burdensome computations that are not required for financial statement or internal management reporting purposes. Commentators suggested that Prop. Reg. § 1.446–4(e)(9) (published in the **Federal Register** on July 18, 1994, 59 FR 36394), which permits separate entity treatment for certain hedging transactions between members, should be extended beyond hedging transactions to other intercompany obligations, provided one party to the transaction marks its position to market. Separate entity treatment would avoid the deemed satisfaction and reissuance rule if one member is a dealer in securities required to mark its securities to market.

The final regulations do not adopt this suggestion. The rules of § 1.446–4 limit the nonmarking member's ability to selectively recognize gain or loss on its position in the intercompany obligation. Without a limitation of this type, separate entity treatment would allow taxpayers to achieve results that are contrary to the purposes of these regulations (for example, by allowing a member to mark a loss position in an intercompany obligation while the other member defers realization of the associated gain). Accordingly, separate entity treatment is not made available in the final regulations to other types of intercompany obligations.

The Treasury and the IRS recognize that Prop. Reg. § 1.446– 4(e)(9) provides an important exception to the general single entity treatment of these final regulations. The Treasury and the IRS anticipate that the proposed section 446 regulations will be finalized shortly.

b. Cancellation of Intercompany Indebtedness

The proposed regulations do not affect the application of section 108 to the cancellation of intercompany indebtedness. For example, under the proposed regulations if S loans money to B, a cancellation of the loan subject to section 108(a) may result in: (i) excluded income to B; (ii) a noncapital, nondeductible expense to S (under the matching rule); and (iii) a reduction of B's tax attributes (such as its basis in depreciable property). As a result, B's tax attributes are reduced even though the group has not excluded any income on a net basis. Accordingly, the final regulations provide that section 108(a) does not apply to the cancellation of intercompany indebtedness. As a result of this change, the general principles of the matching rule will prevent transactions to which section 108(a) would otherwise apply from having inappropriate effects on basis and consolidated taxable income. In the preceding example, S and B will have offsetting ordinary income and ordinary loss, and B's tax attributes will not be reduced. However, no inference is intended as to whether the extinguishment of a loan between S and B would be properly characterized as a transaction giving rise to cancellation of indebtedness income within the meaning of sections 61(a)(12) and 108, or as a contribution to capital, a dividend or other transaction.

c. Obligations Becoming Intercompany Obligations

Under the proposed regulations, if an obligation becomes an intercompany obligation, it is treated as satisfied and reissued immediately after the obligation becomes an intercompany obligation. This treatment applies to both the issuer and the holder. The attributes of the issuer's items and the holder's items are separately determined, and thus may not match. Commentators requested that the rules be revised to allow for single entity treatment of attributes, to avoid the mismatch of ordinary income with capital loss.

This suggestion was not adopted. The use of separate return attributes for gain and loss assures that the attributes of gain or loss will be the same whether the obligation is retired immediately before the transaction in which the obligation becomes an intercompany obligation, or is deemed retired as a result of that transaction. Providing for the use of single entity attributes would result in undue selectivity. In addition, the separate entity treatment of attributes in these circumstances best reflects the fact that the income and loss taken into account accrued before the issuer and the holder joined in filing a consolidated return.

Commentators also noted that, under § 1.1502–32, downward stock basis adjustments would be required upon the expiration of any capital losses created by the deemed satisfaction if a member joins the group while holding an obligation of another member. Because the proposed regulations provide that the deemed satisfaction and reissuance is treated as occurring immediately after the obligation becomes an intercompany obligation, these losses could not be waived under § 1.1502–32(b)(4). In response to this comment, the final regulations provide that, solely for purposes of § 1.1502–32(b)(4) and the effect of any elections under that provision, the joining member's loss from the deemed satisfaction and reissuance is treated as a loss carryover from a separate return limitation year. Thus, the group may elect to waive the capital losses and avoid the downward basis adjustment.

d. Warrants and Similar Instruments

The proposed regulations do not provide special rules for the treatment of warrants to acquire a member's stock. The proposed regulations could, however, be read to include warrants within the definition of intercompany obligations.

Under section 1032, warrants and other positions in stock of the issuer are treated like stock. See, for example, Rev. Rul. 88–31, 1988–1 C.B. 302. The treatment of warrants as intercompany obligations subject to a single entity regime is inconsistent with the general separate entity treatment of stock under these regulations. Accordingly, the final regulations provide that warrants and other positions with respect to a member's stock are not treated as obligations of that member. Instead, these instruments are governed by the rules generally applicable to stock of a member. In addition, the final regulations provide that the deemed satisfaction and reissuance rule for intercompany obligations will not apply to the conversion of an intercompany obligation into the stock of the obligor.

9. Anti-avoidance Rule

The purpose of the intercompany transaction regulations is to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability). The proposed regulations provide that transactions which are engaged in or structured with a principal purpose to achieve a contrary result are subject to adjustment under the anti-avoidance rule, notwithstanding compliance with other applicable authorities. Some commentators criticized this rule as being overly broad, unnecessary, and more appropriately placed in other regulations, such as § 1.701–2 (the partnership anti-abuse regulation). Other commentators supported the use of anti-avoidance rules but criticized the particular examples. The Treasury and the IRS continue to believe that the anti-avoidance rule is necessary to prevent transactions that are designed to achieve results inconsistent with the purpose of the regulations and therefore the final regulations retain the rule. Routine intercompany transactions that are undertaken for legitimate business purposes generally will be unaffected by the anti-avoidance rule.

The anti-avoidance provision can apply to transactions that are structured