

Elimination of Circular Stock Basis Adjustments When There is No Excluded COD Income Provisions Do Not Limit Amount of Illinois Net Loss Carryovers of Member of Combined Group. (This is a GIL.)

March 16, 2017

Re: Combined return regulations

Dear Xxxx:

This is in response to your letter February 7, 2017, in which you request a General Information Letter (GIL). A GIL is designed to provide general information, is not a statement of Department policy, and is not binding on the Department. See 86 Ill. Adm. Code 1200.120(b) and (c), which may be accessed from the Department's web site at [www.Iltax.com](http://www.Iltax.com).

Your letter states as follows:

As previously discussed, COMPANY on behalf of its client, a U.S. corporation organized under Delaware law and the common parent of an affiliated group of corporations ("Taxpayer") does hereby request the Department of Revenue ("Department") to issue a General Information Letter ("GIL") based on the facts contained in this letter. The Taxpayer understands that a GIL is not a statement of the Department's policy and is not binding on the Department. Once the Department issues the GIL, the Taxpayer may immediately request a Private Letter Ruling ("PLR") and comply with all requirements as authorized by 86 Ill. Adm. Code 1200.110.

#### Facts

The Taxpayer files a U.S. federal consolidated tax return and has a calendar year end. The Taxpayer owns 100% of the stock of a US holding company which in turn is the sole shareholder of a US subsidiary ("Subsidiary"). Subsidiary owns 100% of the stock of a lower tiered US Subsidiary ("Subsidiary 2"). Subsidiary 2 owns a number of companies both in the U.S. and overseas.

The Taxpayer has federal and Illinois net operating losses ("NOLs"). During 2016, Subsidiary sold 100% of the stock of Subsidiary 2 to an unrelated third party.

#### Federal Income Tax Treatment

For federal income tax purposes, the sale of Subsidiary 2 will be treated as a stock sale and Subsidiary's gain will be determined as the amount realized less Subsidiary's basis in Subsidiary 2. As a member of a consolidated return, Subsidiary will apply Treas. Reg. §1.1502-32 to determine its basis in Subsidiary's 2 stock.

Where an affiliated group member of the federal consolidated group has generated a loss that is not fully offset by income of the other members of the consolidated group, Treas. Reg. §1.1502-32 requires a positive adjustment to be made to the affiliated group member's stock basis equal to the amount of the group's loss allocable to the affiliated group member under

Treas. Reg. 1.1502-21(b)(2)(iv). To the extent that these unabsorbed losses, representing net operating loss carryovers attributable to Subsidiary 2 and its consolidated group members are utilized by the consolidated group in future periods, a negative stock basis adjustment is made to the basis of the relevant companies as provided for by Treas. Reg. 1.1502-32(b)(2) and 1.1502-32(b)(5) Example 2(d).

The Taxpayer's federal consolidated group has net operating losses ("NOLs") that will be carried to the 2016 tax year. Subsidiary 2 and its subsidiaries have certain of these NOL attributes as provided under Treas. Reg. 1.1502-21, and Subsidiary 2 has negative basis adjustments under Treas. Reg. 1.1502-32 to the extent these NOLs will be utilized by the Taxpayer's consolidated group in 2016. Treas. Reg. 1.1502-11(b) provides specific rules concerning the use of NOLs attributable to a member being sold to offset the gain on the sale of that same subsidiary member's shares. In particular, Treas. Reg. 1.1502-11(b)(1) states "Elimination of circular stock basis adjustments where there is no excluded COD income. In general – If one member (P) disposes of the stock of another member (S), this paragraph (b) limits the use of S's deductions and losses in the year of disposition and the carryback of items to prior years. The purpose of the limitation is to prevent P's income or gain from the disposition of S's stock from increasing the absorption of S's deductions and losses, because the increase absorption would reduce P's basis (or increase its excess loss account) in S's stock under Treas. Reg. 1.1502-32 and, in turn, increase P's income or gain." As a result of this provision, the Taxpayer can only use the current year or carryforward losses of Subsidiary 2 and its subsidiaries to the extent that the other consolidated members of the Taxpayer have taxable income without regard to the sale of Subsidiary 2 stock.

As a result of Treas. Reg. §1.1502-11(b)(2), a portion of Subsidiary 2's NOL will be utilized by the Taxpayer for the 2016 tax year for which a downward adjustment to Subsidiary's basis in Subsidiary 2 stock will be made for the amount of Subsidiary 2 NOLs used by the Taxpayer's consolidated group under Treas. Reg. §1.1502-32, and a portion of Subsidiary 2's NOLs will not be utilized by the Taxpayer for the 2016 tax year for which no adjustment to the basis of Subsidiary's stock in Subsidiary 2 will be required under Treas. Reg. §1.1502-32.

#### Guidance Requested

1. Does Illinois adopt the provisions of Treas. Reg. 1.1502-11(b) and 1.1502-32 in determining the stock basis for purposes of calculating gain or loss on the sale of stock?
2. When calculating the amount of Illinois NOLs that a Taxpayer can use in the year of the sale of the subsidiary stock, do the provisions of Treas. Reg. 1.1502-11(b) impair the Taxpayer's use of available Illinois NOLs from prior years?
3. When a member of a unitary group leaves the group during the tax year, are there any limitations on the unitary group's ability to use the NOLs attributes relating to the member that is leaving the unitary group?

#### Discussion

The Department has adopted the federal consolidated return rules to calculate the combined base income of a unitary group. 86 Ill. Adm. Code Section 100.5270(a)(1) provides that the

designated agent will determine the combined base income “by treating all members of the unitary business group (including ineligible members) as if they constituted a federal consolidated group and by applying the federal regulations for determining consolidated taxable income, except that the separate return limitation year provisions and the limitations on consolidation of life and non-life companies in Treasury Reg. Section 1.1502-47 shall not apply. (See Treas. Reg. Section 1.1502-11, 26 CFR 1.1502-11).”

To the extent deductions and losses of the Taxpayer are limited under Treasury Regulation Section 1.1502-11(b), the same limitations will apply in determining the combined base income. The gain reported on the sale by Subsidiary of its ownership in Subsidiary 2 should be the same for Illinois purposes as it is for federal.

However, the provisions of Treasury Regulation Section 1502-11(b) should not limit the Taxpayer’s use of the Illinois NOL carryover attributable to Subsidiary 2. 86 Ill. Adm. Code Section 100.5270(b)(3) provides that the designated agent to compute the combined Illinois NOL deduction in accordance with 86 Ill. Adm. Code Sections 100.2330, 100.2340 and 100.2350. In addition, nothing in the Department’s combined return regulations extend the investment adjustment rules of Treasury Regulations Section 1.1502-32 to either the Illinois modification adjustments under Illinois Income Tax (“IITA”) Section 203(b)(2) or the Illinois net operating loss deduction under IITA Section 207.

Finally, the Taxpayer’s designated agent must compute the combined Illinois NOL deduction in accordance with 86 Ill. Adm. Code Section 100.2330, 100.2340 and 100.2350. In particular, 86 Ill. Adm. Code Section 100.2350(b) provides that “if a corporation ceases to be a member of a unitary business group during the year, regardless of whether it filed a separate or combined return, the amount of net loss attributable to that member for that portion of the tax year prior to leaving shall be determined in accordance with 86 Ill. Adm. Code Section 100.5270(f)(2) of this Part.”

There is nothing in the Department’s regulations which would prohibit or impair the Taxpayer’s use of the available Illinois NOLs from any member of the unitary group in the year a member leaves the group. For Illinois purposes, the entity that left the group during the year will be included with the other members full year return. After applying the provisions of 86 Ill. Adm. Code Section 100.5270 to calculate the amount of NOLs that can be used to offset income for the group, any excess NOL will be assigned to the members of the unitary group, including the member that has left the group during the tax year. The portion of the excess NOL not used in the year of the sale that is assigned to the member that left the group, will become an attribute of that entity. The entity that was sold may utilize this NOL attribute on either a separate return or a combined return if it becomes a member of another unitary group.

## **RULING**

Section 502(e) of the Illinois Income Tax Act (“IITA”; 35 ILCS 5/502(e)) states, in part, as follows:

For taxable years ending on or after December 31, 1993, taxpayers that are corporations (other than Subchapter S corporations) and that are members of the same unitary business group shall be treated as one taxpayer for purposes of any original return, amended return which includes

the same taxpayers of the unitary group which joined in filing the original return, extension, claim for refund, assessment, collection and payment and determination of the group's tax liability under this Act.

To implement IITA Section 502(e), Department Regulations Section 100.5270(a)(1) states that the designated agent will determine combined base income "by treating all members of the unitary business group (including ineligible members) as if they constituted a federal consolidated group and by applying the federal regulations for determining consolidated taxable income, except that the separate return limitation year provisions and the limitations on consolidation of life and non-life companies in Treasury Reg. Section 1.1502-47 shall not apply. (See Treasury Reg. Section 1.1502-11, 26 CFR 1.1502-11)."

Treasury Regulations § 1.1502-11(a) states:

The consolidated taxable income for a consolidated return year shall be determined by taking into account—

- (1) The separate taxable income of each member of the group (see § 1.1502-12 for the computation of separate taxable income)
- (2) Any consolidated net operating loss deduction (see § 1.1502-21 (or § 1.1502-21A, as appropriate) for the computation of the consolidated net operating loss deduction);
- (3) Any consolidated capital gain net income (net capital gain for taxable years beginning before January 1, 1977) (see § 1.1502-22 (or § 1.1502-22A, as appropriate) for the computation of the consolidated capital gain net income (net capital gain for taxable years beginning before January 1, 1977);
- (4) Any consolidated section 1231 net loss (see § 1.1502-23 (or § 1.1502-23A, as appropriate) for the computation of the consolidated section 1231 net loss);
- (5) Any consolidated charitable contributions deduction (see § 1.1502-24 for the computation of the consolidated charitable contributions deduction);
- (6) Any consolidated section 922 deduction (see § 1.1502-25 for the computation of the consolidated section 922 deduction);
- (7) Any consolidated dividends received deduction (see § 1.1502-26 for the computation of the consolidated dividends received deduction); and
- (8) Any consolidated section 247 deduction (see § 1.1502-27 for the computation of the consolidated section 247 deduction).

Treasury Regulations § 1.1502-12 defines separate taxable income. The section states in part, as follows:

The separate taxable income of a member (including a case in which deductions exceed gross income) is computed in accordance with the provisions of the Code covering the determination of taxable income of separate corporations, subject to the following modifications:

...

- (o) Basis shall be determined under §§ 1.1502-31 and 1.1502-32, and earnings and profits shall be determined under § 1.1502-33;

Treasury Regulations § 1.1502-11(b)(1) states, in part:

If one member (P) disposes of the stock of another member (S), this paragraph (b) limits the use of S's deductions and losses in the year of disposition and the carryback of items to prior years.

The purpose of the limitation is to prevent P's income or gain from the disposition of S's stock from increasing the absorption of S's deductions and losses, because the increased absorption would reduce P's basis (or increase its excess loss account) in S's stock under § 1.1502-32 and, in turn, increase P's income or gain.

The Treasury Regulations §1.1502-11(b)(2)(i) and (ii) set forth this limitation, as follows:

(i) If P disposes of one or more shares of S's stock, the extent to which S's deductions and losses for the tax year of the disposition (and its deductions and losses carried over from prior tax years) may offset income and gain is subject to limitation. The amount of S's deductions and losses that may offset income and gain is determined by tentatively computing taxable income (or loss) for the year of disposition (and any prior years to which the deductions or losses may be carried) without taking into account P's income and gain from the disposition.

(ii) Application of limitation. S's deductions and losses offset income and gain only to the extent of the amount determined under paragraph (b)(2)(i) of this section. To the extent S's deductions and losses in the year of disposition cannot offset income or gain because of the limitation under this paragraph (b), the items are carried to other years under the applicable provisions of the Internal Revenue Code and regulations as if they were the only items incurred by S in the year of disposition. For example, to the extent S incurs an operating loss in the year of disposition that is limited, the loss is treated as a separate net operating loss attributable to S arising in that year. The tentative computation does not affect the manner in which S's unlimited deductions and losses are absorbed or the manner in which deductions and losses of other members are absorbed. (If the amount of S's unlimited deductions and losses actually absorbed is less than the amount absorbed in the tentative computation, P's stock basis adjustment under §1.1502-32 reflect only the amounts actually absorbed.)

The provisions of Treasury Regulations § 1.1502-32 apply in the determination of consolidated taxable income, and therefore under Department Regulations section 100.5270 the same apply in determining the combined based income of a combined group. In addition, the combined return regulations do not require that basis be adjusted for Illinois addition and subtraction modifications. Therefore, the basis used to determine a member's separate taxable income under the consolidated return regulations is the basis used to determine the combined base income of a combined group.

The provisions of Treasury Regulations § 1.1502-11(b) apply in the determination of consolidated taxable income, and therefore under Department Regulations section 100.5270 the same apply in determining the combined based income of a combined group. Accordingly, to the extent deductions and losses of S are limited under Treasury Regulations § 1.1502-11(b), the same limitation applies in determining combined base income.

However, the provisions of Treasury Regulations § 1.1502-11(b) do not apply to limit the use of the Illinois net operating loss carryovers of a member of the combined group. Department Regulations section 100.5270(b)(3) states:

The designated agent shall compute the combined Illinois net loss deduction by determining the amount of deduction available for each member of the combined group in accordance with Sections 100.2330, 100.2340 and 100.2350 of this Part and then by combining these amounts.

Department Regulations Section 100.2350(a) states:

IITA Section 207 provides that the amount of Illinois net loss that is available as a carryback or carryover is determined after applying the allocation and apportionment provisions of Article 3. That Section does not limit the amount of Illinois net loss that may be carried into a given year. As a consequence, no such limitation shall apply.

Pursuant to this provision, the limitations imposed under Treasury Regulations § 1.1502-11(b) do not apply to Illinois net operating loss carryovers.

Where a member of the combined group leaves the group during the taxable year, Department Regulations section 100.5270(f)(1) states:

General rule. If a corporation becomes a member of a unitary business group after the beginning of the combined return year or ceases to be a member of the unitary business group during the combined return year, two tax returns will be affected for that taxable year. The combined return shall include the separate company items of such corporation for the part of the year it was a member of the unitary business group. Separate company items of a part-year member for any portion of its taxable year prior to the date it joins or after the date it leaves the unitary business group shall either be reported in a short year separate return filed by such part-year member (if it is subject to Illinois income tax during that period) or included in any combined return filed on behalf of a unitary business group to which such part-year member belongs during that portion of the year.

Department Regulations section 100.5270(a)(3) states:

Carrybacks and carryovers, if any, shall be determined for each member and not for the group. A pro rata share of the loss is attributable to each of the loss members. For Illinois net losses that occurred in taxable years ending on or after December 31, 1986, the amount of any carryback or carryover shall be determined by applying Sections 100.2340, 100.2350(c)(3) and (c)(4) of this Part. For federal net operating losses that occurred in taxable years ending prior to December 31, 1986, the amount of any carryback or carryforward shall be determined by applying Section 100.2230 of this Part.

Department Regulations section 100.2350(c)(3) states:

Portion of combined Illinois net loss attributable to a member. The portion of a combined Illinois net loss attributable to a member of a group is an amount equal to the combined Illinois net loss of the group multiplied by a fraction, the numerator of which is what would have been the separate Illinois net loss of such corporation had a combined return not been filed, and the denominator of which is the sum of what would have been the separate Illinois net losses of all members of the group in such year having such losses. The separate Illinois net loss of a member of the group shall be determined pursuant to Sections 100.2320 and 100.2340 above.

Department Regulations section 100.2350(c)(4) states, in part:

Examples. The provisions of this subsection (c) may be illustrated by the following examples:

C) Example 3: i) Corporation P was formed on January 1, 1986. P filed a separate return for the calendar year 1986. On March 15, 1987, P formed Corporation S. P and S filed a combined return for 1987. On January 1, 1988, P purchased all the stock of Corporation T, which had been formed in 1987 and had filed a separate return for its taxable year ending December 31, 1987. ii) P, S, and T join in the filing of a combined return for 1988, which return reflects a combined Illinois net loss of \$11,000. \$2,000 of such combined net loss is attributable to P, \$3,000 to S, and \$6,000 to T. Such attribution of the combined net loss was made on the basis of the separate net losses of each member as determined under subsection (c)(3).

...

D) Example 4: i) Assume the same facts as in Example 3. Assume further that on June 15, 1989, P sells all the stock of T to an outsider, that P and S file a combined return for 1989 (which includes the income of T for the period January 1 through June 15), and that T files a separate return for the period June 16 through December 31, 1989. ii) The 1988 combined Illinois net loss, to the extent not absorbed in prior years [Note: IITA Section 207 no longer allows Illinois losses to be carried back], must first be carried to the short period ending June 15, 1989. Any portion of the \$6,000 amount attributable to T which is not absorbed in ... the short combined period ending June 15, 1989, shall then be carried to T's separate short return year ending December 31, 1989.

Pursuant to these provisions, the Illinois net operating loss carryover of a part-year member that leaves the group is a separate company item of such member that must be included in the combined Illinois net loss deduction of the combined group that includes such member. As indicated above, IITA Section 207 does not limit the amount of Illinois net loss that may be carried into a given year. Accordingly, there is no limitation on the amount of the loss of the part-year member that is carried to the combined return of the selling group. See Schedule UB/NLD for the determination of the amount of the loss carryover of the part-year member absorbed by the selling group and the amount available to carry over to any separate return filed by such member or to the combined return of any unitary business group that member might join.

As stated above, this is a GIL. A GIL does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department.

Sincerely,

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