of Encore whether they would be prepared to join with Rite Aid in a Code section 338(h)(10) election, which would cause the sale of the stock of Encore to a corporate purchaser to be treated as a sale of Encore's assets by the Rite Aid group. A sale on this basis would likely have permitted Rite Aid to obtain a tax benefit from the realization of built-in losses attributable to the excess of the tax bases of the assets of Encore (approximately $52 million at the time of sale) over the value of those assets.

The only bidder for Encore refused to agree to make a section 338(h)(10) election, however, and the stock of Encore was ultimately sold in November 1994, without such an election being made, for consideration consisting of $18 million in cash (less closing adjustments) and warrants to purchase stock of the bidder's parent corporation. On the closing date, Rite Aid contributed to Encore the $45 million intercompany debt owed to it by Encore. After taking into account this contribution and other adjustments to the stock basis of Rite Aid in Encore, Rite Aid realized a loss of approximately $22 million on the sale.

Under the loss disallowance rule, however, a loss realized with respect to the sale of the stock of a subsidiary is not allowable unless (and is allowable only to the extent that) it exceeds the sum of various amounts, including an amount referred to as the subsidiary's "duplicated loss." This duplicated loss is, in essence, the excess of tax basis of the assets of the subsidiary (plus certain carryover losses and "deferred deductions") over the sum of the value of the subsidiary's stock and its liabilities.

Encore's duplicated loss was approximately $28 million. Since that exceeded the $22 million loss that Rite Aid realized upon the sale of Encore's stock, all of Rite Aid's loss realized from the stock sale was disallowed. Rite Aid then filed a refund claim asserting that the loss should be allowed, the IRS denied the claim, and Rite Aid sued for a refund in the Court of Federal Claims.

Proceedings Below

The parties made cross-motions for summary judgment in the Court of Federal Claims. Rite Aid argued that the loss disallowance rule was fundamentally inconsistent with Code section 165(a), which generally allows a deduction for losses sustained, and therefore that the promulgation of the regulation containing the rule exceeded the Treasury's authority. Conversely, the government argued that the regulation was within the express grant of authority to the Secretary of the Treasury, under Code section 1502, to promulgate regulations relating to the filing of consolidated tax returns that are necessary "clearly to reflect the income tax liability" of the members of the affiliated group filing a consolidated return, and to "prevent avoidance of such tax liability."

More specifically, the government apparently argued that the duplicated loss rule in the loss disallowance regulation was necessary to foreclose an opportunity that would otherwise exist for an affiliated group to recognize a loss on the sale of a subsidiary's stock and for the purchaser of the subsidiary then to recognize, through the subsidiary, deductions or losses that could be viewed in economic terms as the same loss recognized by the seller, such as depreciation deductions or a loss on disposition of the subsidiary's assets.

The Court of Federal Claims held for the government, on the ground that the Treasury had put forth and established a purpose for the regulation that was in furtherance of the purposes of the consolidated return regulations as set forth in code section 1502, and denied the refund claim. On appeal to the Federal Circuit, however, the taxpayer prevailed.

Federal Circuit Decision

The Federal Circuit's opinion notes (as did the opinion of the Court of Federal Claims below) that the express delegation by Congress of rulemaking authority to the Treasury with respect to consolidated return matters, pursuant to Code section 1502, caused the consolidated return regulations at issue to be legislative, rather than interpretive, in character. The opinion further observes that other cases concerning challenges to the validity of regulations have indicated that legislative regulations "are entitled to 'controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute.'"

The Federal Circuit's opinion refers to *American Standard, Inc. v. United States*, 602 F.2d 256 (1979), a Court of Claims case that declared invalid a provision of the consolidated return regulations concerning Western Hemisphere trade corporations. *American Standard* states that section 1502 "does not authorize the Secretary to choose a method that imposes a tax on income that would not otherwise be taxed." The Federal Circuit further concluded that the Code provisions concerning the promulgation of regulations regarding consolidated returns did not provide the Treasury with authority to change the application of Code provisions to members of an affiliated group filing a consolidated return except in the context of a "problem" created by the filing of consolidated returns.

The government argued that the loss disallowance rule in general, and the duplicated loss rule in particular, were intended, as are other consolidated return regulations (such as the investment adjustment rules under section 1.1502-32), to prevent duplication of losses and thereby to assure the clear reflection of the income of the affiliated group and of its members. The government also argued, by reference to the language of Code section 1501, that the filing of a consolidated tax return is a "privilege" elected by the affiliated group, and that corporations electing to file consolidated returns must therefore "take the bitter with the sweet."

The tart reply of the appellate court to these arguments was that "[t]he 'bitter with the sweet' does not include the invalid." The court concluded that the duplicated loss issue did not arise from the filing of consolidated returns, but rather could also be present in other contexts, such as where a corporate shareholder sells the stock of a non-consolidated subsidiary.[6] The court also noted that Congress had (to some extent) addressed issues relating to the sale of corporations with built-in losses by limiting the subsidiary's future deductions under Code section 382. Because the loss duplication problem is not limited to the consolidated return context, the court found that the Treasury's attempt to address this issue in the consolidated return context alone, through the loss disallowance regulation, was not authorized under Code section 1502 and was therefore invalid.

Observations

To the authors' knowledge, the government has not decided whether to seek review of this decision by the Supreme Court. Given past pronouncements by the IRS, however, indicative of a strong belief that the loss disallowance rule is necessary to prevent significant damage to the fisc, it is reasonable to expect the Service to place a high priority on clarifying the status of these rules, either by filing an appeal or, perhaps, by seeking legislative action.

One possible legislative approach to avoiding potential duplicate loss abuses, at least in the context of sales of corporate subsidiaries to other corporations, would be to require that all such sales be accounted for as asset sales – that is, by making mandatory the asset purchase treatment that is presently elective under Code section 338(h)(10).

That would clearly, however, be a radical change to the present Federal tax law, which generally continues to give separate effect to transactions involving the stock of a corporation, as opposed to a sale of its assets.

Given the current uncertainty as to the validity of the loss of disallowance rule, any corporation that has suffered a loss disallowance under section 1.1502-20 of the regulations, with respect to a transaction completed in a tax return year for which the statute of limitations has not yet closed, should consider filing amended returns to claim any tax benefit that would otherwise be available.