

Bump-and-Strip Regs. Finalized

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In the typical bump-and-strip transaction, a consolidated group indirectly sells the appreciated stock of a subsidiary (the target) in the following manner: the owning member distributes the target stock to another member, the target distributee cash or other property to the distributee member, and the target then issues enough new target stock to break the affiliated group status.

The genesis of the bump-and-strip transaction is the consolidated return regulations. Under Regs. 1.1502-13 and 1.1502-14, and Temp. Regs. 1.1502-13T and 1.1502-14T, gain or loss recognized on a transfer of property from one member of a consolidated group (the selling member) to another member (the purchasing member) is deferred and taken into account by the selling member when, for example, the property is depreciated or disposed of outside the group. This deferral system is intended to prevent intercompany transactions from affecting the timing of consolidated taxable income, and to fix the location, character, and source of the deferred gain or loss, generally with reference to the selling member.

Before the bump-and-strip transaction was addressed by the Service, some taxpayers argued that such a transaction permitted the group to indefinitely defer income that otherwise would result from the cash distribution and the disaffiliation. Temporary regulations were released in March 1990 to deal with this perceived abuse (TD 8295). Now, approximately two years later, the Service has made these regulations final.

Intragroup Acquisitions

The basic thrust of the regulations is to ensure that

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the deferral provisions operate so that the group's overall income or loss is generally not affected by transactions between members. The first part of the regulations requires that deferred gain with respect to an acquisition of stock of a subsidiary in an intercompany transaction be taken into account:

1. On a disposition of the stock of the subsidiary in an amount equal to the amount that would have created or increased the excess loss account ("ELA") if the adjustment to basis (or the ELA) of the stock of the subsidiary resulting from the acquisition had not occurred; or
2. Following a disposition of the stock of the subsidiary, to the extent distributions with respect to the stock to which a member becomes entitled no later than 24 months after the disposition would exceed the basis of the stock if the adjustment to the basis of the stock resulting from the acquisition had not occurred (Reg. 1.1502-13(o)(1)).

Example. Corporations P, S1, S2, and S3 file consolidated returns on a calendar-year basis. P owns all of the stock of S1 and S2, and S1 owns all 100 shares of S3. The S3 shares have an adjusted basis of \$1,000 and a value of \$10,000. S1 sells all of its S3 stock to S2 for \$10,000 and recognizes \$9,000 of gain deferred under Reg. 1.1502-13(c). S2 takes a \$10,000 basis in the S3 stock under Reg. 1.1502-31(a).

S3 borrows \$5,000 in 1992 and distributes it to S2 in the same year. S3 has no current E&P, and the distribution reduces S2's basis in the S3 stock from \$10,000 to \$5,000.

In 1993, S3 has no current E&P. At the end of that year, S3 issues 100 shares of stock to X, an unrelated third party. As a result, S2 no longer owns at least 80% of the S3 stock, and S3 ceases to be a member of the group. This is treated as a disposition of the S3 stock under Reg. 1.1502-19(b)(2)(i). If the basis of the S3 stock had not been adjusted as a result of the sale of the S3 stock by S1 to S2, the \$5,000 distribution would have resulted in a \$4,000 ELA with respect to the S3 stock. Accordingly, S1 is required to take into account \$4,000 of the deferred gain (the amount that would have been in the ELA but for the adjustment to the basis of the S3 stock resulting from its sale).

In 1994, S2 sells its 100 shares of S3 stock to X for \$6,000. S2 recognizes \$1,000 gain on the sale. Furthermore, under Reg. 1.1502-13(f)(1)(i), because the S3 stock is disposed of outside the group, S1 must take into account the remaining \$5,000 of deferred gain on the S3 stock (Reg. 1.1502-13(o)(2)).

Intragroup Dispositions

The second part of the regulations requires gain that is deferred with respect to a distribution of stock of a subsidiary from one member to another member to be taken into account:

1. On a disposition of the stock of the subsidiary in an amount equal to the amount that would have created or increased the ELA if the adjustment to the basis of the stock of the subsidiary resulting from the distribution had not occurred; or
2. Following a disposition of stock of the subsidiary, to the extent distributions with respect to the stock to which a member becomes entitled no later than 24 months after the disposition would exceed the basis of the stock if the adjustment to the basis of the stock resulting from the distribution had not occurred (Reg. 1.1502-14(g)(1)).

No Effective Date Relief

One of the principal objections to the temporary regulations released in 1990 was their effective date, which is any taxable year for which the return due date (without extensions) is after 3/14/90. The final regulations carry the same effective date. ■