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THE FEDERAL CIRCUIT'S SHALLOW ANALYSIS OF CONSOLIDATED TAXATION INVALIDATES THE LOSS DISALLOWANCE RULE—*RITE AID CORP. V. UNITED STATES*

*Christopher R. Egan**

IN a recent holding that could cost the United States Treasury $10 billion in revenue,[1] the Federal Circuit invalidated the long-criticized[2] loss disallowance rule in Treasury Regulation Section 1.1502-20. This rule limits the loss that consolidated corporate parents can recognize from the sale of their subsidiary stock. Critics argue that the loss disallowance rule is invalid because it creates a new tax without Congressional approval. The Federal Circuit recently agreed in *Rite Aid Corp. v. United States*.[3] The Federal Circuit held that the loss disallowance rule is "manifestly contrary" to I.R.C. Section 1502, so Rite Aid Corporation ("Rite Aid") did not have to follow it.[4] The following demonstrates that the Federal Circuit's analysis ignores the built-in gain problem that the loss disallowance rule was implemented to solve, and it ignores the inherent nature of consolidated taxation.

Rite Aid Corp. v. United States revolved around Rite Aid's sale of its consolidated subsidiary Penn Encore ("Encore"). In 1984 and 1988, Rite Aid purchased all of Encore's stock for $4,659,730.[5] After this purchase, Encore was only marginally profitable, and in the final three years before 1994, Encore's net income decreased from a $1.7 million profit to a $5.2 million loss.[6] Because of this loss, Rite Aid decided to sell Encore in 1994 to an unrelated company named CMI Holding Corporation ("CMI") for $18,000,000 in cash and additional CMI stock warrants.[7]

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1. John D. Mckinnon, *Nominee for IRS Legal Job Wins Ruling That May Hurt Tax-Shelter Crackdown*, WALL ST. J., July 11, 2001, at A10.
2. *See* Michael L. Schler, *The Loss Disallowance Rule and Abusive Transactions*, 46 TAX NOTES 1462 (1990); Elliot Pisem & David E. Kahen, *Rite Aid: Consolidated Return Loss Disallowance Held Invalid*, N.Y.L.J., Aug. 16, 2001, at 5.
3. 255 F.3d 1357 (Fed. Cir. 2001) [hereinafter *Rite Aid Corp. I*].
4. *Id.* at 1360.
5. *Id.* at 1358.
6. *Id.*
7. *Id.*

Rite Aid wanted to treat the sale as an I.R.C. Section 338(h)(10) asset sale, but it agreed to a stock sale after CMI insisted.[8] At the time of sale, Rite Aid's basis in Encore stock had increased to $38,644,400 because Rite Aid had contributed $44,890,476 to Encore's capital, and Encore had accumulated $10,905,806 in negative earnings and profits.[9] In accordance with I.R.C. Section 1001, Rite Aid subtracted this basis from the selling price and calculated a $22,136,739 loss.[10]

The controversy arose because Treasury Regulation Section 1.1502-20(c) disallows this entire loss. The loss disallowance rule in Treasury Regulation Section 1.1502-20(c) prohibits consolidated corporations from recognizing loss on the sale of their subsidiary stock to the extent of a duplicative loss factor.[11] For this case's purposes, the duplicative loss factor equals the subsidiary's adjusted basis in its assets minus the fair market value of the subsidiary's stock at the time of sale.[12] Encore's factor equaled $28,535,858, so all of Rite Aid's $22,136,739 loss was disallowed.[13]

Rite Aid paid its 1994 tax without recognizing the Encore loss and then filed a claim for refund. The Internal Revenue Service denied this claim, so Rite Aid filed a complaint with the United States Court of Federal Claims. The Court of Federal Claims granted the government's motion for summary judgment,[14] and Rite Aid appealed to the Federal Circuit.

On appeal, the Federal Circuit considered one issue—whether Treasury Regulation Section 1.1502-20 validly implements the legislative authority granted in I.R.C. Section 1502.[15] Section 1502 grants the Secretary of the Treasury the authority to "prescribe such regulations. . .in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group. . .may be [determined] in such manner as clearly to reflect the income-tax liability. . .and in order to prevent avoidance of such tax liability."[16] Rite Aid argued that the loss disallowance rule in Treasury Regulation Section 1.1502-20 oversteps Section1502 because, instead of helping measure an already existing tax, the loss disallowance rule creates a new tax.[17]

The Federal Circuit agreed with Rite Aid and invalidated the loss disallowance rule.[18] The court stated that I.R.C. Section 1502 "does not au-

8. *Id.*
9. *Id.*
10. *Id.*
11. Treas. Reg. § 1.1502-20 (1991).
12. *See* Treas. Reg. § 1.1502-20(c) (1991); Rite Aid Corp. v. United States, 46 Fed. Cl. 500, 503 (2000) [hereinafter *Rite Aid Corp. II*]. The Federal Circuit may have misunderstood this calculation; see its description at page 1358. *Rite Aid Corp. I*, 255 F.3d at 1358.
13. *Rite Aid Corp. I*, 255 F.3d at 1358.
14. *Rite Aid Corp. II*, 46 Fed. Cl. 500 (2000).
15. *Rite Aid Corp. I*, 255 F.3d at 1358.
16. I.R.C. § 1502 (2001).
17. *Rite Aid Corp. I*, 255 F.3d at 1360.
18. *Id.* at 1360.

thorize the Secretary to choose a method that imposes a tax on income that would not otherwise be taxed."[19] The loss disallowance rule imposes this new tax, stated the court, because it unilaterally excepts I.R.C. Section 165.[20] Section 165 generally allows a parent corporation to deduct losses from the sale of subsidiary stock.[21] But the loss disallowance rule, concluded the court, excepts Section 165 by taking these losses away from parents that file consolidated returns.[22] According to the court, this loss restriction might be valid if filing consolidated returns caused these losses, but these losses occur "regardless of whether corporations file separate or consolidated returns."[23] Because I.R.C. Section 1502 allows the Treasury to address only problems that arise from consolidated taxation, the court concluded that the loss disallowance rule oversteps the authority granted in Section 1502.[24]

Before analyzing the court's argument, one must recognize the power of legislative regulations like the loss disallowance rule. Because these regulations implement legislative delegations of power, the Supreme Court grants them "controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute [granting power]."[25] This test creates a high burden that the Federal Circuit's analysis does not overcome.

Treasury implemented the loss disallowance rule to solve a consolidated taxation problem that allows parent corporations to sell subsidiary built-in gain assets—assets with a higher fair market value than adjusted basis—without recognizing gain. For example,[26] suppose parent corporation P purchased the stock of subsidiary corporation S for $400 and elected to file a consolidated return with S. S has two assets with $100 of built-in gain each: Asset #1 with a $100 basis and a $200 market value, and Asset #2 with a $100 basis and a $200 market value. If S sells Asset #1, P's consolidated group would recognize $100 of gain. In addition, Treasury Regulation Section 1.1502-32 allows P to increase its basis in S stock by $100 to a total basis of $500. Regulations allow this increase in stock basis, "so that income or loss previously included in a group's consolidated taxable income is not reflected a second time on the sale of a subsidiary's stock."[27] But in the above situation, where S's income relates to built-in gain, this basis increase allows P's consolidated group to permanently avoid all taxation on the Asset #1 sale. For example, if P

19. *Id.* at 1359 (quoting Am. Standard, Inc. v. United States, 602 F.2d 256, 261 (1979)).

20. *Id.* at 1360.

21. I.R.C. § 165 (2001); *Rite Aid Corp. I*, 255 F.3d at 1360.

22. *Rite Aid Corp. I*, 255 F.3d at 1360.

23. *Id.* at 1360.

24. *Id.* at 1360.

25. *Id.* at 1359 (citing Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 844 (1984)).

26. This example is based on example 2 in Consolidated Return Regulations, 55 Fed. Reg. 9426-01, 9427 (Temp. Reg. announced Mar. 14, 1990).

27. I.R.S. Notice 87-14, 1987-1 C.B. 445.

now sells all of its S stock, it recognizes an artificially created $100 loss[28] that offsets the $100 gain that S recognized on the Asset #1 sale. This result directly conflicts with I.R.C. Sections 336 and 337, which require corporations to recognize gain when they distribute or sell corporate property.[29] To take advantage of this conflict, many taxpayers created abusive tax-shelter schemes with labels like "son of mirror."[30]

To solve this problem, Treasury considered many complicated solutions.[31] Theoretically, the most accurate solution is tracing. Tracing involves tracking a subsidiary's built-in gain and not allowing the parent to increase its subsidiary stock basis for any earnings or gain related to that built-in gain. Built-in gain changes as an asset's value changes, so tracing requires constant appraisal.[32] These appraisals are not only incredibly burdensome, they can be very imprecise and inconsistent.[33] Treasury concluded that "[t]racing becomes more subjective the deeper you go into it."[34] Accordingly, tracing was rejected.

After considering other combinations of tracing and presumption, the treasury decided on the loss disallowance rule.[35] The other options were as administratively burdensome and imprecise as tracing.[36] Treasury admitted that the loss disallowance rule was imperfect because it not only disallowed losses related to built-in gain, it disallowed economic losses.[37] Rite Aid's loss, for example, related to Encore's decline in economic value. Nevertheless, Treasury's other options, like tracing, had other problems and burdens. In the end, Treasury chose the loss disallowance rule because it saved the taxpayer and IRS resources, and it produced a predicable result.[38]

One may disagree with Treasury's decision, but mere disagreement with a carefully-weighed solution to a complex problem should not overturn a legislative regulation. The Supreme Court has made it clear that if

28. $400 price minus $500 basis equals $100 loss.

29. *See* I.R.C. §§ 336-337 (2001). These code sections repealed Gen. Utils. & Operating Co. v. Helvering, 296 U.S. 200 (1935).

30. *See* Boris I. Bittker & James S. Eustice, Federal Taxation of Corporations and Shareholders § 13.42(5)(c) (2001) for a detailed explanation of "son of mirror" transactions.

31. *See* Consolidated Return Regulations, 55 Fed. Reg. 9426-01, 9428-9429 (Temp. Reg. announced Mar. 14, 1990), for a detailed analysis of all of these solutions and their drawbacks.

32. Lee A. Sheppard, *Government Defends Loss Disallowance Rules*, 90 Tax Notes Today 64-10 (1990).

33. *Id.*

34. *Id.*

35. *See* Consolidated Return Regulations, 55 Fed. Reg. 9426-01, 9428-9429 (Temp. Reg. announced Mar. 14, 1990).

36. *Id.*

37. At a Federal Bar Association meeting in 1990, IRS representatives admitted that the disallowance of economic loss was the "rough cut" under the loss disallowance model. Lee A. Sheppard, *Government Defends Loss Disallowance Rules*, 90 Tax Notes Today 64-10 (1990). But IRS representatives reiterated that there are "different rough cuts under other models." *Id.*

38. *See* Consolidated Return Regulations, 55 Fed. Reg. 9426-01 (Temp. Reg. announced Mar. 14, 1990).

a "choice represents a reasonable accommodation of conflicting policies that were committed to the agency's care by the statute, we should not disturb it unless it appears from the statute or its legislative history that the accommodation is not one that Congress would have sanctioned."[39] Congress has never objected to the loss disallowance rule since Treasury implemented it in 1990.[40] In fact, Congress considered legislation that would repeal *Rite Aid*.[41] Congress wanted Treasury to make hard, complex decisions that would further clear measurement of consolidated taxable income.[42] In the Federal Circuit's perfect world, the loss disallowance rule may not be the best decision. But in the real world, every solution to the built-in gain problem presents disadvantages. Treasury carefully chose the loss disallowance rule because it presents the least disadvantages.

In addition to the Federal Circuit's failure to consider built-in gain problems, the Federal Circuit ignored consolidated taxation's inherent nature. The Federal Circuit reasoned that the loss disallowance rule creates tax because it forbids *consolidated* parents from deducting a loss that I.R.C. Section 165 allows *separate* parents to deduct.[43] This reasoning "ignores the fact that the consolidated return regulations adopt a comprehensive approach to gain and loss duplication that represents a fundamental departure from separate return treatment."[44] Unlike separate taxation, consolidated taxation treats Rite Aid and Encore as one corporation for taxation purposes.[45] Accordingly, the loss disallowance rule furthers the clear-measurement purpose of I.R.C. Section 1502 by prohibiting that one corporation from recognizing the same loss twice—once when Rite Aid sells Encore and once when Encore later sells its assets.[46] I.R.C. Section 165 allows both a separate parent and separate subsidiary to recognize this loss, but Encore and Rite Aid were not treated as separate corporations when this loss was created. In short, the Federal Circuit is comparing apples to oranges when it compares consolidated treatment to separate treatment.

If taken to its logical conclusion, the Federal Circuit's apples-to-oranges comparison would invalidate many consolidated regulations that

39. Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 845 (1984) (quoting United States v. Shimer, 367 U.S. 374, 382 (1961)).

40. *See* Consolidated Return Regulations, 55 Fed. Reg. 9426-01, 9428-9429 (Temp. Reg. announced Mar. 14, 1990).

41. *See* Kenneth J. Kies, *Kies Opposes Overturning Rite Aid*, 2001 TAX NOTES TODAY 169-23 (2001). Granted, "the view of a later Congress cannot control the interpretation of an earlier enacted statute." O'Gilvie v. United States, 519 U.S. 79, 90 (1996). But it does give insight into what a prior Congress might have intended.

42. *See* I.R.C. § 1502 (2001).

43. *Rite Aid Corp. I*, 255 F.3d at 1360.

44. Consolidated Return Regulations, 55 Fed. Reg. 9426-01, 9429 (Temp. Reg. announced Mar. 14, 1990).

45. Textron Inc. v. Commissioner, 117 T.C. 7 (2001) ("'The basic concept underlying * * * [the consolidated return] provisions is that the consolidated group is * * * a single taxable enterprise. . . .'" (quoting 3 BITTKER & LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS, par. 90.5 at 90-48 (2d ed. 1991))).

46. *Rite Aid Corp. II*, 46 Fed. Cl. at 506.

benefit consolidated parents. For example, Treasury Regulation Section 1.1502-32 allows a consolidated parent to increase its subsidiary stock basis when its subsidiary recognizes income.[47] This increase prevents the consolidated group from recognizing the subsidiary's income a second time upon sale of the subsidiary stock. Separately filing parents, however, may not increase their subsidiary stock basis, so the separate parent must recognize the subsidiary income a second time. Under the Federal Circuit's rational, the basis increase in Treasury Regulation Section 1.1502-32 is invalid because it "addresses a situation that arises from the sale of stock regardless of whether corporations file separate or consolidated returns."[48]

The Federal Circuit also did not consider Rite Aid's consent. I.R.C. Section 1501 clearly states that consolidated treatment is a privilege that corporations may take advantage of only if they "consent to all the consolidated return regulations prescribed under section 1502. . . ."[49] Therefore, Rite Aid consented to the loss disallowance rule when it decided to file a consolidated return. Rite Aid obviously decided that consolidated taxation's advantages outweighed its disadvantages, but then wanted to back out of the deal it made with the government. As the government stated in its Federal Circuit brief, Rite Aid agreed to all of the consolidated return regulations and "must take the bitter with the sweet."[50]

A final interesting point involves Rite Aid's attorney, B. John Williams. Before the *Rite Aid* decision, President Bush nominated Mr. Williams as IRS Chief Counsel.[51] This coincidence highlights concerns that the Bush administration will not fight corporate tax shelters as aggressively as the Clinton Administration.[52] But Treasury officials vigorously deny this criticism, stating that they are "working with the IRS to identify all abusive transactions and will close them down immediately."[53]

Despite Treasury's position against tax shelters, the IRS has decided not to appeal *Rite Aid.* Instead, it announced in Notice 2002-11 that it plans to implement new regulations governing loss disallowance on sales of consolidated subsidiary stock.[54] Until those new regulations are implemented, consolidated groups should use Treasury Regulation Section 1.337(d)-2 to determine the allowable loss from a sale of their subsidiary stock.[55]

47. Treas. Reg. § 1.1502-32 (1991).
48. *Rite Aid Corp. I*, 255 F.3d at 1360.
49. I.R.C. § 1501 (2001).
50. *Rite Aid Corp. I*, 255 F.3d at 1360.
51. John D. McKinnon, *Nominee for IRS Legal Job Wins Ruling That May Hurt Tax-Shelter Crackdown*, WALL ST. J., July 11, 2001, at A10.
52. *Id.*
53. *Id.* (quoting Treasury spokeswoman Tara Bradshaw).
54. I.R.S. Notice 2002-11, 2002-7 I.R.B. 526.
55. *Id.*