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LIMITATIONS ON CORPORATE TAX ATTRIBUTES

AN ANALYSIS OF SECTION 382 AND RELATED PROVISIONS

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I. Introduction

As a result of the economic recession caused by the COVID-19 pandemic, many corporations find themselves with unprecedented losses from investments and operations. Many economically profitable businesses also find themselves with tax losses due to the availability of deducting the full costs of equipment under the bonus depreciation rules.

These losses can result in the creation of tax attributes for the corporation that can be used as deductions against past or future profits. Corporations with such attributes have to understand the rules that limit the use of these tax attributes.

This paper discusses the rules on the limitation and use of tax attributes (carryforwards and built-in items) by corporations. The bulk of the paper discusses the limitation rules of section 382 of the Internal Revenue Code, of 1986, as amended (the “Code”), which limit the use of tax attributes after an ownership change. The paper also discusses the other rules that can apply to limit a corporation’s use of its tax attributes.

Sections 382 and 383 together limit the use of net operating losses (NOLs), and certain other tax attributes, by corporations. These provisions apply after a corporation undergoes an ownership change (i.e., a greater than 50% increase in stock ownership over, generally, a three-year period). The limitation is generally based upon the value of the stock of the corporation before the ownership change multiplied by the long-term tax-exempt rate, a rate published monthly by the Internal Revenue Service (IRS).

Section 384, a provision that shares many concepts with sections 382 and 383, limits the use of NOLs (and certain other tax attributes) by corporations. This provision applies where a corporation acquires the stock or assets of another corporation.

The separate return limitation year (SRLY) limitation rules limit the use of NOLs (and certain other tax attributes) by a consolidated group. The SRLY rules also share concepts with sections 382 and 383. These provisions apply if a new member joins (or an existing member departs) a consolidated group.

This paper discusses each of the applicable rules (sections 382, 383, 384 and SRLY) separately. For an excellent article that discusses the loss limitations as if they were a coherent whole see Jasper L. Cummings, “Juxtaposing Income and Loss,” 174 Tax Notes Federal. 371 (2022).

The legislative and regulatory rules and IRS guidance described below have varying effective dates. The paper generally discusses the rules that apply to 2019 and later taxable years (and carrybacks from such taxable years and carryforwards to such taxable years). However, with respect to carryforwards, rules that existed for testing periods, testing dates, change dates, etc. before January 1, 2012 are not generally described in this paper. For transactions before that date, the reader is advised to check the effective date to determine if the rules described below apply to the transaction.

The Treasury Department and the IRS have issued extensive regulations concerning the determination as to whether a loss corporation has undergone an ownership change. These regulations are discussed in detail in Sections II through IV of this paper.

Sections V through VII of this paper are concerned with the effects of an ownership change on a corporation. In this area of the law, the regulations and other guidance are less comprehensive. In many cases, the primary source for understanding the provisions (more than thirty years after the enactment) is the legislative history.

Section VIII of this paper describes the extensive consolidated return regulations that have been promulgated to provide guidance on the application of sections 382 and 383. These regulations provide rules for both determining whether an ownership change has occurred and the effect of such an ownership change.

Section IX of this paper describes section 384. This provision limits the ability of an acquiring corporation to offset certain income against NOLs (and other tax attributes) of an acquired corporation (and vice versa). In this area of the law, no regulations or other guidance have been issued. In many cases, the primary source for understanding the provisions (more than thirty years after the enactment) is the legislative history.

Section X of this paper describes the SRLY limitation rules contained within the consolidated return regulations. These provisions limits the ability of an acquiring consolidated group to offset certain income against NOLs (and other tax attributes) of an acquired corporation. Unlike sections 382 through 384, these rules do not appear in statutory form.

An appendix to this paper lists specialized terms and acronyms that are used throughout this paper. All references to a section in this paper are to a section of the Code, unless otherwise indicated.

A. History of Sections 382 and 383

The original version of section 382 was enacted in 1954 (as part of the enactment of the Internal Revenue Code of 1954) to limit tax-motivated acquisitions of corporations with NOLs. After a taxable purchase of stock, the NOLs were disallowed unless the corporation continued to conduct its “historic” trade or business (*i.e.*, the business conducted most recently). In the case of a corporate reorganization, the NOLs were generally allowed if the target corporation’s shareholders received at least 20% of the stock in the acquiring corporation. Section 383 was enacted in 1971 to expand the provisions of section 382 to certain tax credits and capital losses.

Section 382 was modified by the Tax Reform Act of 1976, PL 94-455. The revised version would have reduced the amount of a corporate NOL after a more than 60 percentage point owner shift. The amount of NOLs reduced was based on the size of the owner shift (with a 100% reduction in the case of a 100% owner shift). In the case of a corporate reorganization, the NOLs were generally allowed if the target corporation’s shareholders received at least 40% of the stock in the acquiring corporation.

Congress delayed the effective date of the 1976 amendments to section 382 on several occasions and the provisions had still not become effective by the time the Tax Reform Act of 1986 was enacted. In the end, the 1976 revisions only ever applied to a very limited set of taxpayers.

Congress became concerned that the 1954 and 1976 versions of sections 382 and 383 were overly easy to avoid. In addition, there were too many instances where economically similar transactions received different treatment (either harsh or lenient).

New replacement versions of sections 382 and 383 were enacted in 1986 as part of the enactment of the Internal Revenue Code of 1986 (which replaced the Internal Revenue Code of 1954) under the Tax Reform Act of 1986, PL 99-514. The new rules were generally effective with respect to ownership changes after December 31, 1986. PL 99-514, § 621(f)(1)(A)(i).

Since 1986, Congress has tinkered with the language of section 382 on several occasions (as recently as 2017); but there has not been a major overhaul of the provisions.

After the enactment of the Tax Reform Act of 1986, the Staff of the Joint Committee on Taxation published a book that attempted to explain the provisions of the tax legislation. JCS-11-87 (May 4, 1987). This book is referred to by many (and in this paper) as the “Blue Book” due to the blue cover. The book compiles the language from the various committee reports, attempting to take into account differences between the language of the bill and the language of the enacted statute.

Where helpful, we have discussed the insights of the Blue Book. The reader should not assume that statements in the Blue Book will necessarily be followed by the IRS or a court. We have experienced instances where the language in the Blue Book better tracks earlier drafts of the bill than the enacted statute. In addition, the courts in recent years have less-frequently looked to legislative history to interpret statutes than previously. *See, e.g., Gitlitz v. Comm’r*, 531 US 206 (2001) (contradictory legislative history not referred to in majority opinion). **The TCJA & Subsequent Legislation**

On December 22, 2017, Congress enacted major tax legislation that fundamentally changed the way corporations are taxed in the United States. The 2017 tax legislation is commonly referred to as the Tax Cuts and Jobs Act (TCJA), PL 115-97 (2017). The changes made by the TCJA generally affect the 2018 calendar year (and fiscal years beginning after December 31, 2017) and later taxable years.

The tax rate was changed from a graduated rate with a maximum rate of 35% to a flat rate of 21%. Many favorable deductions, exemptions, and methods of accounting were repealed.

The TCJA did not make major changes to sections 382 through 384. However, the legislation did make major changes to the NOL deduction rules under section 172. Post-2017 NOLs can now be carried forward indefinitely (instead of a 20-year carryforward) but can generally only offset 80% of taxable income.

The Joint Committee on Taxation issued a “blue book” that provides a general explanation of the TCJA in 2018. JCS-1-18 (Dec. 2018). This document, in many cases, is a key source of information as to what Congress intended.

On March 27, 2020, Congress enacted major changes to the corporate tax attribute rules as a way to stimulate the economy and deal with the crises caused by the COVID-19 pandemic. The “Coronavirus Aid, Relief, and Economic Security Act” or “CARES Act,” PL 116-136 (2020), generally applies to 2018 through 2020 calendar years (and fiscal years beginning after December 31, 2017 and before January 1, 2021).

On November 19, 2021, the House of Representatives passed the Build Back Better Bill (BBBB). HR 5376, 117th Cong. (2021). The bill has not yet come before the Senate for a vote and it is not clear whether it will be voted on by the Senate before the end of the current Congress. Nonetheless, the provision of the BBBB are discussed in this paper as it is very possible that one or more of the provisions will make their way into future legislation or a modified version of the BBBB. President Biden has also proposed major changes to taxation of corporations and high net worth individuals. Among other changes, the corporate tax rate is proposed to increase from 21% to 28% (starting in 2022). The Department of Treasury issued a “green book” that provides a general explanation of the President’s tax proposals. Treas. Dep’t, “General Explanations of the Administration’s Fiscal Year 2023 Revenue Proposals,” [Revenue Proposals | U.S. Department of the Treasury](#) (Mar. 2022) (the “Green Book”). This document, is a key source of information as to the proposed legislation (which has not yet been reduced to legislative language). The version of the BBBB that was passed by the House of Representatives did not include the proposed increase to the corporate tax rate (but earlier versions of the bill did).

B. Corporate Income Tax

In order to help the reader better understand the tax attribute limitation rules, a brief overview of the income tax treatment of corporations follows. Generally, corporations are liable for US federal income tax. IRC § 11(a). For post-2017 taxable years, the tax owed equals 21% of taxable income. IRC § 11(b) (as amended by the TCJA). Before the enactment of the TCJA, corporations were subject to tax at graduated tax rates (with a maximum rate of 35% where taxable income exceeded \$10 million). IRC § 11(b) (before amendment by the TCJA).

For fiscal year taxpayers, a blended tax rate will apply to a taxable year that begins before December 31, 2017 but ends after such date. The regular tax is determined based on the number of days in the tax year for which each rate was in effect. IRC § 15(a)(2); Notice 2018-38, 2018-18 IRB 522. For example, a taxpayer with a June 30 fiscal year could end up with a regular tax rate as high as approximately 28% for the taxable year ending on June 30, 2018 (average of 35% and 21%).

The President has proposed increasing the corporate tax rate from 21% to 28%. The proposal would be effective for taxable years beginning after December 31, 2022. For fiscal years that include December 31, 2022, a blended tax rate will apply. Green Book p. 2-3.

A corporation's taxable income generally equals gross income reduced by exemptions, deductions, and other allowances. IRC § 63(a). Included in the list of allowable deductions are NOLs, net capital losses, charitable contributions, business interest expense, and deductions under section 250 with respect to foreign-derived intangibles income (FDII) and global intangible low-taxed income (GILTI). A corporation is allowed to reduce the amount of regular tax owed by certain credits (including the foreign tax credit, the general business credit, and the minimum tax credit).

Domestic members of an affiliated group are permitted to choose to file an income tax return on a consolidated basis (in lieu of separate returns). Once a group chooses to file a consolidated return, the group must continue to file on a consolidated basis until the group is terminated. IRC § 1501; Treas. Reg. § 1.1502-75(a). Extensive regulations have been issued that govern the filing of a consolidated return. Many of such rules override the rules that would govern if separate returns were filed. *See* IRC §§ 1502, 1503(a).

Where a consolidated return is filed, the regular tax (at a 21% rate) is imposed on consolidated taxable income. Treas. Reg. § 1.1502-2(a). Consolidated taxable income is determined based upon a mix of items that are computed on a consolidated basis and the sum of other items that are computed on a separate member basis.

Each member of the group computes its separate taxable income, which generally takes into account the member's gross income and deductions (computed on a standalone basis). Separate taxable income does not take into account items that are computed on a consolidated basis and can be a negative amount (if deductions exceed gross income). Many of the tax attributes discussed herein are computed on a consolidated basis and such items are not taken into account in determining a member's separate taxable income. Treas. Reg. §§ 1.1502-11(a), -12.

Corporations are also potentially liable for tax under an alternative tax regime. For taxable years beginning after December 31, 2017, certain large corporate taxpayers can be subject to the base erosion and anti-abuse tax (BEAT) (technically called the base erosion minimum tax) of section 59A. IRC § 59A(a); TCJA § 14401(a). For earlier taxable years, corporate taxpayer are generally subject to the alternative minimum tax (AMT) regime of sections 55 through 59. IRC § 55(a) (before amendment by the TCJA); TCJA § 12001(a).

The BBBB includes a new corporate AMT regime, to replace the AMT regime that was repealed by the TCJA. The new regime would impose a minimum 15% tax on the adjusted financial statement income (book net income) of large corporations. The proposed AMT would only be imposed on corporations with average book net income in excess of \$1 billion (\$100 million in the case of a subsidiary with a foreign parent corporation). Taxpayers would be allowed a deduction for book NOLs and could reduce the AMT with foreign tax credits. Amounts paid under the AMT would be allowed as a credit against regular tax in future years (similar to the minimum tax credit under the old AMT regime). The proposal would be effective for taxable years beginning after December 31, 2022. BBBB § 138101.

GILTI

Before the enactment of the TCJA, “US shareholders” (i.e., US persons that own 10% or more of a controlled foreign corporation (CFC), directly or indirectly by attribution) were generally subject to tax on actual and deemed dividends from a CFC. Such a shareholder would include their pro rata share of subpart F income of the CFC, as well as their pro rata share of the average amounts of US property held by the CFC. The amount of such income inclusions were limited to the earnings and profits (“E&P”) of the CFC. IRC §§ 951(a)(1), 952(c)(1)(A), 956(a).

To the extent a US shareholder that was a corporation included an actual or deemed dividend from a CFC, the corporation was permitted to take into account the pro rata share of foreign taxes paid or accrued by the CFC for foreign tax purposes. Such deemed foreign taxes were included in gross income. IRC §§ 78, 960; IRC § 902 (as in effect before repeal by the TCJA).

The TCJA fundamentally changed the treatment of US shareholders of CFCs. First, US shareholders that are corporations are generally provided with a 100% dividends received deduction (the “participation exemption”) with respect to actual dividends received from a CFC. IRC § 245A. Second, the deemed payment of foreign tax on actual dividends was repealed. Third, the GILTI provisions (described below) were enacted. The TCJA largely left the subpart F regime intact.

Section 956 was not repealed by the TCJA, but regulations issued in 2019 essentially repealed them with respect to domestic corporations to the extent that the participation exemption would have applied to an actual dividend. Treas. Reg. § 1.956-1(a)(2), (3). These regulations apply to taxable years of CFCs beginning on or after July 22, 2019. However, a US person can choose (or can be required) to apply these rules to all post-2017 taxable years if the taxpayer (and all related parties that are US persons) consistently applies the rules to such earlier periods in their entirety to all CFCs. Treas. Reg. § 1.956-1(g)(4).

After 2017, US corporations generally pay a 21% tax on subpart F income, but an effective 10.5% tax on GILTI inclusions (if the full benefit of section 250 is available). Both such taxes can generally be offset by foreign tax credits (assuming that the corporation is not subject to BEAT in that taxable year). Actual dividends and section 956 inclusions are generally exempt from tax.

GILTI regulations were issued on June 6, 2019. They generally apply to taxable years of foreign corporations beginning after December 31, 2017 (and to taxable years of US shareholders in which such taxable years end). Treas. Reg. § 1.951A-7(a).

Each person that is a US shareholder (i.e., a US person that owns at least 10% of stock of a CFC, directly or indirectly by attribution) of any CFC during a taxable year is required to include GILTI in gross income. IRC §§ 951(b), 951A(a); Treas. Reg. § 1.951A-1(b). Such income is generally treated the same as an inclusion of subpart F income for various provisions of the Code. IRC § 951(f)(1); Treas. Reg. § 1.951A-5(b)(1). As a result, GILTI inclusion income is treated as ordinary income that is not a dividend (even

though it is essentially treated as a deemed dividend for many purposes of the Code). Treas. Reg. § 1.951A-5(b); *SIH Partners LLLP v. Comm’r*, 150 TC 28 (2018) (section 956 inclusion not treated as qualified dividend income), *aff’d*, 923 F.3d 296 (3d Cir. 2019), *cert. den.*, 140 S Ct 854 (2020); *Rodriguez v. Comm’r*, 137 TC 174 (2011) (same), *aff’d*, 722 F.3d 306 (5th Cir. 2013); CCA 201640018 (May 23, 2016) (subpart F income did not qualify for the dividends received deduction); CCA 201320014 (Jan. 18, 2013) (same).

Essentially, the GILTI regime treats each CFC as a flow-through entity similar to a partnership or S corporation. The shareholder takes into account his pro rata share of the taxable income (reduced by his pro rata share of the current year losses, but not below zero, of other CFCs) of each CFC with respect to which such shareholder is a US shareholder for the taxable year. The taxable income of the CFC is included by the shareholder in the taxable year that includes the last day of the taxable year of the CFC. For this purpose, a foreign corporation is treated as a CFC if it is a CFC at any time during the taxable year. IRC § 951A(b)(1)(A), (c)(1), (e)(3); Treas. Reg. § 1.951A-1(c)(1), (2), (d)(1), (2), (4).

The BBBB, if enacted, would provide for a country-by-country application of the GILTI regime. This would end the ability to blend the calculation with respect to investments in multiple countries. The proposal would be effective for taxable years beginning after December 31, 2022. BBBB § 138126(a), (g)(1).

If a US shareholder that is a corporation elects to apply the foreign tax credit regime (instead of deducting foreign income taxes) in a taxable year in which there is a GILTI inclusion, the US shareholder is deemed to have paid a portion of the CFC’s foreign income taxes. IRC § 960(a). The amount deemed paid for foreign tax credit purposes generally equals 80% of the foreign taxes paid or accrued by the CFC multiplied by the income inclusion ratio (i.e., the portion of the tested income of the CFC that is included in income by the US shareholder). IRC § 960(d). The deemed paid amount is included in gross income by the US shareholder (applying 100% of the taxes instead of 80%) as a dividend. IRC § 78. The amount includable is taken into account for purposes of the section 250 deduction (but not the dividends received deduction). IRC §§ 78, 250(a)(1)(B)(ii).

The amount of foreign income taxes deemed paid by the US shareholder is eligible for the foreign tax credit. However, the limitation is computed by treating the GILTI inclusion income (and the gross-up inclusion) as a separate basket and no carryback or carryforward is allowed for the excess amount. IRC § 904(c), (d)(1)(A); Treas. Reg. § 1.904-4(o). As a result of all of this, a US shareholder that is a corporation will not generally have to pay additional federal income tax under the GILTI regime if the CFCs pay foreign income taxes at a blended rate in excess of approximately 15.11% (10.5% tax rate after taking into account section 250, 80% foreign tax credit, and 100% gross-up).

The BBBB, if enacted, would allow for a carryforward of foreign tax credits in the GILTI basket of up to five taxable years (ten taxable years after 2030). In addition, 95% of the amount of foreign taxes deemed paid with respect to a GILTI inclusion would be taken into account (100% in the case of taxes related to US possessions). This would be an increase from the current deemed paid amount of 80%. The proposal would be effective for taxable years beginning after December 31, 2022. BBBB §§ 138124(c)(2), (h)(2), 138127(a), (f)(1).

To determine the GILTI inclusion for a taxable year, the shareholder must separately determine the tested income (taxable income) and tested loss (NOL) of each CFC for which the shareholder is a US shareholder and his pro rata share of each such amount. Tested income or loss equals gross income over deductions (including taxes) that are properly allocable to the gross income. Certain items are excluded from the computation of tested income and loss (including US source income, subpart F income, certain related party transactions, insurance income, and foreign oil and gas extraction income). IRC § 951A(c)(2), (e)(1); Treas.

Reg. § 1.951A-2. Unlike subpart F income, the amount of tested income is not limited to E&P. *See* Treas. Reg. § 1.951A-2(c)(4)(iii)(A), (B).

The next step in the process is to determine the amount of “net CFC tested income.” This is the aggregate of the shareholder’s pro rata share of tested income of each CFC reduced (but not below zero) by the aggregate of the pro rata share of the tested loss of each CFC. For purposes of determining tested income and loss, a shareholder only takes into account his pro rata share if the shareholder is a US shareholder with respect to the CFC. IRC § 951A(c)(1); Treas. Reg. § 1.951A-1(c)(2).

The GILTI inclusion amount is generally determined by subtracting from net CFC tested income the amount of any “net deemed tangible income return.” The net deemed tangible income return generally equals the shareholder’s pro rata share of the qualified business asset investment (QBAI) of each CFC for which the shareholder is a US shareholder, multiplied by 10%. QBAI generally equals the quarterly average of the adjusted basis of the tangible business assets of each CFC. For purposes of determining adjusted basis, the alternative depreciation system (ADS) is used. Tangible assets are only taken into account if they used by a CFC with tested income (and not if there is a tested loss). IRC § 951A(b)(1), (2)(A), (d); Treas. Reg. §§ 1.951A-1(c)(1), (3), (d)(3), -3. The amount of net deemed tangible income return is generally reduced (but not below zero) by the excess (if any) of interest deductions over interest income that were taken into account in determining net CFC tested income. IRC § 951A(b)(2)(B); Treas. Reg. §§ 1.951A-1(c)(3)(i)(B), (iii) (d)(3), -4.

Under the BBBB, the QBAI rate would be changed from 10% to 5%. The proposal would be effective for taxable years beginning after December 31, 2022. BBBB § 138126(d), (g)(1).

Where a consolidated return is filed, the applicable regulations require that the consolidated group determine the GILTI inclusion amount partly on a separate company basis and partly on a consolidated basis. For this purpose, tested income and net deemed tangible income return are computed on a separate company basis. Tested loss is computed on a consolidated basis and allocated to members based on their share of the consolidated tested income. QBAI and interest deductions are also computed on a consolidated basis. Treas. Reg. § 1.1502-51. The consolidated GILTI regulations apply to taxable years of US shareholders for which the due date of the consolidated return (without extensions) is after June 21, 2019. However, a consolidated group may apply the rules in their entirety to earlier years. Treas. Reg. § 1.1502-51(g)(1).

Pursuant to the GILTI regulations, gross income and allowable deductions for purposes of determining tested income and loss are determined under section 1.952-2 of the Treasury regulations. Treas. Reg. § 1.951A-2(c)(2)(i). Section 1.952-2 provides rules for determining subpart F income of a CFC. Under those rules, gross income is determined by treating the CFC as domestic corporation taxable under section 11 and by applying the principles of section 61 (definition of gross income). Treas. Reg. § 1.952-2(a)(1). However, gross income includes gain or loss only if it would be recognized under the Code if the CFC was a domestic corporation taxable under section 11 (other than with respect to section 367). Treas. Reg. § 1.952-2(c)(3).

Taxable income is determined by treating the CFC as a domestic corporation taxable under section 11 and by applying the principles of section 63 (definition of taxable income). Treas. Reg. § 1.952-2(b)(1). The provisions of subchapters F, G, H, L, M, N, S, and T of chapter 1 of the Code (sections 501-597, 801-999, and 1361-1388) and section 103 do not apply except if distinctly expressed. Treas. Reg. § 1.952-2(c)(1). As a result, the rules that generally apply to foreign source income, foreign entities, tax-exempt entities, personal holding companies, banking institutions, insurance companies, regulated investment companies (RICs), real estate investment trusts (REITs), S corporations, and cooperatives do not generally apply for

GILTI purposes. The regulations also provide rules for applying the accounting rules of the Code to CFCs. Treas. Reg. §§ 1.952-2(c)(2), 1.964-1.

Section 1.952-2 does not permit a CFC to take an NOL deduction or to carry a capital loss forward or backward. Treas. Reg. § 1.952-2(c)(5). This rule makes perfect sense in the context of subpart F income. The amount of subpart F income that is included in gross income by a US shareholder can be reduced by the shareholder's pro rata share of a prior year deficit in E&P (but limited to the same activity that produced the subpart F income). IRC § 952(c)(1)(B); Treas. Reg. § 1.952-1(c). Allowing a deduction of an NOL or excess capital loss for subpart F purposes would grant a double benefit. However, not permitting such deductions for tested income and loss purposes does not have similar policy support (except to the extent that the loss was a tested loss that reduced tested income in computing net CFC tested income).

The BBBB, if enacted, would allow a US shareholder to carryforward a net CFC tested loss to the succeeding taxable year. The statutory language specifically states that the change would not create an inference regarding the treatment under current law. The proposal would be effective for taxable years beginning after December 31, 2022. BBBB § 138126(c), (g)(1).

It is possible that the regulation that disallows a deduction of NOL or excess capital loss for tested income and loss purposes is not valid. Under the statute, deductions are allowed for tested income and loss purposes if they are "properly allocable to" gross income that is taken into account for purposes of determining tested income or loss "under rules similar to the rules of section 954(b)(5)." IRC § 951A(c)(2)(A)(ii). Section 954(b)(5) permits a deduction if (under regulations) it is "properly allocable" to relevant gross income. IRC § 954(b)(5). Applicable regulations provide that deductions are properly allocable under section 954(b)(5) using the principles of sections 861, 864, and 904(d). Treas. Reg. § 1.954-1(c)(i). For purposes of section 954(b)(5), an NOL is allocated and apportioned in the same manner as the underlying deductions that make up the NOL. Treas. Reg. § 1.861-8(e)(8). As a result, the statute seems to support deductions of NOLs and excess capital losses to the extent properly allocable to gross income that is taken into account for tested income or loss purposes. The argument that the statute supports the deduction would be undercut by a variety of difficult to resolve questions (e.g., multiple US shareholders of the same CFC, NOLs of one CFC offset tested income of other CFCs).

It is possible that the drafters of the GILTI provisions intended each year to be a separate calculation without reference to prior or future taxable years. (It should be noted that the legislative history is silent on this point and as to whether deductions of NOLs and excess capital losses should be allowed.) This argument is undercut by the allowance of carryforwards under section 163(j). *See* Treas. Reg. § 1.163(j)-7(c)(2)(i) (allowance of carryforward to CFC group). It is possible that a court could consider the distinction between the allowance of 163(j) carryforwards and the disallowance of NOL and excess capital loss deductions as an arbitrary and capricious distinction under section 706(2)(A) of the Administrative Procedure Act (APA), 5 USC § 706(2)(A). *See Mayo Found. for Medical Educ. and Research v. United States*, 562 US 44 (2011) (APA applies to Treasury regulations); *Motor Vehicle Mfr. Assoc. v. State Farm Mut. Auto. Ins. Co.*, 463 US 29, 43-52 (1983) (standard for reviewing an agency action).

Since section 1.952-2 permits deductions with reference to deductions allowed to a domestic corporation, there is uncertainty as to whether deductions that are only permitted to be taken by a domestic corporation are allowable as a deduction to a CFC under GILTI. Since such deductions are not allowable to a foreign corporation (even if the corporation has effectively connected income (ECI)), there does not appear to be a good policy argument for allowing such deductions. A partial list of such items include the section 250 deduction and the ordinary worthless stock deduction of section 163(g)(3).

Similarly, there is an issue as to whether the at risk rules of section 465 and the passive activity loss rules of section 469 apply for tested income and loss purposes if a CFC is a closely-held corporation (i.e., more than 50% of the stock (by value) is owned by five or fewer individuals, directly or indirectly by attribution). IRC §§ 465(a)(1)(B), 469(a)(2)(B), (j)(1), 542(a), 544. It is possible that these provisions do not apply since sections 542 and 544 (which are used to determine if a corporation is a closely-held corporation) are among the provisions that are not taken into account by section 1.952-2 for purposes of determining tested income and loss. Treas. Reg. § 1.952-2(c)(1). These two sections are part of the personal holding company tax rules, which otherwise would not be consulted in determining gross or taxable income. Bolstering this argument is that fact that foreign corporations are exempt from the personal holding company tax. IRC § 542(a), (c)(5).

The Treasury Department and the IRS announced in 2019 that they intend to issue guidance on issues related to the application of section 1.952-2 to GILTI. The guidance is expected to clarify that provisions that are expressly limited in their application to domestic corporations do not apply for GILTI purposes. TD 9866, 84 Fed. Reg. 29288, 29293 (2019).

In 2020, regulations were issued which provided for an elective exemption from GILTI inclusion for high-taxed income. The “high-tax election” applies to net income that is subject to foreign tax at an effective rate of over 90% of the maximum corporate tax rate (currently, 18.9%). The determination of whether income is subject to a high tax is generally made separately for each unit of a CFC with a separate set of books and records. However, multiple units that are tax residents of, or located in, the same foreign country are combined. US federal income tax concepts (and not taxable income for foreign tax purposes) are used in determining the effective foreign tax rate (including the rules that require the allocation and apportionment of deductions). Treas. Reg. § 1.951A-2(c)(1)(iii), (7), (8).

The high-tax election can be an important tool in protecting NOLs. For example, if a US corporation has negative taxable income in a taxable year, a high-tax election, if available, would reduce or eliminate the amount of any GILTI inclusion. This would avoid a reduction of NOLs by GILTI. This election gains greater importance as a result of the disallowance of the section 250 deduction in a taxable year where there is not positive taxable income. IRC § 250(a)(2). In such case, 100% of the GILTI inclusion would reduce the NOL (or increase the absorption of NOL carryforwards). IRC § 172(d)(9).

There are certainly circumstances where a high-tax election will not be advisable. For example, if the high-tax businesses are producing losses, an election would result in the inclusion of tested income from the remaining businesses (without offset by tested losses from the high-tax businesses). A high-tax election may not be advisable if both the high-tax businesses and the remaining businesses have net profits. In such case, the excess of foreign taxes of the high-tax businesses would not be able to reduce the tax on the remaining businesses (i.e., the US shareholder would lose the benefit of the blending of the rates). Modeling of various scenarios is advisable before a decision is made to make (or not make a high-tax election).

The high-tax election is generally made by the controlling domestic shareholders of a CFC on a timely-filed original tax return. The controlling domestic shareholders are generally US shareholders who, in the aggregate, own more than 50% of the stock of the CFC (by vote), directly or indirectly by attribution. An election (or revocation of an election) can be made on an amended return, in certain instances. Treas. Reg. §§ 1.951A-2(c)(7)(viii), 1.964-1(c)(5)(i). It appears that the election is not available if one of the controlling domestic shareholders refuses to make the election.

If a CFC is a member of a “CFC group,” a high-tax election can only be made (or revoked) for all of the members of the group that are CFCs in the taxable year. A “CFC group” is defined as one or more chains of corporations connected through stock ownership with a parent corporation if the parent owns (directly,

or indirectly by attribution) more than 50% of the stock (by vote or value, not counting pure preferred stock) of at least one other corporation. The members of the CFC group include (i) the parent corporation, and (ii) each corporation (other than the parent corporation) the stock of which is owned (directly, or indirectly by attribution) more than 50% (by vote or value, not counting preferred stock) by a member of the group. A CFC can only be a member of a single CFC group with respect to a taxable year and tie-breaker rules exist where a CFC would otherwise be a member of multiple groups. Treas. Reg. § 1.951A-2(c)(7)(viii)(E).

A similar high-tax election is also available under the subpart F income inclusion rules. IRC § 954(b)(4); Treas. Reg. § 1.954-1(d)(5). If that election is made, the income and deductions that are subject to that election are not taken into account in determining the amount of the GILTI inclusion. Treas. Reg. § 1.951A-2(c)(1)(iii).

The high-tax election regulations apply to taxable years of CFCs beginning on or after July 23, 2020 and to taxable years of US shareholders in which such CFC taxable years end. US shareholders can choose to apply the rules to earlier taxable years if they consistently applies the rules to such taxable years. Treas. Reg. § 1.951A-7(b).

FDII

The FDII provisions are designed to be a tax-incentive for US corporations to export goods and services. Essentially it lowers the federal tax rate on such income to 13.125% (approximately 16.41%, after 2025).

The FDII amount is computed by dealing with a flurry of terms with strange acronyms that do not appear elsewhere in the Code. At the risk of oversimplifying the discussion, the FDII amount equals deemed intangible income (DII) multiplied by the foreign-derived ratio. The foreign-derived ratio equals the ratio (not to exceed 1) of foreign-derived deduction eligible income (FDDEI) (essentially net export income) to deduction eligible income (DEI) (essentially domestic income from specific sources). IRC § 250(b)(1); Treas. Reg. § 1.250(b)-1(b), (c)(13).

DEI equals net income (gross income less allocable deductions) from all sources other than (i) deemed and actual distributions from a CFC (including, subpart F income, section 956 inclusions, and GILTI inclusions), (ii) financial services income, (iii) domestic oil and gas extraction income, and (iv) foreign branch income. IRC § 250(b)(3)(A); Treas. Reg. § 1.250(b)-1(c)(2), (15).

DEI (as well as FDDEI) is determined by taking into account deductions that are allocable to gross income that is taken into account for FDII purposes. In order to simplify the interaction with provisions that provide for taxable income limitations, the deductions of the taxpayer are determined without regard to sections 163(j), 170(b)(2), 172, 246(b), and 250. Treas. Reg. § 1.250(b)-1(d)(2)(ii). It appears that the adjustment to these deductions is designed to reduce the impact of circularity problems.

DEI is the cornerstone of the FDII calculation. A taxpayer that does not have positive DEI will not have a FDII amount. As a result, a corporation with a current year operating loss from US operations (i.e., an overall domestic loss, using foreign tax credit terminology) will generally not have any DEI or FDII. However, a corporation with current operating profits but no taxable income due to an NOL deduction, will generally have DEI and may be entitled to a FDII deduction.

DII equals the excess (if any) of DEI over the deemed tangible income return (DTIR) of the corporation. IRC § 250(b)(2)(A); Treas. Reg. § 1.250(b)-1(c)(3). DTIR equals the quarterly average adjusted basis of the tangible business assets of the corporation multiplied by 10%. For purposes of determining adjusted

basis, ADS is used. Tangible assets that are used in a foreign branch are not taken into account. IRC §§ 250(b)(2)(B), 951A(d); Treas. Reg. §§ 1.250(b)-1(c)(4), -2.

FDDEI equals net income that is included in DEI which is derived in connection with (i) property which is sold by the taxpayer to foreign persons for a foreign use, and (ii) services provided by the taxpayer to a foreign person or with respect to property that is located outside the United States. In certain cases, net income derived from a foreign related party can meet the FDDEI requirements. IRC § 250(b)(4), (5); Treas. Reg. §§ 1.250(b)-1(c)(12), (16), -3.

Where a consolidated return is filed, the applicable section 250 regulations require that consolidated group determines the FDII amount on a consolidated basis. For this purpose, DEI, DII, DTIR, and FDDEI are all computed on a consolidated basis. Treas. Reg. § 1.1502-50

Taxpayers are required by statute to substantiate that the requirements of the FDDEI rules are met. An amount is only included in FDDEI (and taken into account for purposes of determining the FDII amount) if the taxpayer establishes to the satisfaction of the IRS that the amount is proper. IRC § 250(b)(4)(A)(ii), (B), (5)(C)(i)(II), (ii).

The applicable regulations have expanded the substantiation requirements, generally, starting in 2021. The enhanced substantiation requirements do not apply to small businesses (taxpayers with gross receipts during the prior taxable year of less than \$25 million, taking into account gross receipts of related parties). Treas. Reg. § 1.250(b)-3(f)(2).

Under the enhanced substantiation requirements, taxpayers will have to produce evidence or documents that are specified in the regulations in order to take into account the net profit from a transaction as eligible for FDDEI treatment. Under the regulations, substantiating documents must be in existence by the extended due date of the applicable tax return. The documentation must be provided to the IRS within 30 days of a request. Treas. Reg. § 1.250(b)-3(b)(3), (f)(1), -4(d)(3), -5(e)(4). Many taxpayers will find these requirements difficult to meet or may decide that the costs of compliance are greater than the potential benefits.

In the case of a loss transaction, a taxpayer has an incentive to fail to meet the substantiation requirement since the transaction would reduce the amount of FDDEI and the amount of FDII. The enhanced substantiation requirements do not apply to a transaction that would increase the amount of FDDEI by not treating the transaction as eligible for FDDEI treatment. In such case, a “reason to know” standard applies. For example, if taxpayer sells inventory at a loss and has reason to know (or has actual knowledge) that the sale is to a foreign person for a foreign use, then the net loss from the sale would be taken into account for FDDEI purposes. The reason to know standard is met if information indicates that the transaction is eligible but the taxpayer fails to obtain evidence establishing eligibility. Treas. Reg. § 1.250(b)-3(f)(3).

The anti-abuse rules described above only applies to transactions that increase FDDEI by ignoring them. As a result, it appears that taxpayers that want to ignore FDII entirely can do so by not substantiating the transactions. The practical problem with this is that many taxpayers will only realize that forgoing the FDII benefits will reduce tax after the taxable year has ended. By that time the taxpayer may have already accumulated sufficient information to substantiate the deduction.

Even if the taxpayer substantiates the amount of gross income related to FDDEI, it may still be possible for a taxpayer to not report a FDII deduction. The requirements to compute FDII are onerous. The computation itself is only partially performed on IRS forms. The bulk of the calculation must be done on complicated work sheets involving hours of professional time. It is not an understatement to say that the calculation can

only be performed as a result of the current wide use of computers by tax professionals. If a taxpayer chooses to not perform these detailed calculations, it is possible that the general substantiation requirement has not been met. We are not aware of any case or ruling on point as to whether a taxpayer can opt out of a deduction by not preparing a voluminous calculation. However, the position does not seem unreasonable.

The preamble to the section 250 regulations stated that no rule was provided in regulations as to whether taxpayers can choose not to claim a FDII deduction. The authors of the preamble noted that the resolution is governed by general tax principles. TD 9901, 85 Fed. Reg. at 43052.

Where the enhanced substantiation rules do not apply (small businesses and pre-2021 transactions), the general substantiation rules of section 6001 apply. Meeting these rules will likely be significantly easier. As an example of how the general substantiation rules can be met, the preamble to the section 250 regulations state that the foreign use of inventory can be substantiated with (i) evidence of a foreign shipping address, and (ii) a memorialized conversation with the recipient regarding the place of resale (if reliable). TD 9901. 85 Fed. Reg. at 43044.

For pre-2021 transactions, a taxpayer can choose to apply the transition rules of the proposed regulations in order to meet the substantiation requirement. However, the transition rules can only be relied upon for taxable years beginning on or before March 4, 2019 unless the taxpayer adopts the proposed regulations in their entirety for all pre-2021 taxable years. TD 9901 at 85 Fed. Reg. 43044.

Where transition rules is relied upon, a taxpayer is permitted to substantiate amounts based upon “any reasonable documentation maintained in the ordinary course of the taxpayer’s business that establishes that a recipient is a foreign person, property is for a foreign use . . . , or a recipient of a general service is located outside the United States.” Prop. Reg. § 1.250-1(b). This documentation can only be taken into account if, as of the extended due date of the return, the taxpayer does not know (and does not have reason to know) that the documentation is unreliable or incorrect (using a reasonably prudent person standard). The documentation must have been obtained by the taxpayer by the extended due date of the return, but not earlier than one year before the date of the sale or service. Prop. Reg. § 1.250(b)-3(d).

Section 250

The TCJA added the FDII and GILTI provisions to the Code. FDII as a tax-incentive for US corporations to export goods and services. GILTI is a provision that imposes a tax on the net income of a CFC with respect to certain US shareholders on a pass-through basis. Both FDII and GILTI involve section 250.

Section 250 regulations were issued in 2020. They generally apply to taxable years beginning on or after January 1, 2021. However, a taxpayer can generally choose to apply these rules to any post-2017 taxable years if the taxpayer consistently applies the rules to subsequent taxable years in their entirety. Treas. Reg. §§ 1.250-1(b), 1.1502-50(g).

Section 250 is only available to US corporations. The deduction is not available to RICs (i.e., mutual funds), REITs, and S corporations. IRC § 250(a)(1); Treas. Reg. § 1.250(a)-1(c)(1).

US corporations are allowed a deduction equal to 37.5% (21.875% for taxable years beginning after December 31, 2025) of the FDII amount for the taxable year. IRC § 250(a)(1)(A), (3)(A). In addition, such a corporation is allowed a deduction equal to 50% (37.5% for taxable years beginning after December 31, 2025) of the GILTI inclusion (and any related section 78 gross-up) for such taxable year. IRC § 250(a)(1)(B), (3)(B); Treas. Reg. § 1.250(a)-1(b)(1), (3).

The BBBB has proposed changing the section 250 rate with respect to GILTI to 28.5% and FDII to 24.8%. This would increase the effective tax rate on GILTI inclusion income (before foreign tax credit benefits) from 10.5% to approximately 15%. The proposal would be effective for taxable years beginning after December 31, 2022. BBBB § 138121(a), (d)(1). The President's proposal would increase the effective tax rate on GILTI inclusion income to 20% (through a combination of a change in the section 250 rate and an increase in the corporate tax rate to 28%) generally starting in 2023. Green Book, p. 2-3. The aggregate section 250 deduction is limited by reference to the taxable income of the corporation for the taxable year (before the section 250 deduction is taken into account). The deduction is not limited to the taxable income but by a formula in which taxable income is a component. IRC § 250(a)(2)(A); Treas. Reg. § 1.250(a)-1(c)(5).

Where the combined amount of FDII and GILTI exceeds the taxable income limitation, the excess is reduced for section 250 purposes (and the deduction is reduced accordingly). The amount of FDII is reduced by the combined excess amount multiplied by the ratio of the FDII amount (before reduction) over the combined FDII/GILTI amount (before reduction). The amount of GILTI is reduced by the remainder of the excess. IRC § 250(a)(2)(B); Treas. Reg. § 1.250(a)-1(b)(2).

Taxable Income Limitation Example. A domestic corporation has FDII of \$100 million, GILTI of \$300 million, and taxable income (before section 250) of \$300 million. The combined amount of FDII and GILTI (\$400 million) exceeds taxable income by \$100 million. As a result, the FDII amount for section 250 purposes is reduced by \$25 million (\$100 million multiplied by \$100 million over \$400 million) to \$75 million. The GILTI amount for section 250 purposes is reduced by the remaining \$75 million of the excess to \$225 million. The section 250 deduction equals \$140.63 million (\$75 million multiplied by 37.5%, plus \$225 million multiplied by 50%). Treas. Reg. § 1.250(a)-1(f).

If the FDII amount had been zero, then the section 250 deduction would have equaled \$150 million (\$300 million multiplied by 50%). As a result, the taxpayer's deduction is reduced by \$9.27 million by claiming a FDII amount of \$100 million.

As can be seen from the prior example, there can be circumstances in which the taxpayer will have an incentive to not report an amount as FDII. As discussed in more detail below, FDII is only permitted if the taxpayer meets substantiation requirements. As a result, it may be possible for taxpayers to intentionally not substantiate the amount of FDII in order to reduce the amount of tax. The ability of the taxpayer to not report otherwise allowable deductions is discussed in Section VI.C below. The ability to avoid meeting the specific substantiation requirements of section 250 are discussed below with respect to the FDII provisions.

The taxable income limitation of section 250 can be difficult to apply in conjunction with other limitations that have taxable income (or adjusted taxable income limitations), such as NOLs, section 163(j), and charitable contributions. See the discussion of circularity problems in the prior segment for a full discussion as to how to apply these rules.

Where a consolidated return is filed, the applicable regulations require that the consolidated group determine the section 250 deduction on a consolidated basis (i.e., the deduction reflects the appropriate items of all of the members). For this purpose, the FDII deduction (before limit), the GILTI deduction (before limit), and the taxable income limitation under section 250 are all computed on a consolidated basis. Treas. Reg. § 1.1502-50

Section 246(b) (as amended by the TCJA) limits the aggregate deductions under section 250 as well as the dividends received deduction under section 243(a)(1) and subsection (a) and (b) of section 245. The limit

is based on either 50% or 65% of taxable income (as modified). No limitation applies in a taxable year for which there is an NOL. IRC § 246(b).

The inclusion of section 250 as subject to limitation appears to be a drafting error. There is already a taxable income limitation. In addition, the provision that determines the applicable percentage (50% or 65%) makes the determination based on the type of dividend received (not applicable to section 250). As a result, it is possible to read the provision as not limiting the section 250 deduction, but taking the section 250 deduction into account in determining the limit on the dividends received deduction. It should be noted that example 2 of section 1.250(a)-1(f)(2) of the proposed regulations does not apply the limitation of section 246(b) in determining the allowable section 250 deduction.

The technical corrections bill that was proposed by Representative Brady, then Chairman of the House Ways and Means Committee, in 2019 would have removed section 250 from the limitation rules of section 246(b). Tax Technical and Clerical Corrections Bill, § 4(mm)(20), [untitled \(house.gov\)](#) (Jan. 2, 2019) (last accessed on May 28, 2022). It appears that the draft was never formally introduced in Congress.

Circularity Problems

Various provisions of the Code impose limitations (or special rules) that are based on taxable income (or modified or adjusted taxable income). Many of these rules require knowledge of the effect of one provision on taxable income to determine the effect of another provision (and vice versa). As a result of the growth in number of these provisions due to the enactment of TJCA, they are becoming a significant feature of estimating and determining tax liability.

Provisions with taxable income limitations can be difficult to apply in conjunction with other limitations that have taxable income (or similar) limitations. A partial list pertaining to corporations includes:

- Business interest expense deduction (limited to 30% (or 50% in 2019 and 2020) of adjusted taxable income). IRC § 163(j)(1)(B), (8).
- Charitable contribution deduction (limited to 10% of modified taxable income). IRC § 170(b)(2)(A), (D).
- NOL deduction (limited to 80% of modified taxable income, with respect to post-2017 NOLs). IRC § 172(a)(2).
- Dividends received deduction (limited to 50% (or 65%, in certain cases) of modified taxable income). IRC § 246(b).
- Section 250 deduction (limitation based on the amount of taxable income). IRC § 250(a)(1)(2).
- Percentage depletion deduction for oil and gas wells (limited to 65% of modified taxable income). IRC § 613A(d)(1).

In addition, various provisions of the Code and regulations provide for relational limitations in that certain deductions can only be applied against specific sources of income. These provisions can also cause circularity issues. A partial list includes:

- Section 384 rules (preacquisition losses cannot offset acquired built-in gains). IRC § 384.
- Passive activity losses (such losses and deductions are limited to passive activity gross income and, in certain cases, net active income). IRC § 469.
- Dual consolidated loss rules (loss of a subsidiary or foreign branch cannot offset other taxable income). IRC § 1503(d).

- SRLY rules (tax attributes of an acquired subsidiary cannot offset other taxable income). Treas. Reg. §§ 1.1502-15, -21.

How to apply two or more of these provisions in conjunction with each other has been a long-standing source of controversy. In 2019, the Treasury Department and the IRS issued proposed regulations under section 250 which would have provided for ordering rules with respect to sections 163(j), 172, and 250 only.

Under the ordering rules of the proposed regulations, taxable income for section 250 purposes is determined by taking into account the application of sections 163(j) and 172(a). Prop. Reg. § 1.250(a)-1(c)(4), 84 Fed. Reg. 8188, 8211 (2019). This is done by performing the calculations in the following order:

1. Calculate the tentative section 250 deduction (including amounts related to FDII and GILTI) for purposes of section 163(j) (without regard to sections 163(j), 172, or 250(a)(2)).
2. Calculate the disallowance of business interest expense under section 163(j)(1).
3. Calculate the NOL deduction under section 172(a).
4. Calculate the actual FDII amount.
5. Calculate the actual section 250 deduction.

Prop. Reg. § 1.250(a)-1(f)(2), 84 Fed. Reg. at 8212..

After receiving comments, the Treasury Department and the IRS announced in 2020 that further study was needed to determine rules for coordinating sections 250(a)(2), 163(j), 170(b), 172, 246(b), and 613A(d), as well as similar provisions (including the dual consolidated loss rules of section 1503(d)). Future guidance may require use of simultaneous equations (discussed below) or an ordering rule. Further comments have been requested.

Until additional guidance coordinating taxable income limitations is issued, taxpayers are permitted to apply any reasonable method. A reasonable method includes the ordering rules described in the proposed regulations or simultaneous equations. The method chosen must be applied consistently for all taxable years beginning on or after January 1, 2021. TD 9901. 85 FR 43042, 43044-45 (July 15, 2020). It should be noted that the final section 250 regulations resolve some of the circularity issues. The deductions of the taxpayer for FDII purposes are determined without regard to sections 163(j), 170(b)(2), 172, 246(b), and 250. Treas. Reg. § 1.250(b)-1(d)(2)(ii).

Circularity issues can be solved through the use of simultaneous equations. This can be performed by using linear algebraic equations. It can also be performed by applying an iterative approach (i.e., repeatedly redetermining the amounts until there is little or no variance remaining). GLAM 2009-009 (Sept. 1, 2009) (iterative approach is a reasonable method). The iterative approach has also been referred to as “trial and error” or “trail and substitution.” *Shell Oil v. Comm’r*, 89 TC 371, 419 (1987), *rev’d in part and remanded in part*, 958 F.2d 885 (5th Cir. 1992); IRS Pub. 904, “Interrelated Computations for Estate and Gift Taxes,” 92 TNT 78-9 (May 1985),

Cases and ruling have generally approved of the use of simultaneous algebraic equations or the iterative approaches (interchangeably) for solving circularity issues. *Shell Oil v. Comm’r*, 89 TC at 418-19 (windfall profits tax); Rev. Rul. 79-347, 1979-2 CB 122 (sections 246(b) and 613A(d)); IRS Pub. 904; CCA 201226021 (Mar. 13, 2012) (charitable contribution and AMT NOL); GLAM 2009-009 (sections 114 and 199). *But see Lastarmarco, Inc. v. Comm’r*, 79 TC 810 (1982) (ordering rules applied to interaction of sections 243(b), 613A(d), and NOL), *aff’d* 737 F.2d 1440 (5th Cir. 1984). For a discussion of how to solve circularity problems by using algebra or ordering rules, see Libin Zhang, “Simultaneous Equations: The

Statute Strikes Back,” 2020 TNTF 194-9; Ken Brewer and Nicolaus F. McBee, “The Good, the Bad, and the GILTI: Part 4, the Circularity Myth?,” 2018 TNT 190-13.

It should be noted that some of the above-referenced authorities were issued before the advent of personal computers. Solving problems with multiple variables under the iterative approach is significantly easier now with the use of spreadsheet software. For instance, preparing the below example using the iterative approach (instead of applying the ordering rules) took the author less than 30 minutes using Excel.

Interaction of sections 163(j), 172, and 250. In 2021, a US corporation (Corp) has gross income of \$300 million (none of which is from interest income). All of the gross income is includible for purposes of computing DEI and FDDEI (as defined below in the discussion of FDII). Corp has a current year business interest expense of \$100 million, all of which is properly allocable to gross FDDEI. Corp also has an NOL carryforward from 2020 of \$130 million. In 2021, Corp does not own any tangible assets or stock in a CFC.

Corp must first compute its tentative section 250 deduction for purposes of section 163(j). Corp’s tentative FDII amount is \$200 million (gross income of \$300 million, less interest deduction of \$100 million). The tentative section 250 deduction equals \$75 million (\$200 million multiplied by 37.5%).

Corp must then determine its allowable business interest deduction under section 163(j)(1). Adjusted taxable income is determined without reference to NOL and business interest deductions, but with reference to section 250. IRC § 163(j)(8). As a result, adjusted taxable income equals \$225 million (gross income of \$300 million, less tentative section 250 deduction of \$75 million). The section 163(j) limitation equals \$67.5 million (\$225 million multiplied by 30%). The \$32.5 million of current year business interest expense that exceeds the section 163(j) limitation becomes a disallowed business interest expense (and is carried forward).

Corp must then determine its NOL deduction under section 172. Modified taxable income is determined without reference to NOL deduction or the section 250 deduction. As a result, modified taxable income equals \$232.5 million (gross income of \$300 million, less business interest expense deduction of \$67.5 million). The section 172 limitation equals \$186 million (\$232.5 million multiplied by 80%). As a result, Corp can deduct the full \$130 million NOL from 2020.

Corp must then compute its actual FDII amount. Since the final section 250 regulations ignore sections 163(j), 170(b)(2), and 250, the actual FDII amount equals \$200 million (the same as the tentative FDII amount).

Corp must then compute its actual section 250 deduction. Taxable income for this purpose is determined without regard to the section 250 deduction. As a result, taxable income for limitation purposes equals \$102.5 million (gross income of \$300 million, less business interest expense of \$67.5 million, less NOL deduction of \$130 million). As a result, the FDII amount is reduced under section 250(a)(2) to \$102.5 million. The amount of section 250 deduction equals \$38.44 million (\$102.5 million multiplied by 37.5%).

Corp’s taxable income for 2021 equals \$64.06 million (gross income of \$300 million, less business interest expense of \$67.5 million, NOL deduction of \$130 million, and section 250 deduction of \$38.44 million). Corp can carryforward to 2022, the disallowed business interest expense of \$22.5 million.

The above example is based on example two in the proposed section 250 regulations, Prop. Reg. § 1.250(a)-1(f)(2), 54 Fed. Reg. at 8212, but revised to take into account section 1.250(b)-1(d)(2)(ii) of the final section 250 regulations.

If Corp had chosen to use simultaneous equations to determine the limitations, it would have been able to reduce its taxable income for 2021 from \$64.06 million to \$56.34 million (see below).

	Simultaneous Equation	Ordering Rule
Taxable income		
Gross income	300.00	300.00
Business Interest expense deduction	(79.86)	(67.50)
Section 250 deduction	(33.80)	(38.44)
NOL deduction	<u>(130.00)</u>	<u>(130.00)</u>
Taxable income	<u>56.34</u>	<u>64.06</u>
Business interest expense deduction		
Business interest expense	100.00	100.00
Section 163(j) limitation	<u>79.86</u>	<u>67.50</u>
Deductible business interest expense	<u>79.86</u>	<u>67.50</u>
Section 163(j) limitation		
Gross income	300.00	300.00
Section 250 deduction	<u>(33.80)</u>	<u>(75.00)</u>
Adjusted taxable income	<u>266.20</u>	<u>225.00</u>
Inclusion rate	30%	30%
Section 163(j) limitation	<u>79.86</u>	<u>67.50</u>
FDII Amount		
Gross income	300.00	300.00
Business interest expense (gross amount)	<u>(100.00)</u>	<u>(100.00)</u>
FDII (before limitation)	200.00	200.00
FDII limitation	<u>90.14</u>	<u>102.50</u>
FDII amount	<u>90.14</u>	<u>102.50</u>
FDII Limitation		
Gross income	300.00	300.00
Business interest expense deduction	(79.86)	(67.50)
NOL deduction	<u>(130.00)</u>	<u>(130.00)</u>
Taxable income	<u>90.14</u>	<u>102.50</u>

Section 250 Deduction

FDII amount	90.14	102.50
Deduction rate	<u>37.5%</u>	<u>37.5%</u>
Section 250 deduction	<u>33.80</u>	<u>38.44</u>

NOL deduction

NOL carryforward	130.00	130.00
Deduction limit	<u>176.11</u>	<u>186.00</u>
NOL deduction	<u>130.00</u>	<u>130.00</u>

NOL limitation

Gross income	300.00	300.00
Business Interest expense deduction	(79.86)	(67.50)
Modified taxable income	<u>220.14</u>	<u>232.50</u>
Limitation percentage	80%	80%
Deduction limit	<u>176.11</u>	<u>186.00</u>

Base Erosion and Anti-Abuse Tax

The BEAT provisions provide for an alternative corporate tax with a higher base (disallowance of deductions for payments to related foreign persons) and a lower rate. Final BEAT regulations were issued on December 6, 2019 (and additional regulations were issued on October 9, 2020). The regulations generally apply to taxable years ending on or after December 17, 2018 (but some provisions have a later applicability date). However, taxpayers may apply the regulations in their entirety to earlier taxable years. Alternatively, taxpayers can apply the proposed regulations on which the final rules were based in their entirety for all taxable years ending on or before December 6, 2019. Treas. Reg. § 1.59A-10.

President Biden has proposed eliminating the BEAT provisions. BEAT would be replaced with a new under taxed profits rule (UTPR) regime that would disallow deductions for payments to entities in the same financial reporting group if the recipient is subject to tax at the “designated minimum tax rate.” The designated minimum tax rate would be 15%. The proposal would be effective for taxable years beginning after December 31, 2023. Green Book p. 4-8.

BEAT only applies to corporations with average annual gross receipts (for the prior three taxable years) of at least \$500 million (taking into account gross receipts of related persons). IRC § 59A(e)(1)(B), (3); Treas. Reg. § 1.59A-2(b-d). There is an exemption from the tax for (i) RICs (i.e., mutual funds), (ii) REITs, and (iii) S corporations. IRC § 59A(e)(1)(A); Treas. Reg. § 1.59A-2(b)(1).

There is also an exemption for corporations whose base erosion tax benefits are considered to be de minimis. The de minimis exception will apply if the base erosion percentage is less than 3% for the taxable year (2% for banks and registered securities dealers). IRC § 59A(c)(4), (e)(1)(C); Treas. Reg. § 1.59A-2(b)(3), (e). The BBBB, if enacted, would repeal the de minimis exception for taxable years that begin in 2024 or thereafter. BBBB § 138131(c).

The numerator of the base erosion percentage is the base erosion tax benefit (i.e., the total deductions for base erosion payments). The denominator is generally the aggregate amount of deductions for regular tax purposes (including deductions of base erosion payments) for the taxable year. The applicable regulations

have a list of deductions that are excluded from the denominator. IRC § 59A(c)(4); Treas. Reg. §§ 1.59A-1(b)(7), -2(e)(3)(ii).

Final regulations were issued on October 9, 2020 that permit a taxpayer to waive a deduction so as to be able to take advantage of the de minimis exception. For example, if a corporation made interest payments of \$325 thousand to a related foreign person during a taxable year (and had total deductions of \$10 million), the corporation could avoid BEAT if the allowed interest deduction was reduced to below \$300 thousand. This reduction would bring the base erosion percentage below 3%.

Under the BEAT regulations, taxpayers can elect to waive certain deductions (in whole or in part). In order to make the election (or elect to increase the amount of waived deductions), the taxpayer must determine that it would have been subject to BEAT (absent an election). Treas. Reg. § 1.59A-3(c)(6)(i). This appears to mean that a corporation that meets the de minimis exception absent the election cannot make the election.

The preamble to the regulations clarifies that a corporation that is not otherwise subject to BEAT cannot make an election. For example, a CFC that does not have any ECI cannot make the election. TD 9910, 85 Fed. Reg. 64346, 64350.

The regulations could potentially be read as not permitting a waiver election in excess of the amount needed to avoid BEAT status. Azeka Abramoff, special counsel to the IRS associate chief counsel (international), has said that some flexibility is permitted. For example, if the taxpayer needs to waive \$100 of deductions to avoid BEAT, they would be permitted to waive \$110, but not \$200 or \$300. Andrew Velarde, *BEAT Waiver Language on Applicable Taxpayer is About Flexibility*, 169 Tax Notes Federal 487 (2020)

Where the election is made, the deduction is waived for all purposes of the Code and the applicable regulations. A waiver election is disregarded for certain tax purposes, including (i) determining the taxpayer's methods of tax accounting, (ii) certain adjustments to basis, (iii) E&P, and (iv) any item that would provide the taxpayer with a benefit for the waived deduction. Treas. Reg. § 1.59A-3(c)(6)(iii).

The election itself is not a method of accounting. For example, if a taxpayer waives some or all of the deduction for depreciation in an earlier year, the deduction for depreciation is not impacted in a later year. Treas. Reg. § 1.59A-3(c)(6)(iii)(C), (d)(8), (9).

The election may be made on an original return or an amended return (filed within three years of the original return). The elected amount can also be increased (but not decreased) on such an amended return. The election is made on an annual basis and IRS permission is not needed to change course in a subsequent taxable year. Treas. Reg. § 1.59A-3(c)(6)(ii)(A).

If a taxpayer does not elect to waive a deduction, then the deduction must generally be taken into account for purposes of determining the base erosion percentage. The regulations require taxpayers to take into account all deductions that could properly be claimed by the taxpayer (taking into account permissible methods of tax accounting and any elections). Treas. Reg. § 1.59A-3(c)(6). The regulations fail to refer to methods and elections that are actually made by the taxpayer. *Cf.* Treas. Reg. § 1.1374-4(b)(1) (computation of recognized built-in gain or loss). As a result, it is possible that a taxpayer could be required to apply potentially available methods and elections that increase the base erosion percentage. The preamble clarifies that a failure to make a BEAT waiver election (whether or not permitted by the regulations) does not affect the taxpayer's ability to refuse to take into account a deduction (or waive the deduction) under other tax principles. TD 9910, 85 Fed. Reg. at 64350.

The regulations that allow for a deduction waiver apply to taxable years beginning on or after October 9, 2020. Taxpayers can apply the waiver rules to earlier years if they apply them to all subsequent taxable years. Treas. Reg. § 1.59A-10(b).

BEAT generally equals the greater of (i) the regular tax liability, or (ii) the tentative base erosion minimum tax. IRC § 59A(a), (b)(1); Treas. Reg. §§ 1.59A-1(b)(16), -5(b). The tentative base erosion minimum tax equals modified taxable income multiplied by the applicable tax rate (the “BEAT Rate”). IRC § 59A(b)(1)(A); Treas. Reg. § 1.59A-5(b)(2)(i).

The BEAT Rate equals (i) 5% for taxable years beginning in 2018, (ii) 10% for taxable years beginning in 2019 to 2025, and (iii) 12.5% thereafter. Banks and registered securities dealers bear a rate of tax that is 1% higher. IRC § 59A(b)(1-3); Treas. Reg. §§ 1.59A-1(b)(5), -5(c). Section 15 does not apply to provide a blended rate for fiscal year taxpayers. Treas. Reg. § 1.59A-5(c)(3).

The BBBB, if enacted, would increase the BEAT Rate starting in taxable years beginning in 2023. The proposed rates would be (i) 12.5% for taxable years beginning in 2023, (ii) 15% for taxable years beginning in 2024, and (iii) 18% thereafter. The increased rate for banks and registered securities dealers would be repealed starting in 2025. BBBB § 138131(a).

For purposes of computing BEAT, only certain credits are allowed (i.e., taken into account in determining regular tax liability). Certain credits are allowed in full, including (i) the research credit (section 41), (ii) the minimum tax credit (section 53), (iii) withholding on foreign source payments to foreign corporations (section 33), and (iv) overpayments of tax (section 37). In addition, up to 80% of the low-income housing credit (section 42), the renewable electricity production credit (section 45), and the investment energy credit (section 48) are allowed. IRC § 59A(b)(1)(B); Treas. Reg. §§ 1.59A-1(b)(2), -5(b)(2)(ii), (3). However, in taxable years beginning after December 31, 2025 only the credits under sections 33, 37, and 53 (described above) will be allowed. IRC § 59A(b)(2)(B); Treas. Reg. § 1.59A-5(b)(3)(ii). To the extent a credit does not result in a reduction in BEAT, it appears that it will still be treated as having been applied against regular tax (i.e., it will be applied without a tax benefit). *See* Treas. Reg. § 1.383-1(d)(3)(i). The BBBB would allow all credits against BEAT for taxable years beginning in 2022 and thereafter. BBBB § 138131(a)(2), (f).

The tentative base erosion minimum tax is computed based upon the corporation’s modified taxable income. IRC § 59A(b)(1)(A); Treas. Reg. § 1.59A-5(b)(2)(i). Modified taxable income is determined by starting with taxable income (for regular tax purposes) and generally disallowing (i) any base erosion tax benefit (i.e., the allowable deduction (including related deductions for depreciation or amortization) with respect to a base erosion payment), and (ii) the portion of any NOL deduction that is attributable to a base erosion tax benefit. Treas. Reg. § 1.59A-4(b). For this purpose, a deduction is taken into account if allowable under chapter 1 of subtitle A of the Code (Normal Taxes and Surtaxes). Treas. Reg. § 1.59A-1(b)(7).

In computing modified taxable income, an NOL deduction is not permitted to reduce taxable income below zero. However, a current year NOL can cause the starting point to be a negative amount. Where an NOL deduction would otherwise result in a taxpayer having negative taxable income (e.g., because pre-2018 NOLs are not subject to a taxable income limit), the taxable income for purposes of determining modified taxable income is considered to be zero. This rule is there to prevent such an NOL from being taken into account in multiple years. For example, if a taxpayer had taxable income (before NOLs) in 2019 of \$1 million and a pre-2018 NOL carryforward of \$1.5 million, the full deduction of \$1.5 million would be allowed as a deduction in 2019, and \$500 thousand would be allowed as an NOL deduction in a future taxable year. So the regulations provide that regular taxable income for BEAT purposes in 2019 is zero under this example, instead of negative \$500 thousand.

BEAT NOL Example. Assume taxpayer has gross income of \$100 million, deductions of \$150 million (\$70 million of which is a base erosion tax benefit) and an NOL carryforward of \$400 million (from a pre-2018 taxable year). Taxable income for regular tax purposes would be negative \$450 million (but none of the NOL carryforward would be absorbed in the taxable year). However, the starting point for computing modified taxable income would be negative \$50 million (\$100 million less \$150 million) and modified taxable income would be \$20 million (\$70 million less \$50 million). The NOL deduction is not taken into account in computing modified taxable income since the taxable income (before NOL deductions) was already less than zero. Treas. Reg. § 1.59A-4(c)(1).

A base erosion payment includes any amount paid or accrued by the taxpayer to a related foreign person for which a deduction is allowable (or in connection with the acquisition of depreciable or amortizable property). There are numerous exceptions to base erosion payment treatment (including an exception for payments that reduce gross income, including cost of goods sold). IRC § 59A(c)(1)(A), (2)(A), (d); Treas. Reg. § 1.59A-3. The BEAT would make changes to the exceptions to base erosion payment treatment for taxable years beginning in 2022 and thereafter. BBBB § 138131(b), (f).

For BEAT purposes, a related foreign person is a foreign person that (i) owns, directly or indirectly by attribution, at least 25% of the stock of the taxpayer (by vote or value), (ii) is related to the 25% owner or the taxpayer (within the meaning of sections 267(b) or 707(b)(1)), or (iii) is related to the taxpayer (within the meaning of section 482). IRC § 59A(f), (g); Treas. Reg. § 1.59A-1(b)(12), (17).

Business interest that is paid (or accrued) to a related foreign person in a post-2017 taxable year is generally considered to be a base erosion payment. Treas. Reg. § 1.59A-3(b)(4)(vi), (c)(4). If section 163(j) limits the deduction in the year of payment or accrual, the amount of interest that is considered to result in a base erosion tax benefit is determined by following the ordering rules under section 163(j) (i.e., earliest year amounts are absorbed first). Treas. Reg. § 1.59A-3(c)(4)(ii).

The BBBB, if enacted, would provide for an exception from treatment as a base erosion payment for amounts that are subject to US federal income tax or a foreign tax at a rate of at least 15% (or the BEAT Rate, if lower). The change is proposed to be effective in taxable years beginning in 2022 and thereafter. BBBB § 138131(b)(4)(A), (f).

Modified taxable income can be adjusted if the taxpayer deducts an NOL for regular tax purposes. For purposes of computing modified taxable income, a percentage of the NOL deduction is disallowed. The amount of the NOL deduction that is subject to reduction is limited to the positive taxable income for the year (before the deduction for NOLs is taken into account). The disallowance percentage is the base erosion percentage for the taxable year in which the NOL arose (i.e., the vintage year). IRC § 59A(c)(1)(B); Treas. Reg. § 1.59A-4(b)(2)(ii), (c). Essentially, the rule prevents a base erosion benefit from a prior taxable year from reducing modified taxable income. As a result of this rule, taxpayers that are carrying forward pre-2018 NOLs may need to determine the base erosion percentage for taxable years for which BEAT did not apply (e.g., the carryforward of an NOL from the 1990s). There also may be difficulty getting information where a member (with an NOL) left one consolidated group and joined a different consolidated group.

Where a consolidated return is filed, the applicable regulations require that the consolidated group determine the amount of BEAT on a consolidated basis. For this purpose, the amount of tax due (and whether the consolidated group is an applicable taxpayer) is determined as if the members of the consolidated group were a single taxpayer. For purposes of related party determinations, if a person is a related party with respect to a member of a consolidated group, that person is a related party of the group and of each of its members. As is the case in other areas, special complicated rule apply in dealing with the

section 163(j) limitation rules for BEAT purposes. Treas. Reg. §§ 1.1502-2(a)(9), -59A(a-c), (g). The consolidated BEAT regulations apply to taxable years of consolidated groups for which the due date of the consolidated return (without extensions) is after December 6, 2019. Treas. Reg. §§ 1.1502-2(d), -59A(h).

Unlike AMT, there is no provision in the BEAT rules that (i) allows for a credit for BEAT that is paid in a prior taxable year, or (ii) allows for a tax benefit rule to prevent unfair results. As a result, the taxpayers can be impacted by BEAT in ways that are not equitable.

The BEAT could have been treated as a parallel tax regime by the IRS, like the AMT and adjusted current earnings (ACE) regimes that were repealed by the TCJA. The Treasury and IRS rejected a “recomputation” approach in favor of an “add-back” approach. TD 9885, 84 Fed. Reg. 66968, 66987 (2019). As a result, there will not be an independent and parallel set of tax attributes and carryforwards for BEAT purposes.

Alternative Minimum Tax

The since-repealed AMT generally applies to corporations for pre-2018 taxable years. The AMT tax owed generally equals the greater of (i) the regular tax, or (ii) the tentative minimum tax. IRC § 55(a) (before amendment by the TCJA). The regular tax is a tax regime that imposes a tax on a corporation’s taxable income at a 35% rate (or lower rate if taxable income is \$10 million or less). IRC § 11(b) (before amendment by the TCJA).

As mentioned, previously, this paper generally discusses the rules that apply to 2019 and later taxable years (and carrybacks from such taxable years and carryforwards to such taxable years). AMT is discussed because of the ability to carryback NOLs from 2019 and 2020 five taxable years. The AMT will be relevant for purposes of some of these carryback taxable years.

The tentative minimum tax is generally computed based upon a corporation’s alternative minimum taxable income and is determined at a 20% rate. For fiscal year taxpayers, a blended tax rate will apply to a taxable year that begins before December 31, 2017 but ends after such date. The tentative minimum tax rate will be determined based on the number of days in the tax year for which each rate was in effect. IRC § 15; Notice 2018-38, 2018-18 IRB 522. For example, a taxpayer with June 30 fiscal year would end up with a tentative minimum tax rate of 10% for the taxable year ending on June 30, 2018 (average of 20% and zero).

Alternative minimum taxable income is computed by making adjustments to taxable income. Most of the adjustments result in an increase in alternative minimum taxable income (over regular taxable income). Many of the adjustments disallow certain exemptions and deductions, and the use of certain tax accounting methods. In addition, few credits are allowed to reduce the tentative minimum tax. (A notable exception is the foreign tax credit.) IRC §§ 55(b), 56-59 (before amendment by the TCJA).

Essentially, the tentative minimum tax is imposed on a higher base and at a lower rate than the regular tax. The AMT is a parallel tax regime. As a result, many tax attributes (e.g., NOLs) are recomputed for AMT purposes. IRC §§ 56(d) (NOL), 59(h); Treas. Reg. § 1.55-1(a).

If a corporation’s tentative minimum tax exceeds the regular tax, the taxpayer owes an AMT equal to the excess. IRC § 55(a) (before amendment by the TCJA). The regular tax liability generally equals the amount of regular tax owed (before credits other than the foreign tax credit). IRC §§ 26(b), 55(c)(1). Essentially, this mechanism causes a corporation to owe the greater of the regular tax, or the tentative minimum tax, as described above.

Only a small number of tax credits are allowable to reduce the amount of tentative minimum tax. IRC § 38(c)(1)(A). The foreign tax credit is allowed, but is recomputed to take into account differences between taxable income and alternative minimum taxable income. IRC §§ 55(b)(1)(B)(ii), (c)(1), 59(a) (before amendment by the TCJA). In addition, specified general business credits are allowed to reduce the amount of tentative minimum tax. IRC § 38(c)(2).

Only limited regulations were ever issued regarding the computation of AMT with regard to members of a consolidated group. Regulations were issued regarding the adjusted current earnings (ACE) adjustment and the minimum tax credit only. Treas. Reg. §§ 1.56(g)-1(n), 1.1502-55. Regulations on the consolidated treatment of AMT were proposed in 1992, but were never finalized. Under the proposed regulations, consolidated alternative minimum taxable income was determined by making positive and negative adjustments to consolidated taxable income. These adjustments were each separately determined on a consolidated basis. Prop. Reg. § 1.1502-55.

C. Corporate Tax Attributes

Below is a general discussion of the rules for carryback and carryforward tax attributes of a corporation.

Many of the tax attributes described herein have limitations that are based upon taxable income (or modified or adjusted taxable income), such as NOLs, section 163(j), and charitable contributions. These limitations can be difficult to apply in conjunction with other provisions that have taxable income (or similar) limitations. See the discussion of circularity problems in Section 1.C above for a full discussion as to how resolve these issues.

Net Operating Losses

A corporate NOL equals the excess of a corporation's deductions over its gross income (with modifications). Said another way, the corporate NOL generally equals any negative amount of taxable income. IRC § 172(c), (d).

The starting point for determining the corporate NOL is the excess of deductions over gross income. This amount is modified as if no deduction was allowed for (i) NOLs, (ii) the FDII deduction under section 250, and (iii) the GILTI deduction under section 250. In addition, a corporate NOL is modified so that the special deductions under sections 243 and 245 are computed as if no limitation applied. IRC § 172(c), (d)(1), (5), (7), (9); Treas. Reg. § 1.172-2.

Generally, if a corporation has an NOL in a post-2020 taxable year, the NOL cannot be carried back. Instead, the NOL can be carried forward indefinitely. IRC § 172(b)(1)(A) (as amended by the CARES Act). The NOL is deductible in the taxable year to which it is carried to. IRC § 172(a), (b)(2); Treas. Reg. § 1.172-1(a), (b). The NOL deduction of a post-2017 NOL can only offset 80% of the corporation's taxable income (before NOL deductions). IRC § 172(a)(2). This rule essentially results in a 4.2% minimum tax (21% tax rate reduced by 80% limitation).

Special rules apply for certain industries. Farming losses generally can be carried back two years (unless the taxpayer waives the carryback). IRC § 172(b)(1)(B). Insurance companies (other than life insurance companies) can carry NOLs back two years (unless the taxpayer waives the carryback) and forward twenty years. IRC § 172(b)(1)(C). For 2018 through 2020, the five-year carryback provisions of the CARES Act (described below) apply instead of the special two-year carryback provisions for farming businesses and insurance companies. IRC § 172(b)(1)(D)(i)(II) (as amended by the CARES Act).

The CARES Act repealed the 80% limitation for 2018 through 2020 (i.e., taxable years that begin after December 31, 2017 and begin before January 1, 2021). IRC § 172(a)(1) (as amended by the CARES Act). For later taxable years, the 80% limitation will still apply. However, the limit on post-2017 NOLs will equal 80% of the excess of (i) taxable income computed without regard to FDII and GILTI deductions, over (ii) the deduction for pre-2018 NOLs (which are not subject to the 80% limitation). IRC § 172(a)(2) (as amended by the CARES Act).

If a corporation has an NOL in a pre-2018 taxable year, the NOL generally can be carried forward only twenty taxable years. IRC § 172(b)(1)(A) (before amendment by the TCJA); CARES Act § 2303(c)(1). The NOL is deductible in the taxable year to which it is carried to. IRC § 172(a), (b)(2) (before amendment by the TCJA).

For regular tax purposes, the deduction of a pre-2018 NOL generally can offset the full amount of taxable income (unless section 382 or other rules imposes a limitation). IRC § 172(b)(2) (before amendment by the TCJA). For AMT purposes, the NOL deduction cannot generally offset more than 90% of the corporation's alternative minimum taxable income (before NOL deductions). IRC § 56(d)(1) (before amendment by the TCJA). This rule essentially results in a 2% "toll charge" to deduct an NOL (20% tax rate reduced by 90% limitation).

After 2020, taxpayers with both pre-2018 and post-2017 NOLs will have some NOLs that are subject to an 80% limit and some that are not subject to any limit. The rule under the Code is that the earliest NOLs are used first. As a result, the pre-2017 NOLs will generally be used first and will not be subject to the 80% limit. Where the pre-2018 NOLs do not completely eliminate taxable income, the post-2017 NOLs will be subject to the 80% limit. Under the TCJA, there was uncertainty as to how to compute the limit. This uncertainty has been fixed by the CARES Act. It is now clear that the 80% limit is computed after deducting pre-2018 NOLs. IRC § 172(a)(2)(B) (as amended by the CARES Act).

The TCJA generally ended the ability of taxpayers to carry back post-2018 NOLs. However, the CARES Act has generally revived the ability to carry back NOLs that arise in 2018 through 2020 (i.e., taxable years that begin after December 31, 2017 and before January 1, 2021). Such NOLs can be carried back five taxable years. IRC § 172(b)(1)(D)(i) (as amended by the CARES Act).

A taxpayer can elect to relinquish the ability to carryback an NOL from any taxable year (including a five-year carryback pursuant to the CARES Act). (It should be noted that there is no similar election to relinquish the carryback for other tax attributes.) Such an election is for the entire carryback period and for the full amount of the NOL for which the election is made. To be effective, the election must be made by the extended due date for filing the return for the taxable year of the NOL. An election, once made, is irrevocable. IRC § 172(b)(3). The CARES Act extended the time for making relinquishment (and other) elections for fiscal years beginning before January 1, 2018 and ending after December 31, 2017 until 120 days after enactment of the legislation (i.e., July 27, 2020). CARES Act § 2303(d)(4); Rev. Proc. 2020-24 § 4.04(1), 2020-18 IRB 750.

With respect to the five-year carryback pursuant to the CARES Act, a taxpayer can make the election to relinquish the carryback for 2018 or 2019 by the due date (including extensions) for the 2020 tax return. IRC § 172(b)(1)(D)(v)(II) (as amended by the CARES Act); Rev. Proc. 2020-24 § 4.01(1). If an NOL is carried back to a taxable year in which section 965 applied, the taxpayer is deemed to have made the election under section 965(n) not to have the NOL offset the section 965 inclusion. IRC § 172(b)(1)(D)(iv) (as amended by the CARES Act). In addition, a taxpayer can elect to exclude the section 965 inclusion year entirely from the carryback. IRC § 172(b)(1)(D)(v)(I) (as amended by the CARES Act); Rev. Proc. 2020-24 § 4.01(2).

If an election is made to relinquish the carryback period, it applies for both regular tax and AMT purposes. Rev. Rul. 87-44, 1987-1 CB 3. If a consolidated group makes an election to relinquish the carryback period for a consolidated NOL, the election applies to all of the members of the group. Treas. Reg. § 1.1502-21(b)(3)(i). The split-waiver rules are discussed below in Section VIII.

Where a consolidated return is filed, the applicable regulations require that the consolidated group determine the amount of NOLs on a consolidated basis (a consolidated NOL or CNOL). For this purpose, the CNOL is determined by taking into account the excess of deductions over gross income (computed on a consolidated basis). Treas. Reg. § 1.1502-21(e). The amount of the consolidated NOL deduction (or CNOL deduction) is the aggregate of the NOL carryforwards and carrybacks to the year under the principals of section 172. The amount deductible includes carryforwards and carrybacks of CNOLs of the group, as well as NOLs of members arising in separate return years. Treas. Reg. § 1.1502-21(a), (b)(1). These CNOLs and separate NOLs are all subject to applicable limitations (e.g., sections 382 and 384).

There is some uncertainty as to how the five-year carryback provisions interact with AMT. In prior recessions, Congress changed the NOL limitation for AMT purposes from 90% to 100% when a taxpayer carried back the NOLs. However, the CARES Act did not make any changes to the NOL limitation under AMT. It appears that only 90% of the adjusted minimum taxable income can be offset by the NOL. In which case, the AMT could be carried forward as a credit and taken as a refundable credit in 2018 (or 2018 and 2019).

If a post-2017 NOL is carried back to a pre-2018 taxable year, there was also a question as to how to determine the amount of the NOL carryback for AMT purposes. The TCJA repealed the AMT for corporations but not for individuals. As a result, many of the Code sections that relate to AMT are still in place. More specifically, there is still a definition of NOL for AMT purposes in the Code after the enactment of the TCJA. IRC § 56(d)(2)(A) (NOL for regular tax purposes with adjustments). Many taxpayers have applied this definition in preparing carryback refund claims.

The IRS announced on a web site that the correct amount of a post-2017 NOL for AMT purposes for a corporation is zero. This interpretation applies to amended returns and refund claims filed on or after June 1, 2020. The IRS warned that the processing of a refund would be delayed if a different amount is used by a taxpayer. Taxpayers that filed a return or claim before June 1, 2018 were permitted to use an amount other than zero. [Questions and Answers about NOL Carrybacks of C Corporations to Taxable Years in which the Alternative Minimum Tax Applies | Internal Revenue Service \(irs.gov\)](#) (last updated on Jan. 25, 2022).

The IRS interpretation that the amount of AMT NOL is zero would result in a carryback for regular tax (but not for AMT purposes). This would result in a larger AMT in the carryback year, which would be refundable as a minimum tax credit. For most taxpayers, the amount of the AMT NOL will not affect the amount of the refund receivable and will result only in timing difference.

The amount of NOL that is considered applied in a given taxable year can differ from the amount of the NOL deducted in that year. The amount of NOL that is considered applied in a given year equals the adjusted taxable income for the year. IRC § 172(b)(2). (For AMT purposes, the amount of NOL that is considered applied in a given year equals 90% of the adjusted minimum taxable income. IRC § 56(d)(1)(B)(ii).)

Adjusted taxable income (or adjusted minimum taxable income) is generally computed as if no deduction was allowed for (i) NOLs for the loss year (and any taxable year thereafter), (ii) manufacturing deductions under section 199 (with respect to pre-2018 taxable years), (iii) the FDII deduction (with respect to post-2017 taxable years), and (iv) the GILTI deduction (with respect to post-2017 taxable years). IRC §

172(b)(2), (d)(7), (9). Under these rules, deductions and other items that are computed or limited based upon taxable income are recomputed. Treas. Reg. § 1.172-5(a)(2)(ii). For taxable years beginning after December 31, 2020, adjusted taxable income is adjusted by the portion of the regular tax that cannot be offset by NOLs due to the 80% of taxable income limitation. IRC § 172(b)(2)(C) (as amended by the CARES Act). However, adjusted taxable income cannot be less than zero. IRC § 172(b)(2)(B).

In a taxable year in which taxable income is offset by NOL carryforwards, the charitable contribution deduction may be reduced since (as described below) the deduction is limited to 10% of taxable income. For purposes of NOL absorption, the 10% limitation is recomputed (as if no NOL deduction was allowed). This results in a reduced amount of NOL carryforward absorbed equal to the increased recomputed charitable contribution deduction. To the extent that the NOL absorbed is reduced by a recomputed charitable contribution deduction, the charitable contribution deduction is treated as absorbed in the taxable year. IRC § 170(d)(2)(B); Treas. Reg. § 1.170A-11(c)(2). This is commonly referred to as a conversion of a contribution carryforward into an NOL carryforward. David Culp & V. Moore, *Complex Benevolence: Converting Charitable Contributions to NOLs*, 2012 TNT 113-12.

As an example of the conversion of a contribution carryforward into an NOL carryforward, assume that a corporation had adjusted taxable income of \$1 million and a pre-2018 NOL carryforward in excess of that amount. The taxable income for the year would be zero since the NOL carryforward would fully offset the adjusted taxable income. Since the taxable income was zero, no charitable contribution deduction would be allowed. For absorption purposes, the charitable contributions limit would be \$100 thousand (\$1 million multiplied by 10%). If the corporation had available charitable contributions in excess of \$100 thousand, \$100 thousand of charitable contributions would be absorbed and only \$900 thousand of NOLs would be absorbed.

It should be noted that the IRS in Chief Counsel Advice 201928014 (July 12, 2019) took the position that the limitation on conversion of charitable contribution carryforwards into NOL carryforwards is computed on a carryforward year-by-year basis. The ruling explains that if a taxpayer had an NOL carryforward from both 2012 and 2013, the limit would be computed first for the 2012 NOL and then for the 2013 NOL. CCA 201928014. This approach is complicated and highly controversial. See Amish M. Shah, Bradley M. Seltzer, Graham R. Green, [Ready, fire, aim - IRS Chief Counsel Advisory misses the mark in NOL carryforward position that contravenes the TCJA | Martindale.com](#) (Aug. 7, 2019) (last accessed on May 28, 2022).

Capital Losses

Corporations are only permitted to deduct losses from the sale or exchange of capital assets (“capital losses”) to the extent of gains from the sale or exchange of capital assets (“capital gains”). IRC § 1211(a); Treas. Reg. § 1.1211-1(a)(1). The amount that is disallowed (i.e., the excess of losses over gains) in a taxable year is considered a “net capital loss.” IRC § 1222(10); Treas. Reg. § 1.1222-1(e).

If a corporation has a net capital loss in a taxable year, the amount can generally be carried back three taxable years and forward five taxable years. The net capital loss is first carried to the earliest year in which the loss can be carried. The amount of the net capital loss absorbed in a year generally equals the capital gain net income (i.e., the excess of capital gains over capital losses), before taking into account carryforwards or carrybacks. IRC §§ 1212(a)(1), 1222(9); Treas. Reg. § 1.1212-1(a)(3).

A net capital loss cannot be carried back if the carry-back produces or increases an NOL. In such case, the amount of net capital loss absorbed is adjusted accordingly. IRC § 1212(a)(1); Treas. Reg. § 1.1212-1(a)(3)(i)(a). However, a net capital loss can be carried back to take the place of an NOL carryforward that

had previously been deducted. Treas. Reg. § 1.1212-1(a)(3)(iv) Ex. (5). There is no provision to waive the carryback period for a net capital loss.

Special rules apply to certain taxpayers and in certain situations. A foreign expropriation capital loss (i.e., a capital loss attributable to a seizure of assets by a foreign government or similar transaction) cannot be carried back. Instead the loss can be carried forward ten years. IRC § 1212(a)(1), (2). Carrybacks are not available to a taxable year in which the corporation is a RIC or a REIT. IRC § 1212(a)(4). RICs can carry forward net capital losses indefinitely. IRC § 1212(a)(3).

Where a consolidated return is filed, the applicable regulations require that the consolidated group determine the amount of any net capital loss on a consolidated basis (“consolidated net capital loss”). For this purpose, the consolidated net capital loss is determined by taking into account the excess of capital losses over capital gains (computed on a consolidated basis). Treas. Reg. § 1.1502-22(e). In addition, all determinations under section 1222 (including capital gain net income, net long-term capital gain, net capital gain, net capital loss, and net short-term capital loss), as well as section 1231, are determined on a consolidated basis. Treas. Reg. §§ 1.1502-22(a), -23.

The amount of the consolidated net capital loss deduction is the aggregate of the capital loss carryforwards and carrybacks to the year under the principals of section 1212. The amount deductible includes carryforwards and carrybacks of consolidated net capital losses of the group, as well as net capital losses of members arising in separate return years. Treas. Reg. § 1.1502-22(b)(1), (2). These consolidated and separate capital losses are all subject to applicable limitations (e.g., sections 382 and 384).

Charitable Contributions

A corporation’s charitable contribution deduction in any taxable year is limited to 10% of adjusted taxable income. IRC § 170(b)(2)(A). For this purpose, adjusted taxable income is generally computed as if no deduction was allowed for (i) charitable contributions, (ii) special deductions for dividends paid or received under sections 243 through 247, (iii) the FDII deduction, (iv) the GILTI deduction, and (v) NOL and capital loss carrybacks. IRC § 170(b)(2)(D); Treas. Reg. § 1.170A-11(a).

The amount of a charitable contribution that is in excess of the limitation in a taxable year (an “excess contribution”) can generally be carried forward for five taxable years. No carryback is allowed. The current year contributions are deductible before the carryforward of excess contributions from earlier taxable years. IRC § 170(d)(2)(A); Treas. Reg. § 1.170A-11(c)(1).

The calculation will get quite interesting in a taxable year after 2020 in which a corporation deducts both post-2017 NOL carryforwards and charitable contributions. Adjusted taxable income for purposes of the 10% contribution limitation takes into account the deduction of NOL carryforwards (but not carrybacks). IRC § 170(b)(2)(C). Adjusted taxable income for purposes of the 80% NOL limitation takes into account the charitable contribution deduction. IRC § 172(a)(2). Since each limit takes into account the other deduction, in many cases, the two limitations can only be determined based upon recursive calculations (or simultaneous linear equations). *See* CCA 201226021 (Mar. 13, 2012) (interplay with 90% limit under AMT). *See* the discussion of circularity problems in Section 1.C above for additional discussion as to how resolve these issues.

Where a consolidated return is filed, the applicable regulations require that the consolidated group determine the amount of any charitable contribution deduction on a consolidated basis. For this purpose, the amount of charitable contributions by members of the group are aggregated. The 10% limitation is determined based on adjusted taxable income, computed on a consolidated basis (“adjusted consolidated

taxable income”). Treas. Reg. § 1.1502-24(a), (c). The amount deductible includes carryforwards of consolidated charitable contribution deductions of the group, as well as charitable contribution deductions of members arising in separate return years. Treas. Reg. § 1.1502-24(b). These consolidated and separate charitable contribution carryforwards are all subject to applicable limitations (e.g., SRLY).

Business Interest Expense

The TCJA amended section 163(j) to limit the deduction of business interest expense by a corporation to generally the sum of (i) 30% of adjusted taxable income, and (ii) business interest income. The CARES Act changed the percentage to 50% for taxable years beginning in 2019 or 2020 (for partnerships, 2020 only). IRC § 163(j)(1), (10)(A) (as amended by the TCJA and the CARES Act); Treas. Reg. § 1.163(j)-2(b)(1), (2).

The new section 163(j) limitation rules apply to taxable years beginning after December 31, 2017. TCJA § 13301(a). There are exceptions to the application of section 163(j) for electing corporations engaged in a real estate or farming business. IRC § 163(j)(3), (7)(A); Treas. Reg. §§ 1.163(j)-1(b)(13), (14), -2(d), -9. There are also special rules for interest incurred with regard to the financing of motor vehicle inventory. IRC § 163(j)(1)(C), (9); Treas. Reg. § 1.163(j)-1(b)(19).

Section 163(j) does not apply to small businesses. This exemption applies to corporations with average gross receipts of less than \$26 million (for 2019 through 2021 and adjusted for inflation in other taxable years) over, generally, the prior three taxable years. IRC §§ 163(j)(3), 448(a)(3), (c)(1), (4); Treas. Reg. § 1.163(j)-2(d)(1); Temp. Reg. § 1.448-1T(f); Rev. Proc. 2020-45, 2020-46 IRB 1016, § 3.31. For purposes of the gross receipts test, the gross receipts of predecessors and related parties are taken into account. IRC § 448(c)(2), (3)(D); Temp. Reg. § 1.448-1T(f)(2)(ii). The exemption does not apply to tax shelters (including an entity or arrangement for which reduction or evasion of federal income tax is a significant purpose). IRC §§ 448(d)(3), 461(i)(3), 6662(d)(2)(C)(ii); Treas. Reg. § 1.6662-4(g)(2); Temp. Reg. § 1.448-1T(b).

The BBBB included a proposal to provide an additional limitation on the deduction of interest by domestic corporation that are members of an international financial reporting group (IFRG). This provision, if enacted, would generally apply to US subsidiaries of foreign entities with average net interest expense of more than \$12 million. The proposal would require IFRGs to allocate their worldwide net interest expense to their US subsidiaries based on EBITDA and a US subsidiary would be allowed a deduction equal to 110% of the allocated amount. The proposed limit would not apply to small businesses, S corporations, REITs or RICs. Any amount disallowed under the proposal would carryforward under rules that are similar to the carryforward of interest under section 163(j). The provision is proposed to be effective for taxable years beginning after December 31, 2022. BBBB § 138111(a), (c), (d). Extensive regulations under section 163(j) were issued in 2020. These regulations generally apply to taxable years beginning on or after November 13, 2020. However, a taxpayer can choose (or can be required) to apply these rules to earlier periods if the taxpayer (and all related parties) consistently applies the section 163(j) regulations to such earlier period in their entirety. For this purpose, a person is a related party if the person has a relationship to the taxpayer described in section 267(b) or 707(b)(1). *See, e.g.*, Treas. Reg. § 1.163(j)-1(c)(1). Under sections 267(b) and 707(b) a person is generally related to another if they are members of a family or there is some element of more than 50% common control. Taxpayers that apply the section 163(j) regulations on a retroactive basis cannot pick and choose the rules that they like. If the taxpayer or a related party applies the rules on a retroactive basis, it appears that all of the rules must be applied by the taxpayer and its related parties.

Under the section 163(j) regulations, interest is broadly defined. It includes amounts that are “paid, received, or accrued as compensation for the use or forbearance of money under the terms” of a debt instrument or contractual arrangement. Treas. Reg. § 1.163(j)-1(b)(22)(i). It also includes (i) original issue discount (OID), (ii) qualified stated interest (QSI), (iii) acquisition discount, (iv) accrued market discount, (v) repurchase premium, (vi) amounts treated as interest (or ordinary income, loss, or expense, in certain cases) under provisions of the Code or the Treasury regulations, including sections 467 (deferred rental payments), 483 (deferred payments), 988 (foreign currency transactions), 7872 (foregone interest). However, this is not an exclusive list. Treas. Reg. § 1.163(j)-1(b)(22)(i-iii). In addition, the section 163(j) regulations provide for an anti-abuse rule that treats an expense or loss as interest expense if the principal purpose of the transaction structure is to avoid treating an amount as interest expense. A similar anti-abuse rule applies if a transaction is structured to artificially increase the amount of interest income. Treas. Reg. § 1.163(j)-1(b)(22)(iv), (v).

All of the interest expense and interest income of a C corporation is considered to be business interest expense and income. Treas. Reg. § 1.163(j)-4(b)(1). In addition, all items of income, gain, deduction, or loss of a C corporation are treated as allocable to a trade or business and generally taken into account for purposes of computing adjusted taxable income. Treas. Reg. § 1.163(j)-4(b)(2).

Taxpayers are permitted to elect to use the amount of adjusted taxable income for 2019 for purposes of determining the limitation for 2020. IRC § 163(j)(10)(B) (as amended by the CARES Act); Treas. Reg. § 1.163(j)-2(b)(3); Rev. Proc. 2020-22 § 6.02, 2020-18 IRB 592. In addition, taxpayers are permitted to elect to apply a 30% limit (instead of 50%) for 2019 and 2020. IRC § 168(j)(10)(A)(iii) (as amended by the CARES Act); Treas. Reg. § 1.163(j)-2(b)(2)(ii); Rev. Proc. 2020-22 § 6.01. It appears that the elections for 2019 and 2020 can be independent of each other.

Adjusted taxable income for purposes of the section 163(j) limitation generally equals taxable income adjusted for (i) interest income and expense, (ii) NOL deductions, and (iii) deductions for depreciation, depletion, and amortization. This is commonly referred to by many as the EBITDA (i.e., earnings before interest, taxes, depreciation, and amortization) limitation. The adjustment for depreciation, depletion, and amortization only applies for taxable years beginning before January 1, 2022. The amount of adjusted taxable income in a taxable year is zero if the amount would otherwise be a negative amount. IRC § 163(j)(8)(A); Treas. Reg. §§ 1.163(j)-1(b), -4(b)(1), (2).

The section 163(j) regulations define adjusted taxable income as equal to “tentative taxable income” with adjustments. Treas. Reg. § 1.163(j)-1(b)(1). Tentative taxable income generally equals taxable income computed without regard to the section 163(j) limitation or the deduction of disallowed business interest expense carryforwards. Treas. Reg. § 1.163(j)-1(b)(43)(i). As a result, a full deduction is allowed for current-year business interest expense in computing tentative taxable income. Adjustments to tentative taxable income apply to RICs, REITs, and cooperatives. Treas. Reg. § 1.163(j)-4(b)(4), (6).

The section 163(j) regulations provide for adjustments (some of which differ from the items described in the statute). These additions and subtractions are only taken into account to the extent included in the computation of tentative taxable income. Adjustments that increase tentative taxable income include (i) business interest expense (other than disallowed business interest expense carryforwards), (ii) NOL deductions, (iii) deductions for depreciation, depletion, and amortization (before taxable years beginning before January 1, 2022), and (iv) deductions for a capital loss carryback or carryover. Adjustments that decrease tentative taxable income include (i) business interest income, (ii) recapture of prior depreciation, amortization, or depletion deductions (including adjustments to basis of stock or partnership interests) upon a sale or other disposition of the property (or the sale or dispositions of the stock of a member of a consolidated group or an interest in a partnership), and (iii) excess inclusions of subpart F income and

GILTI (as described in more detail below). Treas. Reg. § 1.163(j)-1(b)(1)(i), (ii). Other adjustments apply to RICs, REITs, and cooperatives. Treas. Reg. § 1.163(j)-4(b)(4), (6).

Domestic corporations are required to reduce adjusted taxable income by the amount of any “specified deemed inclusion” that is taken into account in determining tentative taxable income. For this purpose, a specified deemed inclusion is an inclusion of subpart F income or GILTI (including related section 78 inclusions) with respect to a CFC. The amount of the reduction with respect to a specified deemed inclusion is reduced by the section 250 deduction that is allocable to the specified deemed inclusion. Treas. Reg. § 1.163(j)-1(b)(1)(ii)(G).

Regulations have been proposed that permit US shareholders of a CFC to increase their adjusted taxable income by the excess taxable income of a CFC. These rules are still in proposed form as the final regulations reserved on these provisions to allow for further study of the appropriate methodology. Treas. Reg. § 1.163(j)-7(j). The excess taxable income adjustment is not permitted if a safe harbor election is in effect for the CFC or the CFC group. Prop. Reg. § 1.163(j)-7(j)(3).

Excess taxable income equals the CFC’s adjusted taxable income multiplied by a fraction. The numerator of the fraction equals the excess of (i) the 30% or 50%, as the case may be, of adjusted taxable income, over (ii) net business interest expense (i.e., excess business interest expense over business interest income). The denominator equals 30% or 50%, as the case may be, of adjusted taxable income. Appropriate adjustments are made to the determination of excess taxable income if an election is made to apply section 163(j) on a group basis. Prop. Reg. § 1.163(j)-7(j)(2), (4).

The amount of the excess taxable income adjustment equals the adjustment for specified deemed inclusions attributable to the CFC (excluding adjustments for section 78) multiplied by (i) the CFC’s excess taxable income, over (ii) the CFC’s adjusted taxable income. The adjustment is limited to 100% of the specified deemed inclusion. Prop. Reg. § 1.163(j)-7(j)(1).

Taxpayers are generally permitted to apply the excess taxable income adjustment if the taxpayer (and all related parties) consistently applies all of the proposed section 163(j) regulations applicable to CFCs (except to the extent final regulations apply). Prop. Reg. § 1.163(j)-7(m)(2); TD 9943, 86 Fed. Reg. 5496, 5513 (Jan. 19, 2021).

The IRS is permitted to provide for other adjustments in determining adjusted taxable income (in addition to the items mentioned in the statute). IRC § 163(j)(8)(B). It is possible that these adjustments can be provided for in IRS form instructions or other guidance, in addition to regulations. Since the section 163(j) regulations do not generally apply until 2021, it is possible that taxpayers must take into account potential sub-regulatory guidance in determining adjusted taxable income before 2021. The current version of the instructions for Form 8990 states that taxpayers should take into account additions and reductions described in published guidance in determining adjusted taxable income. IRS, Instructions for Form 8990, p. 6 (Rev. May 2020). Since there have not been any pronouncements in published guidance, it appears that taxpayers that do not adopt the section 163(j) regulations early should apply only apply the adjustments described in the statute in determining adjusted taxable income in 2018 through 2020 taxable years.

The disallowed interest is carried forward indefinitely. IRC § 163(j)(2) (as amended by the TCJA); Treas. Reg. §§ 1.163(j)-2(c), -5(b). Current year interest is deductible before disallowed interest from a prior year. As to prior year disallowed interest, the interest is deducted in order of the taxable year (i.e., earliest first). Treas. Reg. § 1.163(j)-5(b)(2).

Section 163(j) is one of many provisions that regulate the allowance and timing of deductions of interest expense. Applicable regulations provide that section 163(j) only applies to business interest expense that would be deductible in the current taxable year (without regard to section 163(j)). Thus, section 163(j) generally applies after the application of provisions that would subject a deduction of business interest expense to disallowance, deferral, or capitalization. In addition, section 163(j) generally applies after other limitations. Exceptions to this ordering rule are only available if provided for in section 1.163(j)-2 of the Treasury regulations. Treas. Reg. § 163(j)-2(b)(1).

Business interest expense does not include interest that is permanently disallowed as a deduction. There are no exceptions to this rule. Examples of such provisions include section 163(e)(5)(A)(i) (AHYDO), 163(f) (debt not in registered form), 163(l) (debt payable in equity), 163(m) (IRS interest on nondisclosed reportable transaction), 264(a) (debt issued in connection with life insurance), 265 (debt issued in connection with tax-exempt income), 267A (hybrid transactions and hybrid entities), and 279 (acquisition debt). Treas. Reg. § 163(j)-2(b)(2), (c)(1). Any reduction in the dividends received deduction pursuant to section 246A (debt-financed portfolio stock) is treated as a reduction in the amount of interest expense for purposes of section 163(j). Treas. Reg. § 163(j)-2(b)(6).

Provisions of the Code that defer the deductibility of interest expense generally apply before section 163(j). Examples of such provisions include sections 163(e)(3) (OID earned by related foreign persons), 163(e)(5)(A)(ii) (AHYDO), 267(a)(2) (matching rule for related taxpayers), 267(a)(3) (interest paid to related foreign persons), 1277 (interest allocable to market discount), and 1282 (acquisition discount on short-term obligations). Treas. Reg. § 163(j)-2(b)(3), (c)(2).

Section 163(j) is applied before the limitation rules of sections 465 (at risk) and 469 (passive activity losses). However, sections 465(l) and 469 are taken into account for purposes of determining tentative taxable income. Treas. Reg. § 163(j)-1(b)(3)(i), -2(b)(3), (4), (c)(3-6).

Provisions of the Code that require the capitalization of interest expense apply before section 163(j). There are no exceptions to this rule. Examples of such provisions include sections 263A (UNICAP) and 263(g) (straddles). This rule can result in the recast of business interest expense (subject to section 163(j)) into a depreciation or loss deduction (that is not subject to section 163(j)). Treas. Reg. § 1.163(j)-2(b)(5), (c)(7). Ordering rules are provided by the section 163(j) regulations to determine whether interest expense is capitalized under section 263A(f) (interest allocable to produced property). Treas. Reg. § 1.263A-9(g).

Consolidated Groups. Where a consolidated return is filed, the section 163(j) regulations require that the consolidated group determine the amount of any section 163(j) limitation on a consolidated basis. For this purpose, the consolidated business interest deduction is limited by the section 163(j) limitation (computed on a consolidated basis). The consolidated group's current-year business interest expense and business interest income equals the sum of each member's separate amounts. Adjusted taxable income is computed on a consolidated basis by making adjustments to consolidated taxable income. For purposes of determining the consolidated business interest expense deduction, intercompany transactions and intercompany obligations are ignored. Treas. Reg. § 1.163(j)-4(d).

Unlike other tax attributes discussed in this paper, business interest expense is not a consolidated tax attribute. Instead each member deducts its own business interest expense based on the section 163(j) limitation (computed on a consolidated basis). The excess amount is carried forward by the member as a disallowed business interest expense (subject to the section 163(j) limitation, computed on a consolidated or separate basis depending on the member's status in the subsequent taxable year). Treas. Reg. § 1.163(j)-5(b)(3)(ii)(A), (C)(5), (iii).

If the consolidated group's section 163(j) limitation exceeds the aggregate of each member's current-year business interest expense and disallowed business interest expense carryforwards, then no portion of the business interest expense deductions for the current year are disallowed by section 163(j). Treas. Reg. § 1.163(j)-5(b)(3)(ii)(B).

If the aggregate of each member's current-year business interest expense and disallowed business interest expense carryforwards exceeds the consolidated group's section 163(j) limitation, then ordering rules apply that determine the deductions by each member. In such case, current-year business interest expense of the members is deducted before any disallowed business interest expense carryforwards. The disallowed business interest expense carryforwards of the members are deducted in the order of the taxable year in which they arose, beginning with the earliest taxable year. Treas. Reg. § 1.163(j)-5(b)(3)(ii)(A).

The ordering rules require that the group first determine whether the group's section 163(j) limitation equals or exceeds the aggregate of each member's current-year business interest expense. If the limitation exceeds such aggregate, then none of the current-year business interest expense is disallowed. Treas. Reg. § 1.163(j)-5(b)(3)(ii)(C)(1).

Any limitation that is in excess of the aggregate current-year deduction, is used to allow deductions of disallowed business interest expense carryforwards. Disallowed business interest expense carryforwards of the members are deducted in the order of the taxable year in which they arose, beginning with the earliest taxable year (based on date in which the taxable year ends). If the aggregate disallowed business interest expense of the members for taxable years ending on the same date cannot be fully deducted, then they are deducted on a pro rata basis. For example, if the limitation available for a disallowed business interest expense from 2018 is \$100 million and two members have carryforwards from 2018 of \$210 million and \$90 million, then the members would deduct \$70 million and \$30 million, respectively. The remaining \$140 million and \$60 million, respectively, would be carried forward by the two members to a subsequent taxable year. Treas. Reg. § 1.163(j)-5(b)(3)(ii)(C)(4).

If the aggregate of each member's current-year business interest expense exceeds the group's section 163(j) limitation, then each member is allowed to deduct current-year business interest expense to the extent of the member's current-year business interest income. Treas. Reg. § 1.163(j)-5(b)(3)(ii)(C)(1)(ii), (2). If the group has a remaining section 163(j) limitation (i.e., the group's section 163(j) limitation less amounts deducted as described in the prior sentence), then that limitation is used to allow other deductions of current-year business interest expense. In such case, each member deducts its allocable share of the group's remaining section 163(j) limitation. A member's allocable share equals the product of (i) the group's remaining section 163(j) limitation, and (ii) the member's "current-year interest ratio." A member's current-year interest ratio equals the ratio of the member's remaining current-year business interest expense to the aggregate of all of the member's remaining current-year business interest expense. A member's remaining current-year business interest expense equals the amount of the member's current-year business interest expense reduced by the business interest expense that was deducted against current-year business interest income (as described in the first sentence of this paragraph). Treas. Reg. § 1.163(j)-5(a)(2), (b)(3)(ii)(C)(3).

An example of how to apply section 163(j) to the members of a consolidated group can be found at section 1.163(j)-5(b)(3)(iv) of the Treasury regulations.

The amount eligible for deduction by a consolidated group includes disallowed business interest expense carryforwards of members of the group, as well as disallowed business expense carryforwards of members arising in separate return years. Treas. Reg. § 1.163(j)-5(b)(3)(i). These consolidated and separate deductions are all subject to applicable limitations (e.g., section 382).

One would have expected regulations on how to apply section 163(j) to a consolidated group to be found in a section that began with “1.1502-” and not “1.163(j)-.” Not issuing consolidated regulations under section 1502 is a rare occurrence. It is not clear as to why that occurred in this case. The location of the consolidated section 163(j) rules should not have any substantive difference in treatment as they were issued under the authority of section 1502, as well as section 7805. TD 9905, 85 Fed. Reg. 56686, 56756 (2020).

Partnerships and S corporations. Below is a discussion of the application of section 163(j) to partnerships and S corporations. One might question why there is a discussion of the treatment of partnerships and S corporations in a section 382 paper. The deduction of excess business interest expense (allocated from a partnership) by a C corporation can be subject to section 382 if the C corporation has an ownership change. Similarly, the deduction of business interest expense by an S corporation can be subject to section 382 if the S corporation has an ownership change. Treas. Reg. § 1.163(j)-6(l)(10).

Section 163(j) also applies to partnerships and S corporations. In both such cases, the limitation applies at the entity level. As a result, the business interest expense of a partnership or S corporation is generally limited to the sum of (i) 30% (or 50% in 2020 for a partnership, or 2019 or 2020 with respect to S corporations) of adjusted taxable income, and (ii) business interest income. For this purpose, business interest expense and income (and adjusted taxable income) only takes into account items that are allocable to a trade or business. IRC § 163(j)(4)(A), (D), (5-8); Treas. Reg. § 1.163(j)-6(a), (b), (d), (l).

The BBBB, if enacted, would change the way in which section 163(j) applies to partnerships and S corporations. Under the proposal, section 163(j) would apply to partners and shareholders on a look-through basis from a partnership or S corporation. The proposed effective date of the change is for taxable years beginning after December 31, 2022. BBBB § 138111(b), (d), (e).

Generally, a partner in a partnership and a shareholder in an S corporation does not take into account its distributable share of partnership or S corporation items in determining the partner/shareholder’s adjusted taxable income. However, if the partnership or S corporation has excess taxable income, the distributable share of such amount is taken into account for purposes of determining adjusted taxable income of the owner. Excess taxable income equals the entities’ adjusted taxable income multiplied by a fraction. The numerator of the fraction equals the excess of (i) the 30% or 50%, as the case may be, of adjusted taxable income, over (ii) net business interest expense (the excess of expense over income). The denominator equals 30% or 50%, as the case may be, of adjusted taxable income. IRC § 163(j)(4)(A)(ii); Treas. Reg. §§ 1.163(j)-1(b)(17), -4(b)(3), -6(e)(1), (f), (l)(4)(i).

Where a partnership (but not an S corporation) has business interest expense in excess of the section 163(j) limitation, the excess is allocable to the partners (and cannot be deducted by the partnership in a subsequent taxable year). This excess business interest expense can be deducted by the partner in a subsequent taxable year but only to the extent the partnership allocates an amount of excess taxable income (i.e., excess of adjusted taxable income over business interest expense) or excess business interest income (i.e., excess of business interest income over business interest expense) to the partner in a subsequent taxable year. IRC § 163(j)(4)(B-D); Treas. Reg. § 1.163(j)-6(b)(4), (g).

All of the activities of a C corporation are considered to be allocable to a trade or business and generally taken into account for section 163(j) purposes. Treas. Reg. § 1.163(j)-4(b)(1), (2). This rule does not apply to S corporations. Instead, interest income and expense (as well as other items of income, gain, deduction, or loss) are generally treated as related to investment or business activities (or other activities). The portion related to investment activities are allocated to the shareholders for purposes of determining the investment interest limitation of section 163(d) (determined at the shareholder level). Treas. Reg. § 1.163(j)-6(l)(9). The portion related to business activities is subject to section 163(j) at the S corporation level.

The treatment of investment activities is more complicated with respect to a partnership since the partners can consist of C corporations and other types of taxpayers. Like an S corporation, a partnership must determine the allocation of interest income and expense (as well as other items of income, gain, deduction, or loss) between investment and business activities (or other activities). The portion related to business activities is subject to section 163(j) at the partnership level. Treas. Reg. § 1.163(j)-4(b)(3)(ii).

The portion of items related to investment activities of the partnership are allocated to the partners. The treatment of items related to investment activities differ depending upon the tax status of the partners. Partners that are not C corporations treat items related to investment activities as relevant for purposes of determining the partner's investment interest limitation of section 163(d). Treas. Reg. § 1.163(j)-6(k).

Partners that are C corporations treat items related to investment activities of a partnership as related to business activities of the partner. Similar treatment applies to items that are not related to investment or business activities of a partnership. Such items are treated by the C corporation partner as items related to business activities for section 163(j) purposes. Treas. Reg. § 1.163(j)-4(b)(3)(i), -6(o)(11). As a result of these rules, investment interest expense (and other interest expense) allocated by a partnership to a C corporation partner is treated as business interest expense, but is not treated as excess business interest expense of the partnership. Similarly, investment interest income (and other interest income) allocated by a partnership to a C corporation partner is treated as business interest income, but is not treated as excess taxable income of the partnership. Treas. Reg. §§ 1.163(j)-4(b)(3)(i), (iii), -6(o)(11).

Regulations were proposed in 2020 regarding the allocation of interest expense by a passthrough entity (partnership or S corporation) among investment, business, and other activities. These rules would generally require the allocation of interest expense based on the allocation of the underlying debt obligation. A debt obligation is allocated among activities by tracing disbursements of the debt proceeds to specific expenditures. For example, if money is borrowed to purchase shares of stock of a corporation, the debt obligation (and the related interest expense) would generally be allocable to investment activities. Prop. Reg. § 1.163-14. These proposed rule are similar to existing rules on allocations between investment and other activities. Temp. Reg. § 1.163-8T. The proposed regulations are generally proposed to be applicable to taxable years beginning on or after 60 days after finalization. A taxpayer can choose (or can be required) to apply the proposed regulations before their applicability date. This is available if the taxpayer (and all related parties) consistently apply the proposed regulations in their entirety. Prop. Reg. § 1.163-14(i).

A trade or business of a partnership or S corporation can be exempt from section 163(j) (e.g., elective exemption for real estate trade or business). In such case, the business interest expense of the partnership or S corporation related to the excepted trade or business is not subject to section 163(j) (either at the entity level or the partner or shareholder level). Other items related to the excepted trade or business are not taken into account by the partner or shareholder in computing the section 163(j) limitation. Treas. Reg. §§ 1.163(j)-6(m)(2), (o)(13), -10(c).

A partnership or S corporation could be excluded from the application of section 163(j) under the small business exemption. Such a partnership or S corporation is referred to as an exempt entity. The business interest expense of an exempt entity is not subject to section 163(j) at the entity level or the partner/shareholder level. However, the partner or shareholder takes into account its allocable share of business interest income and expense (and other relevant items) in determining its adjusted taxable income. There are two exceptions to this rule. First, items that are allocable to an excepted trade or business of the exempt entity are not taken into account in determining adjusted taxable income. Second, items that are allocated from an exempt entity cannot reduce a partner/shareholder's adjusted taxable income. That is, if the amount of loss and deduction allocated from the exempt entity exceeds the amount of income and gain

(a net loss allocation), the partner/shareholder does not reduce its adjusted taxable income by the amount of the net loss allocation. Treas. Reg. § 1.163(j)-6(m)(1), (o)(11), (12).

If a partnership that is an exempt entity has items that are allocable at the entity-level to investment activities, a C corporation partner treats the allocable share of investment income and expense as business income or expense. This is the same treatment that would apply to such items if the partnership was not an exempt entity. For example, if a partnership that is an exempt entity allocates \$45 of business interest expense and \$20 of investment interest expense to a C corporation, the partner would treat the \$20 as business interest expense subject to section 163(j). But the \$45 would not be treated by the partner as business interest expense. Treas. Reg. §§ 1.163(j)-4(b)(3)(i), -6(o)(11), (12).

If a partner is allocated excess business interest expense from a partnership in one taxable year and in a subsequent taxable year the partnership becomes an exempt entity, then the partner can generally deduct the excess business interest expense in the subsequent taxable year. However, the interest expense in the subsequent taxable year is potentially subject to the section 163(j) limitation, determined at the partner level. If the excess business interest expense is attributable to an excepted trade or business of the partnership (determined in the subsequent taxable year), then the interest expense is not subject to section 163(j). Treas. Reg. § 1.163(j)-6(m)(3), (o)(14-16).

If an S corporation has a disallowed business interest expense carryforward for a taxable year and in a subsequent taxable year the S corporation becomes an exempt entity, then the disallowed business interest expense continues to be carried forward at the S corporation level. The interest is not subject to section 163(j) in any taxable year the S corporation is an exempt entity. The interest expense is taken into account in determining the non-separately stated taxable income or loss of the S corporation. Treas. Reg. § 1.163(j)-6(m)(4). That is, the amount can be deducted but is subject to normal limitations on the deduction of S corporation items (e.g., basis, at risk, and passive loss limitations).

C Corporation Partner Example 1. Corp (a C corporation) is a partner in PRS with a one third interest. In 2021, PRS has (i) trade or business income (without taking into account business interest income or expense) of \$150 million, (ii) business interest income of \$30 million, (iii) business interest expense of \$45 million, (iv) investment income of \$90 million, and (v) investment interest expense of \$60 million.

PRS is subject to section 163(j) and must determine its limitation. The section 163(j) limitation equals \$75 million (\$150 million times 30%, plus \$30 million). Since this is in excess of the amount of business interest expense of \$45 million. PRS can deduct the full amount of the business interest expense. Thus, PRS will have business income of \$135 million (\$150 million, plus \$30 million, minus \$45 million).

PRS will have an excess taxable income of \$100 million. PRS's adjusted taxable income equals \$150 million. The numerator of the fraction equals \$30 million (\$45 million (\$150 million times 30%), less the excess of \$45 million over \$30 million). The denominator of the fraction equals \$45 million (\$150 million times 30%).

PRS will allocate to Corp, (i) business income of \$45 million, (ii) investment income of \$30 million, (iii) investment interest expense of \$20 million, and (iv) excess taxable income of \$33.3 million. Corp will treat the investment income and investment interest expense as business income and business interest expense respectively.

Corp will have adjusted taxable income of \$63.3 million (\$33.3 million plus \$30 million). The investment income counts but the business income does not. As a result, Corp has a section 163(j) limitation of \$19 million (\$63.3 million times 30%).

Corp will be treated as having business interest expense of \$20 million (the investment interest expense allocated by the PRS). As a result, Corp can deduct \$19 million of the interest and can carry the remaining \$1 million to 2022.

C Corporation Partner Example 2. Same as Example 1, except PRS is an exempt entity.

PRS is not subject to section 163(j). As a result, the business interest expense of PRS is not subject to limitation. PRS will allocate to Corp the same items as in Example 1 (other than excess taxable income).

Corp will have adjusted taxable income of \$75 million (\$45 million plus \$30 million). In this example, both the investment and business income count. As a result, Corp has a section 163(j) limitation of \$22.5 million (\$75 million times 30%).

Corp will be treated as having business interest expense of \$20 million (the investment interest expense allocated by the PRS). As a result, Corp can deduct the full \$20 million of the interest, as well as the allocable share of business interest expense of PRS that is not subject to section 163(j). *See* Treas. Reg. § 1.163(j)-6(o)(11).

Foreign Corporations - ECI. Regulations were proposed in 2020 regarding the application of section 163(j) to foreign corporations with ECI. The proposed section 163(j) regulations are generally proposed to be applicable to taxable years beginning on or after 60 days after finalization. Prop. Reg. § 1.163(j)-8(j). For taxable years beginning on or after November 13, 2020, a taxpayer can choose (or can be required) to apply the proposed regulations before their applicability date. This is available if the taxpayer (and all related parties) consistently applies the proposed regulations in their entirety. For this purpose, a person is a related party if they have a relationship to the taxpayer described in section 267(b) or 707(b)(1).

Taxpayers (and their related parties) who choose to apply the final section 163(j) regulations to pre-2021 taxable years can also rely on the proposed regulations for those earlier taxable years. However, taxpayers who do not choose to rely on the section 163(j) regulations for pre-2021 taxable years cannot rely on the proposed regulations for such earlier taxable years. REG-107911-18, 85 Fed. Reg. 56846, 56874 (2020).

If a foreign corporation has ECI in a taxable year, section 163(j) would apply by only taking into account items that are ECI or allocable to ECI. As a result, adjusted taxable income, business interest expense, and business interest income only take into account items that are ECI or allocable to ECI. Prop. Reg. § 1.163(j)-8(b), (g)(27), (h)(1), (2). The proposed rules also provide for rules regarding (i) investments in partnerships with ECI by foreign corporations, (ii) allocations of deductible and disallowed business interest expense to ECI, and (iii) coordination of section 163(j) with section 1.882-5 of the Treasury regulations. Prop. Reg. § 1.163(j)-8(c-g), (h)(3), (4).

CFCs - GILTI. Two sets of regulations were issued in 2020 on the application of section 163(j) with respect to GILTI. However, large parts of the existing regulations are still in reserved or proposed form. The basics of section 163(j) are discussed below in subsection D below.

Under the regulations, section 163(j) applies to a CFC for GILTI purposes in the same manner as the provision applies with respect to a domestic C corporation. Treas. Reg. § 1.163(j)-7(b). Tentative taxable

income (taxable income before the application of section 163(j)) for GILTI purposes is determined by taking into account gross income and allowable deductions under the principles of section 1.952-2 of the Treasury regulations. Treas. Reg. § 1.163(j)-7(g)(1). The regulations do not provide for other rules regarding the determination of adjusted taxable income.

The rules described in the previous paragraph generally apply to taxable years beginning on or after November 13, 2020. However, a taxpayer can choose (or can be required) to apply these rules to earlier periods if the taxpayer (and all related parties) consistently applies the section 163(j) regulations to such earlier period in their entirety. Treas. Reg. § 1.163(j)-7(m)(1), (3)(i).

A “CFC group” is permitted to elect to apply section 163(j) on a group-wide basis. Where this election applies, a single section 163(j) limitation is computed for a CFC group. For this purpose, the current-year business interest expense, disallowed business interest expense carryforward, business interest income, and adjusted taxable income are all determined on a group basis. The separate respective amounts for each group member for the taxable year are added together to determine the group amount. Treas. Reg. § 1.163(j)-7(c)(2)(i).

Generally, the adjusted taxable income of a taxpayer cannot be less than zero. Treas. Reg. § 1.163(j)-1(b)(1)(vii). In determining the separate adjusted taxable income of a group member, the amount can be negative. However, the adjusted taxable income of the CFC group cannot be less than zero. Treas. Reg. § 1.163(j)-7(c)(2)(i).

If the CFC group’s section 163(j) limitation for the current year equals or exceeds the aggregate amount of the group’s current-year business interest expense and disallowed business interest expense carryforwards, then none of the interest expense of the members of the group is subject to disallowance by section 163(j) in the current taxable year.

If, on the other hand, the reverse is true, then the limitation will limit the business interest expense deduction of the members of the CFC group. In such case, business interest expense of the group is deductible to the extent of the limitation. The current-year business interest expense of the group is deductible (up to the limitation) first. After that, disallowed business interest expense carryforwards are deductible (up to the unused limitation) in the order of the taxable year in which they arose (beginning with the earliest year).

Where the CFC group’s current-year or carryforward amount is in excess of the available limitation, the deductible amount is allocated among the members based on their gross amount. Treas. Reg. §§ 1.163(j)-5(a)(2), (b)(3)(ii), -7(c)(3)(i). For example, if the group’s section 163(j) limit is \$100 million and two members have a current-year business interest expense of \$140 and \$60 million respectively, then the members would be permitted a current year deduction of \$70 and \$30 million respectively (and would each carryforward the remainder to the following taxable year). Treas. Reg. § 1.163(j)-5(b)(3)(ii)(C)(4).

An anti-abuse rule applies with respect to transactions between group members that are entered into with a principal purpose of affecting the section 163(j) limitation (either on a group or separate member basis) by increasing or decreasing adjusted taxable income or business interest income. In such case, the transaction is disregarded for purposes of applying section 163(j). Treas. Reg. § 1.163(j)-7(c)(2)(ii).

A “CFC group” is defined as one or more chains of CFCs connected through stock ownership with a group parent if the group parent owns (directly, or indirectly by attribution) 80% or more of the stock (by vote and value, not counting pure preferred stock) of at least one other CFC. The members of the CFC group include (i) the group parent (if it is a CFC), and (ii) each CFC (other than the group parent) the stock of which is owned (directly, or indirectly by attribution) 80% or more (by vote and value, not counting

preferred stock) by a member of the group. For this purpose, a group parent can be (i) a CFC, (ii) an individual that is a citizen or resident of the US, or (iii) a domestic corporation. IRC § 7701(a)(30)(A), (C); Treas. Reg. § 1.163(j)-7(d), (e)(2), (l)(1), (2).

An election to apply section 163(j) on a group basis is generally made (or revoked) by each “designated US person” on a timely-filed (including extensions) original tax return. Treas. Reg. § 1.163(j)-7(e)(5)(iii), (iv). A designated US person is the group parent (if a US person) or the controlling domestic shareholders of the group parent (if the group parent is a CFC). Treas. Reg. § 1.163(j)-7(k)(12)(ii). The controlling domestic shareholders are generally US shareholders who, in the aggregate, own more than 50% of the stock of the group parent (by vote), directly or indirectly by attribution. Treas. Reg. §§ 1.163(j)-7(k)(12)(ii), 1.964-1(c)(5)(i).

A CFC group election continues to apply to the group until revoked, the group ceases to exist, or the election ceases to be relevant. Treas. Reg. § 1.163(j)-7(e)(3), (5)(i). Once made, the election cannot generally be revoked for sixty months (i.e., five years) and once revoked cannot be made again generally for sixty months. Treas. Reg. § 1.163(j)-7(e)(5)(ii).

The section 163(j) regulations with respect to the group election generally apply to taxable years beginning on or after March 22, 2021. However, a taxpayer can choose (or can be required) to apply these rules to earlier periods if the taxpayer (and all related parties) consistently applies the section 163(j) regulations to such earlier period in their entirety. Treas. Reg. § 1.163(j)-7(m)(2), (3)(ii). A taxpayer can also choose to apply the version of the group election that was described in proposed regulations to earlier years. Prop. Reg. § 1.163(j)-7(b)(3), (f)(7); REG-106089-18, 85 Fed. Reg. 67490 (Dec. 28, 2018).

Regulations also permit a safe harbor election to be made for a CFC in certain circumstances. The safe harbor election is intended to simplify the calculation of any GILTI inclusion where section 163(j) is unlikely to disallow any deductions. The election is an annual election. It is made by the controlling domestic shareholders of a CFC (or the parent of a CFC group) and must be made on a timely-filed return (taking into account extensions). Treas. Reg. § 1.163(j)-7(h)(5).

If the safe harbor election is made then none of business interest expense is disallowed by section 163(j). An election can be made for a stand-alone CFC or a CFC group if the business interest expense for the taxable year is less than or equal to either (i) the business interest income, (ii) 30% or 50%, as the case maybe, of the lesser of (i) tentative taxable income (adjusted for items attributable to excepted trades or businesses), or (ii) the “eligible amount.” The eligible amount generally equals the sum of (i) the subpart F income inclusion, and (ii) the GILTI inclusion (reduced by the applicable section 250 deduction). The eligible amount is computed without regard to the application of section 163(j) and any disallowed business interest expense carryforward. Treas. Reg. § 1.163(j)-7(h)(1-4), (6).

The section 163(j) regulations with respect to the safe harbor election generally apply to taxable years beginning on or after March 22, 2021. However, a taxpayer can choose (or can be required) to apply these rules to earlier periods if the taxpayer (and all related parties) consistently applies the section 163(j) regulations to such earlier period in their entirety. Treas. Reg. § 1.163(j)-7(m)(2), (3)(ii).

Tax Credits

Foreign Tax Credits. A corporation generally has the option to either deduct foreign income taxes or avail themselves of the foreign tax credit rules (with limitations). IRC §§ 164(a)(3), 275(a)(4), 901(a), 906; Treas. Reg. § 1.901-1(a)(2), (c). The choice can be made or changed at any time as long as the statute of limitations for making a refund claim is open. IRC § 901(a); Treas. Reg. § 1.901-1(d).

The amount of the credit that is allowed in any taxable year is limited to the portion of the total US federal income tax that is attributable to foreign-source taxable income. IRC § 904(a); Treas. Reg. § 1.904-1(b). The foreign tax credit cannot be used to reduce a corporation's BEAT liability. IRC § 59A(b)(1).

The limitation calculation is performed separately with respect to several statutorily-defined categories (or baskets) of income, including passive income, general income (i.e., income that is not passive income), foreign branch income, income inclusions under the GILTI rules (other than passive income), and income treated as from foreign sources pursuant to a treaty. Excess foreign taxes in one basket cannot be used to offset excess limitation in another basket. IRC § 904(d), (h)(10); Treas. Reg. § 1.904-4.

The BBBB contained provisions that would modify the foreign tax credit limitation rules to apply limitations on a per-country basis. This would be in addition to the current basket limitations. If enacted, this would end the ability to use investments in low-tax countries to increase the limitation on the foreign taxes of high-tax countries. The BBBB would also repeal the foreign branch income basket. The changes are proposed to apply to taxable years beginning after December 31, 2022. BBBB § 138124(a), (b), (h)(1).

If a corporation has excess foreign taxes (i.e., amounts in excess of the limit) in a taxable year with respect to a basket, the amount can generally be carried back one taxable year and forward ten taxable years but can only be used against excess limitation in that basket. No carryback or carryforward is permitted for taxes paid or accrued with respect to the GILTI inclusion basket. The amount of the excess foreign taxes is carried to the earliest taxable year available. However, current year foreign taxes are absorbed before carried amounts. Amounts that cannot be absorbed in a taxable year (i.e., they exceed the excess of the limitation over current year taxes) are carried forward to a subsequent taxable year. IRC § 904(c); Treas. Reg. § 1.904-2(a), (b)(1), (2), (c)(2), (g).

The BBBB, if enacted, would generally eliminate the ability to carryback excess foreign taxes. It would also permit foreign taxes with respect to the GILTI basket to be carried forward for five taxable years (ten taxable years after 2030). The changes are proposed to apply to taxes paid or accrued in taxable years beginning after December 31, 2022. BBBB § 138124(c), (h)(2).

The credit is only available in the carryback or carryforward year if the corporation chooses the benefits of the foreign tax credit rules in the taxable year carried to. IRC § 904(c). In a taxable year in which the credit is not elected, the excess credits are absorbed as if the credit was elected. Treas. Reg. § 1.904-2(d). There is no provision to waive the carryback period for excess foreign taxes.

Where a consolidated return is filed, the applicable regulations require that the consolidated group (and not the members) choose whether the credit or deduction is to be applied for the taxable year. The common parent makes the choice on behalf of the group. Treas. Reg. § 1.1502-4(a).

A consolidated group determines the amount of any foreign tax credit on a consolidated basis under the principals of sections 901 through 905 and 960. For this purpose, the amount of foreign taxes paid or accrued by members of the group are aggregated. Treas. Reg. § 1.1502-4(c). The limitation is determined based on foreign source taxable income (determined on a consolidated basis), consolidated taxable income, and consolidated tax liability. Treas. Reg. § 1.1502-4(d), (j). Presumably, the credit limitation basket rules are also applied on a consolidated basis.

The amount eligible for credit includes carrybacks and carryforwards of unused consolidated foreign tax credits of the group, as well as foreign tax credits of members arising in separate return years. Treas. Reg. § 1.1502-4(e)(1). These consolidated and separate credits are all subject to applicable limitations (e.g., section 383).

General Business Credits. The general business credit is the combination of numerous separate tax credits (including, the investment credit and the research credit). As of the date of this paper, there were 33 separate tax credits in effect. For the full list see section 38(b). The amount of general business credit allowed in a taxable year is generally limited to 75% of the net regular income tax (i.e. net income tax after other credits) for the taxable year. Under current law, general business credits cannot offset BEAT. IRC § 38(c)(1)(B). The BBBB would allow general business credits to offset BEAT for taxable years beginning in 2022 and thereafter. BBBB § 138131(a)(6), (f).

The amount of credit in excess of the limit can generally be carried back one taxable year and carried forward twenty taxable years. IRC § 39(a)(1). The amounts are carried back first and then carried forward. There are specific ordering rules regarding which credit is absorbed first. However, current year credits are used before carryback amounts. The specific credit components of the general business credit are generally absorbed in the order listed in section 38(b) (or with regard to the investment credit, section 46). IRC §§ 38(d), 39(a)(2), (b), (c); Treas. Reg. § 1.46-2(d). There is no provision to waive the carryback period for an excess general business credit.

Some of the general business credits can be used to reduce a corporation's BEAT liability. These include the research credit (section 41) and a portion of (i) the low income housing credit (section 42), (ii) the renewable electricity credit (section 45), and (iii) the energy investment credit (section 48). IRC § 59A(b)(1)(B)(ii), (4).

There is some uncertainty as to how to determine the general business credit where an affiliated group files a consolidated return. Guidance has only been issued with regard to the research credit (section 41). The research credit is determined on a consolidated basis as if all of the members of the consolidated group were a single taxpayer. IRC § 41(f)(1)(A), (5); Treas. Reg. § 1.41-6(d).

Consolidated regulations were issued with regard to the investment tax credit (which was repealed in 1983). Under these rules, each member determined their entitlement to the credit (before limitations) on a separate entity basis. The consolidated credit was determined based upon the aggregate of the separate credits but limited to the relevant percentage of consolidated taxable income. Treas. Reg. § 1.1502-3(a), (b).

Since there is no guidance on the determination of the amount of general business credit (other than with respect to the research credit) regarding consolidated returns, it appears that taxpayers can apply any reasonable approach. *Occidental Petroleum Corp. v. Comm'r*, 82 TC 819, 829 (1984); *Gottesman & Co. v. Comm'r*, 77 TC 1149, 1156 (1981). This could include a single taxpayer approach (by analogy to the research credit rules) or the approach used in the investment tax credit regulations (separate determination but consolidated limitation). It is also possible that taxpayers could determine the credit entirely on a separate company basis. See Treas. Reg. § 1.1502-80(a)(1); *H Enters. Int'l v. Comm'r*, 105 TC 71, 85 (1995) (section 246A and 265(a)(2)); *Gottesman* (accumulated earnings tax); 1995 FSA Lexis 560 (section 265(a)(2)). But see *United Dominion Indus. v. United States*, 532 US 822 (2001) (product liability loss computed on a consolidated basis); *Marvel Entertainment, LLC v. Comm'r*, 145 TC 69, 76-90 (2015) (section 108 attribute reduction applied on a consolidated basis), *aff'd*, 842 F.3d 1291 (2d Cir. 2016).

Minimum Tax Credits. If a corporation incurs an AMT liability (before the repeal of the corporate AMT by the TCJA), the amount of the tax incurred can be carried forward as a credit against regular tax liability (but not carried back) indefinitely. The cumulative prior year AMT liability (not previously taken as a credit) is allowed as a minimum tax credit. IRC § 53(a), (b), (d)(1).

For pre-2018 taxable years, the amount of the minimum tax credit allowed in any taxable year is limited to the excess of the regular tax liability for the year (reduced by credits) over the tentative minimum tax

liability (i.e., the tentative amount of tax owed under AMT rules). IRC §§ 53(c), (d)(2), 55(b) (before amendment by the TCJA). For post-2018 taxable years, the minimum tax credit can fully offset the regular tax liability for the year (after other credits). IRC § 53(c), (d)(2) (after amendment by the TCJA).

As previously stated, the corporate AMT was repealed for taxable years beginning after December 31, 2017. The TCJA increased the limitation on the credit in 2018 through 2021 taxable years so that the entire amount of the credit is refundable over a four taxable year period. In taxable years beginning in 2018 through 2020, the limitation is increased by 50% of the excess of (i) the credit carryforward from the prior taxable year, and (ii) the amount that would otherwise be allowable in the current taxable year. The limitation is increased for the taxable year beginning in 2021 so that 100% of the unused credit is allowable in that taxable year. IRC § 53(e)(1), (2). In the case of a short taxable year, the increase in the credit limitation is reduced to take into account the reduced number of days in the taxable year (i.e., the additional limitation is reduced to the ratio of the number of days in the short taxable year over 365). IRC § 53(e)(4).

The CARES Act changed the timing of the allowance of refundable credits. Under the revisions, the credits are allowable in full over a one or two taxable year period. In the taxable year beginning in 2018, the limitation is increased by 50% of the excess of (i) the credit carryforward from the prior taxable year, and (ii) the amount that would otherwise be allowable in the current taxable year. IRC § 53(e)(1), (2) (as amended by the CARES Act). The remainder is allowable for the taxable year that begins in 2019. However, an election is available to take the entire refundable credit in the taxable year beginning in 2018. IRC § 53(e)(5) (as amended by the CARES Act).

As an example of how the rules work, assume that a corporation has a minimum tax credit carryforward of \$100 million at end of the calendar year 2017 taxable year. If the corporation has no income tax liability in 2018 through 2019, the taxpayer would be eligible to receive a refund in 2018 of \$50 million and the remaining \$50 million in 2019. Alternatively, the taxpayer could elect to receive a refund of the entire \$100 million in 2018.

The normal amount of the minimum tax credit can only be credited against the regular tax liability (reduced by any credits) of a corporation and is not generally refundable (and is potentially subject to limitations under sections 383 and 384). IRC § 53(a), (c). The additional limitation portion of the credit under the TCJA and CARES Acts is refundable as an overpayment (i.e., it can exceed the tax for the year). IRC §§ 53(e)(3), 6401(b)(1).

There is uncertainty as to whether and how section 383 (and other limitation rules) might limit the refundable portion of the minimum tax credit. It is possible that the treatment of refundable minimum tax credits resulting from the repeal of the corporate AMT by the TCJA will be similar to the treatment under section 168(k)(4) (before repeal by the TCJA). As a result, it is possible that minimum tax credits with an increased limitation under section 168(k)(4) may be treated by the IRS as subject to section 383 if there has been an ownership change. Rev. Proc. 2009-16, 2009-1 CB 449, § 2.09, *mod. by*, Rev. Proc. 2009-33, 2009-2 CB 150. It should be noted that the IRS has ruled that section 383 only applied to refundable credits under section 168(k)(4) if the credits were being used to offset regular tax liability. In the situation where the taxpayer has no regular tax liability (e.g., due to an NOL), section 383 did not apply and the taxpayer was entitled to a full refund under section 168(k)(4). CCA 201126029 (Mar. 17, 2011). As a result, it appears that section 383 (or other limitations) will not prevent a full refund of the credit in 2018 or 2019.

The IRS web site states that any refund payments due to refundable minimum tax credits under section 53(e) will not be subject to sequestration. [Effect of Sequestration on the Alternative Minimum Tax Credit for Corporations \(fiscal year 2019\) | Internal Revenue Service \(irs.gov\)](#) (last updated on July 21, 2021).

Proposed regulations were issued in 1992 regarding the computation of the minimum tax credit with respect to consolidated groups. These regulations, if ever finalized, would require the consolidated group to determine the minimum tax credit on a consolidated basis. Prop. Reg. § 1.1502-55(h).

Section 381

Special rules apply if one corporation acquires assets of another corporation in either a section 332 liquidation or an acquisitive asset reorganization (i.e., a type-A, C, or F reorganization or acquisitive type-D or G reorganization). In such case, section 381 allows the acquiring corporation to succeed to specified tax attributes (subject to conditions and limitations) of the transferor or distributing corporation, as the case may be.

For purposes of section 381, the acquiring corporation is the corporation that directly acquires the assets of the transferor or distributing corporation, as the case may be (even if the assets are subsequently transferred to another corporation). IRC § 381(a); Treas. Reg. § 1.381-1(a), (b). The transferor corporation is the corporation that transfers assets in an acquisitive asset reorganization. The distributing corporation is the corporation that distributes assets in a section 332 liquidation. In the below discussion of section 381, both transferor and distributing corporations are referred to as transferor corporations.

Attributes Affected. Where section 381 applies, the acquiring corporation succeeds to the below carryforwards of the transferor corporation:

- NOLs,
- Capital losses,
- Charitable contributions,
- Business interest expense,
- General business credits, and
- Minimum tax credits.

IRC § 381(c)(1), (3), (19), (20), (24), (25); Treas. Reg. §§ 1.381(c)(1)-1 (NOLs), (c)(3)-1 (capital losses), (c)(19)-1 (charitable contributions), (c)(20)-1 (business interest expense), (c)(23)-1 (investment tax credits). Section 381 also provides for the transfer of other tax attributes that are not carryforwards (e.g., E&P and methods of accounting). IRC § 381(c).

If the transferor corporation had previously acquired the assets of another corporation in a transaction governed by section 381(a), the acquiring corporation also succeeds to and takes into account the unused tax attributes of the earlier acquired corporation. These tax attributes are also subject to the conditions and limitations of section 381. Treas. Reg. §§ 1.381(c)(1)-1(g) (NOLs), (c)(3)-1(f) (capital losses), (c)(23)-1(f) (investment tax credits). The section 381 regulations with respect to the carryforward of disallowed business interest expense does not contain any language regarding successive section 381(a) transactions.

Section 381 does not provide for the carryforward of foreign tax credits. Nonetheless, it appears that the acquiring corporation does inherit the foreign tax credits. *See* Boris I Bittker & James S. Eustice, *Federal Income Taxation of Corporations & Shareholders*, ¶ 14.24 (Nov. 2021 update). This is based upon the legislative history of section 383.

Section 383 was enacted in 1971. Revenue Act of 1971, PL 92-178, § 302(a). The pre-1986 version imposed limitations on the use of foreign tax credits (as well as other tax attributes) if an acquisitive asset reorganization resulted in a “change of ownership” (or “change in ownership,” depending on the tax year). IRC § 383 (as in effect before the enactment of the Tax Reform Act of 1986, PL 99-514). Since the

limitation of section 383 could only apply if the acquiring corporation inherited the foreign tax credits, the IRS ruled in Revenue Ruling 80-144, 1980-1 CB 80, that foreign tax credits were inherited by the acquiring corporation after an acquisitive type-D reorganization.

The post-1986 version of section 383 limits foreign tax credit carryforwards if there is an ownership change (without any reference to a reorganization). As a result, there is less certainty as to whether the acquiring corporation still inherits foreign tax credits after an acquisitive reorganization. The IRS has ruled favorably on one occasion after the enactment of the Tax Reform Act of 1986. PLR 201039019 (Sept 24, 2009) (type-F reorganization). In addition, section 1.367(b)-3(d) of the Treasury regulations imposes limitations when a domestic acquiring corporation inherits the foreign tax credits of a foreign transferor corporation. This regulation potentially settles the issue, as there would be no reason for such a rule if the acquiring corporations did not inherit foreign tax credits under general tax principles.

There is some uncertainty as to whether the list of tax attributes in section 381(c) is an exclusive list (and if not, what items are covered). The fact that Congress has specified 23 items under the current version of the Code (and specifies detailed limitations and conditions for their use) suggests that the list is exclusive. In addition, there is no provision in section 381(c) that suggests that similar items are to be taken into account or that the IRS or the Treasury Department can add to the list (by regulation or otherwise).

Notwithstanding the above, the applicable committee reports related to the enactment of the Internal Revenue Code of 1954 states that section 381 “is not intended to affect the carryover treatment of an item or tax attribute not specified in the section or the carryover treatment of an items or tax attributed in corporate transactions not specified in section 381(a).” S. Rep. 83-1622, p 52, 277 (1954). Further, the applicable regulations state that “no inference is to be drawn from the provisions of section 381 as to whether any item or tax attribute shall be taken into account by the successor corporation” where the transaction is not described in section 381(a) or the attribute is not described in section 381(c). Treas. Reg. § 1.381(a)-1(b)(3).

The IRS in rulings has applied pre-1954 law to determine which attributes (not described in section 381(c)) can be taken into account by a successor corporation. Rev. Rul. 68-350 (foreign tax credit), 1968-2 CB 159, *mod. by*, Rev. Rul. 72-452, 1972-2 CB 438, *obsoleted by*, Rev. Rul. 80-144 (obsoleted for years in which section 383 applies). The key problem is that there are only a small number of pre-1954 cases and rulings and only minimal guidance by the IRS.

In Revenue Ruling 59-535, 1959-2 CB 475, the IRS permitted a successor corporation to take into account NOL and excess profits credit carryforwards after a type-A reorganization (and the predecessor corporation to take into account carrybacks from the successor corporation). However, the ruling took into account limitations imposed by the Supreme Court in *Lisbon Shops, Inc. v. Koehler*, 353 US 382 (1957). *Lisbon Shops* has generally been superseded by the continuity of business enterprise (COBE) rule of section 382(c) where an ownership change has occurred and does not apply where section 381 would otherwise apply. Rev. Rul. 80-144. As a result, where carryforwards not described in section 381(c) are taken into account it is possible that *Lisbon Shops* needs to be considered (which requires a tracing of assets).

GCM 38966 (Mar. 3, 1983) provides a digest (and analysis) of the cases and rulings that apply pre-1954 law. This ruling should be consulted when confronting an issue regarding attributes that are not described in section 381(c). The authors of GCM 38966 conclude that “neither the courts nor the Service have formulated any one rule or set of principles for determining which tax items or attributes not enumerated in section 381(c) will be inherited by an acquiring corporation in a section 381(a) transaction.” *Id.*

For many years, the IRS had issued private rulings regarding the gross receipts test of 165(g)(3) relating to section 381(a) transactions. Section 165(g)(3) allows domestic corporations to take an ordinary worthless stock deduction with respect to stock, options, or debt that was issued by an affiliated corporation (foreign or domestic). The ordinary deduction is only permitted if more than 90% of the aggregate gross receipts of the affiliated corporation (from formation) are from active sources. IRC § 165(g); Treas. Reg. § 1.165-5(a), (d).

A question has arisen as to whether the gross receipts of predecessor corporations are taken into account for purposes of this active gross receipts test. The IRS had permitted taxpayers to take the position that the gross receipts of predecessors (including foreign corporations) are taken into account if assets were acquired in a transaction described in section 381(a). The permission was generally granted if the taxpayer eliminated gross receipts from intercompany transactions with any such predecessor corporation, as appropriate, to prevent duplication. PLR 201830005 (Apr. 24, 2018); PLR 201829004 (Apr. 24, 2018); PLR 201704003 (Oct. 24, 2016); PLR 201548003 (Aug. 3, 2015).

In 2017, the IRS announced that it was reconsidering its views on section 165(g)(3). IRS, “IRS Statement Regarding Private Letter Rulings on Certain Corporate Transactions,” [IRS statement regarding private letter rulings on certain corporate transactions | Internal Revenue Service](#) (Oct. 13, 2017). As a result, the IRS is no longer issuing such rulings except with respect to a section 381(a) transaction in which both parties are members of the same consolidated group (and only if section the 381(a) transaction is not part of a plan to claim an ordinary deduction under section 165(g)(3)). Rev. Proc. 2021-3, 2021-1 IRB 140, § 3.01(37).

Although many practitioners support taking into account the gross receipts history of a predecessor corporation after a section 381(a) transaction, it does add a great deal of complexity to the calculation. It is frequently hard to determine the gross receipts history (since formation) of the worthless subsidiary itself let alone all of the corporations that it may have acquired assets from during its existence. There is also uncertainty as to whether case law even supports the position. *See* GCM 38966. It is possible that the position is contrary to the legislative intent (at least where the assets of an operating company is acquired by a holding company) since section 165(g) was not intended to apply to investment or holding companies. 90 Cong. Rec. S121, 122 (daily ed. Jan. 12, 1944) (statement of Sen. Davis).

Difficulties also apply when trying to determine which attributes can be inherited by a successor corporation in a transaction that is not described in section 381(a). The applicable regulations state that section 381 does not apply to partial liquidations and divisive reorganizations. Treas. Reg. § 1.381(a)-1(b)(3). Several cases have held that carryforwards are not permitted where an attribute was described in section 381(c) but the transaction was not described in section 381(a). *Baicker v. Comm’r*, 93 TC 316 (1989) (investment credit not allowed in a divisive reorganization); *Denver & RGWR Co. v. Comm’r*, 38 TC 557, 581-82 (1962) (accrued deduction after a bankruptcy reorganization), *acq.*, 1963-2 CB 4.

Taxpayers and the IRS have been more successful in taking into account tax attributes where the underlying transaction is a section 351 transaction. *Comm’r v. Joseph E. Seagram and Sons, Inc.*, 394 F.2d 738 (2nd Cir. 1968) (LIFO layers); *Hempt Bros., Inc. v. United States*, 354 F. Supp. 1172, 1181 (MD Pa. 1973) (cash basis receivables received from transferor), *aff’d*, 490 F.2d 1172 (3rd Cir.), *cert. denied*, 419 US 826 (1974); *Philadelphia & Reading Corp. v. United States*, 602 F.2d 338, 343-44 (Ct. Cl. 1979) (amortization of deferred development expenses); Rev. Rul. 70-565, 1970-2 CB 110 (LIFO layers); PLR 201033014 (May 13, 2010) (amortization of deferred R&D costs). However, none of these cases and rulings suggest that loss and credit carryforwards can be carried forward from the transferor to the transferee in a section 351 transaction. *See* Rev. Rul. 69-515, 1969 CB 38 (transferee corporation cannot carry an NOL back to a tax year of the transferor); *see also* Rev. Rul. 61-191, 1961-2 CB 251 (post-liquidation losses of a corporation that undergoes a de facto liquidation cannot be carried back to pre-liquidation years).

Applicable Rules. Where section 381 applies to a transaction, specific rules apply to the carryforward and carryback of the specified tax attributes. The substantive rules are tax attribute specific (i.e., not all rules apply to each tax attribute).

Pursuant to the application of section 381, the acquiring corporation succeeds to (and takes into account) the NOL carryforwards of the transferor corporation. The acquiring corporation determines the amount of such carryforwards as of the transaction date and integrates them with its own NOLs for purposes of determining its taxable income for taxable years ending after the transaction date. In determining the amount of NOL deductions, the provisions of section 172 are applied in accordance with the conditions and limitations of section 381 (and the limitations of section 382 and similar provisions). Treas. Reg. § 1.381(c)(1)-1(a)(1). Similar rules apply to other tax attributes. Treas. Reg. §§ 1.381(c)(3)-1(a)(1) (capital losses), (c)(23)-1(a)(1) (investment tax credits). The section 381 regulations with respect to the carryforward of disallowed business interest expense does not contain any language regarding integration of respective tax attributes.

Under the applicable regulations, the NOL carry forwards and carry backs of the acquiring corporation as of the transaction date are determined without reference to the NOLs of the transferor corporation. Similarly, the NOL carry forwards of the transferor corporation as of the transaction date are determined without reference to the NOLs of the acquiring corporation. Treas. Reg. § 1.381(c)(1)-1(a)(2). Similar rules apply to other tax attributes. Treas. Reg. §§ 1.381(c)(3)-1(a)(2) (capital losses), (c)(20)-1(b) (business interest expense), (c)(23)-1(a)(2) (investment tax credits).

Section 381(b)(3) provides that tax attributes of the acquiring corporation cannot be carried back to a taxable year of the transferor corporation. This rule only applies to carry backs from taxable years ending after the transaction date and only applies to NOLs and capital losses. The rule does not apply to type-F reorganizations. IRC § 381(b)(3); Treas. Reg. § 1.381(c)(1)-1(b).

As stated, the provisions of section 381(b)(3), on their face, only apply to NOLs and capital losses. As a result, there is uncertainty as to what rules apply to the carry back of tax credits. Regulations with regard to investment tax credits apply rules that are similar to the NOL rules to the carry back of such tax credits. Treas. Reg. § 1.381(c)(23)-1(b). Potentially, similar rules apply to the carry back of other general business credits, as well as foreign tax credits.

An acquiring corporation is permitted to carry back its own tax attributes to its own taxable years ending on or before the transaction date. In addition, if the transferor corporation remains in existence after the transaction, it can carry back its own attributes to its own taxable years ending on or before the transaction date. Treas. Reg. §§ 1.381(c)(1)-1(b) (NOLs), (c)(23)-1(b) (investment tax credits).

The first year to which NOL carry forwards of the transferor corporation are carried is the first taxable year of the acquiring corporation ending after the transaction date. IRC § 381(c)(1)(A); Treas. Reg. § 1.381(c)(1)-1(c)(1). A similar rule applies to the carry forward of other tax attributes. IRC § 381(c)(3)(A), (20); Treas. Reg. §§ 1.381(c)(3)-1(b)(1) (capital losses); (c)(20)-1(a) (business interest expense), (c)(23)-1(c)(2)(i) (investment tax credits). However, charitable contribution carry forwards are carried to the first taxable year *beginning* after the transaction date. IRC § 381(c)(19); Treas. Reg. § 1.381(c)(19)-1(a)(2).

The amount of the NOL carryforward of the transferor corporation that is taken into account by the acquiring corporation is the full amount available. This is the case even if the acquiring corporation did not acquire 100% of the assets of the transferor corporation. Treas. Reg. § 1.381(c)(1)-1(c)(2). Similar rules apply to other tax attributes. Treas. Reg. §§ 1.381(c)(3)-1(b)(2) (capital losses), (c)(23)-1(c)(2)(ii) (investment tax credits).

For a taxable year of the acquiring corporation that includes the transaction date, the deduction of NOLs of the transferor corporation is limited. The limitation equals the taxable income of the acquiring corporation (before NOL deductions but taking into account other tax attributes of the transferor corporation) for the year multiplied by the ratio of the number of days in the year after the transaction date to the total number of days in the taxable year. Essentially, this rule treats the acquiring corporation's post-acquisition taxable year as two taxable periods and allocates the available NOL between the two periods. There is no provision that allows the acquiring corporation to use a closing-of-the-books approach. As an example of how the limitation rules applies, assume that an acquiring corporation acquires assets in a section 332 liquidation in the middle of the taxable year, the NOL of the transferor corporation is limited to 50% of the taxable income of the acquiring corporation for the taxable year.

The limitation rule on carryforwards only applies to the taxable year that includes the transaction date and does not apply to subsequent taxable years. IRC § 381(c)(1)(B); Treas. Reg. § 1.381(c)(1)-1(d). Similar limitations apply to other tax attributes (other than charitable contributions). IRC § 381(c)(3)(B) (capital losses); Treas. Reg. §§ 1.381(c)(3)-1(c) (capital losses), (c)(20)-1(c)(5)(i)(C) (business interest expense), (c)(23)-1(e) (investment tax credits).

If the transaction date occurs on the last day of the taxable year of the acquiring corporation, then the NOLs of the transferor corporation are permitted to fully offset the taxable income of the acquiring corporation for the following taxable year (to the extent other rules permit) since the limit equals 100%. This is a result of the rule that allows the NOLs of the transferor corporation to first be carried forward to the first taxable year ending after the transaction date. As a result, none of the NOLs would be available for use in the taxable year that includes the transaction date.

Under the TCJA (as amended), post-2017 NOLs can only offset 80% of taxable income (before NOL deductions) after 2020. The limitation rules of section 381 were not changed by the TCJA. As a result, section 381 appears to permit the acquiring corporation to offset up to 100% of post-acquisition taxable income (to the extent of the 80% limit for the full taxable year).

Section 163(j) regulations were issued in 2020. This regulation package included rules regarding the application of section 381 to the limitations of section 163(j). The regulations provide for a limit on deductions in the taxable year of the acquiring corporation that includes the transaction date. The limit equals the full taxable year section 163(j) limitation of the acquiring corporation multiplied by the ratio of the number of days in the year after the transaction date to the total number of days in the taxable year. The section 163(j) limit is determined by taking into account items that were succeeded to under section 381, other than disallowed business interest expense. Treas. Reg. § 1.381(c)(20)-1(c). These regulations apply to taxable years beginning on or after November 13, 2020. However, a taxpayer can choose (or can be required) to apply these rules to earlier periods if the taxpayer (and all related parties) consistently applies the section 163(j) regulations to such earlier periods in their entirety. Treas. Reg. § 1.381(c)(20)-1(d).

An election is available to determine the 2020 adjusted taxable income for section 163(j) purposes, based on the adjusted taxable income for 2019. IRC § 163(j)(10)(B). If this election is made, the 2019 adjusted taxable income of an acquiring corporation is determined based upon the acquiring corporation's last taxable year beginning in 2019. Treas. Reg. § 1.163(j)-2(b)(3)(iii). Presumably, the adjusted taxable income of the transferor corporation (i.e., with respect to the pre-acquisition period) is not taken into account. This rule applies to taxable years beginning on or after November 13, 2020. However, a taxpayer can choose (or can be required) to apply these rules to earlier periods if the taxpayer (and all related parties) consistently applies the section 163(j) regulations to such earlier periods in their entirety. Treas. Reg. § 1.381(c)(20)-1(d).

Section 381 provides for ordering rules to coordinate the usage of the tax attributes of the acquiring and transferor corporations. The NOLs of the acquiring and transferor corporations are used in the order of the taxable years for which the NOLs are sustained. That is the earliest year (whether of the acquiring or transferor corporation) is used first (subject to limitations). Treas. Reg. § 1.381(c)(1)-1(e)(1).

For purposes of determining the order of the taxable years, the last day of the taxable year is used. As a result, the last day of the taxable year for the year of acquisition for the transferor corporation (other than with respect to a type-F reorganization) is the transaction date. IRC § 381(b)(1).

If the taxable year of an acquiring and transferor corporation ends on the same day, then the taxable year of the transferor corporation is treated as earlier than the taxable year of the acquiring corporation. IRC § 381(c)(1)(C); Treas. Reg. § 1.381(c)(1)-1(e)(2), (4). For example assume that A acquired all of the assets of T on June 30, 2020 in an type-A corporate reorganization (and both A and T use the calendar year) and both A and T had NOLs in both 2019 and 2020. If A has taxable income in 2021, the order of the NOL usage would be (i) T - 2019, (ii) A - 2019, (iii) T - short period 2020, and (iv) A - 2020.

Ordering rules that are similar to the NOL rules apply to other tax attributes. Treas. Reg. §§ 1.381(c)(3)-1(d)(4) (capital losses), (c)(23)-1(d) (investment tax credits). The section 381 regulations with respect to the carryforward of disallowed business interest expense does not contain any language regarding order of usage.

The fact that the section 381 rules give a preference in the ordering rules to NOLs of the transferor corporation, may come as a surprise to many practitioners. However, the rule is consistent with the ordering rules under sections 382 and 384, which require the use of attributes that are subject to limitation before attributes that are not limited. *See* IRC § 382(l)(2)(B), 384(e)(2).

It should be noted that the ordering rules under the consolidated return regulations differ from the rules under section 381. Under those rules, if two members of the group have an NOL for taxable years which end on the same date, the NOLs are applied on a pro rata basis. Treas. Reg. § 1.1502-21(b)(1). As a result, the applicable ordering rules could change depending on whether a target corporation is acquired in a stock deal or an asset deal. There is also uncertainty as to which set of rules apply when a corporation joins a consolidated group and subsequently transfers its assets to another member in a section 381(a) transaction.

If the transaction date occurs on a date other than the last day of the taxable year of the acquiring corporation, then special rules apply with respect to the absorption of NOLs under section 172(b)(2). For this purpose, the taxable year of the acquiring corporation is treated as two separate tax periods (a pre-acquisition part year period and a post-acquisition part year period) solely for purposes of determining the absorption of the NOL deduction. The pre-acquisition part year period is the period ending on the transaction date and the post-acquisition part year period beginning on the following day.

NOLs of the acquiring corporation are first carried to the pre-acquisition part year period and then to the post-acquisition part year. The NOLs of the transferor corporation are only carried to the post-acquisition part year period. Although treated as two separate periods for section 172(b)(2) purposes, the two periods are treated as a single taxable year for purposes of determining the number of carryforward years. As with the deduction limit described above, the taxable income (before NOL deductions) for the taxable year is allocated between the two periods based on the number of days in each period. IRC § 381(c)(1)(C); Treas. Reg. § 1.381(c)(1)-1(f). Absorption rules that are similar to the NOL rules apply to other tax attributes. Treas. Reg. §§ 1.381(c)(3)-1(e) (capital losses), (c)(23)-1(e) (investment tax credits). The section 381 regulations with respect to the carryforward of disallowed business interest expense does not contain any language regarding absorption of tax attributes.

The applicable regulations provide for special rules if an acquiring corporation acquires multiple transferor corporations in the same taxable year but on different dates. Treas. Reg. §§ 1.381(c)(1)-2 (NOLs); (c)(3)-1(c)(3) (capital losses), (c)(20)-1(c)(3) (business interest expense), (c)(23)-1(e)(9) (investment tax credits). These rules should be consulted in the appropriate circumstance.

Section 381 NOL Limitation Example. Acquiring and Target are both C corporations that file their returns on a calendar year basis. On September 1, 2020, Acquiring acquired all of the assets of Target in a type-A corporate reorganization. (Ignore sections 382 and 384 for purposes of this example).

The below table sets out the taxable income (before NOL deductions) and NOLs of Acquiring and Target (in millions):

	Target	Acquiring
2017	0	(35)
2018	(5)	(30)
2019	(25)	(5)
Ending September 1, 2020	(10)	xxx
2020	xxx	90
2021	xxx	20

Acquiring has taxable income in 2020 of \$90 million. This amount must be allocated between the pre- and post-acquisition part year periods based on the number of days in each period. Since there were 244 days in the pre-acquisition part year period and 122 days in the post- acquisition part year period, the limitation on the use of Target NOLs in 2020 under section 381 is \$30 million. (There is no similar limitation in 2021 and subsequent taxable years.)

The taxable income for the pre-acquisition part year period is \$60 million. Only NOLs of Acquiring can be used to offset taxable income in this period. As a result, Acquiring would deduct \$60 million of its own NOLs. Since it had an NOL carryforward of \$70 million, it would apply all of the NOLs from 2017 and \$25 million of the NOL from 2018. It would carry forward to the post-acquisition part year period, NOLs of \$10 million (\$5 million each from 2018 and 2019).

The taxable income for the post-acquisition part year period is \$30 million. NOLs of both Acquiring and Target are available to offset taxable income in this period. However, the NOLs of Target are limited to \$30 million. The NOLs of Acquiring and Target would be used in the following order:

- Target 2018 - \$5 million
- Acquiring 2018 - \$5 million
- Target 2019 - \$20 million

Acquiring would carryforward to 2021 NOLs of \$20 million (Target – 2019 - \$5 million, Acquiring – 2019 - \$5 million, Target – FYE September 1, 2020 - \$10 million).

The taxable income (before NOL deductions) for 2021 equals \$20 million. Acquiring's NOL deduction is limited to \$16 million (80% multiplied by \$20 million).

The NOLs of Acquiring and Target would be used in the following order:

- Target 2019 - \$5 million
- Acquiring 2019 - \$5 million
- Target – FYE September 1, 2020 - \$6 million

Acquiring would carryforward to 2022 NOLs of \$4 million (Target – FYE May 1, 2020).

The ordering rules for charitable contributions differ from the rules used for NOLs. The ordering rules are based on the numbered carryforward taxable years (even if the years do not end on the same date). For example, if A acquires the assets of T on June 30, 2020 (and both T and A use the calendar year), the excess charitable contributions of T would first be carried forward to the 2021 taxable year of A (the first taxable year beginning after the acquisition). In such case, the first contributions carried forward under the ordering rule would be A and T's excess from 2016 (i.e., the fifth preceding year of each entity). However, if T had two short years in 2018, the first contributions carried forward under the ordering rule would be A's excess from 2016 and T's excess from 2017. Where excess contributions are carried forward from the same numbered carryforward years, the amounts of each entity are applied on a pro rata basis. Treas. Reg. § 1.381(c)(19)-1(c)(3), (d), (e).

Section 381 allows the acquiring corporation to inherit the general business and minimum tax credits of a transferor corporation (and items necessary to compute such credits). The items to be taken into account are those items that are needed to carry out the purposes of the section 381 and the applicable credit provisions "under regulations." IRC § 381(c)(24) (general business credit), (25) (minimum tax credit). Regulations have never been issued under either provision. Regulations under section 381 only specify one circumstance in which credit attributes of a transferor corporation are inherited by the acquiring corporation. Treas. Reg. 1.48-9(q)(11) (operating capacity for purposes of the energy credit).

Regulations were issued with respect to investment tax credit carryforwards. *See* Treas. Reg. § 1.381(c)(23)-1. Since the investment credit provisions of section 381 were replaced by the general business credit provisions in 1984, Deficit Reduction Act of 1984, PL 98-369, § 474(r)(11), it is possible that these regulations are relevant for purposes of the general business credit (and possibly the minimum tax credits, as well).

The IRS has ruled on several occasions that the acquiring corporation is entitled to the general business credits of the transferor corporation (without reference to the investment credit regulations). However, the rulings have not been consistent as to whether related items are inherited. *See* PLR 8806074 (Nov. 18, 1987) (credit and related items); PLR 8534027 (May 22, 1985) (just the credit).

As explained, there is some uncertainty as to whether other credit attributes are to be taken into account pursuant to section 381. There is generally no uncertainty with regard to whether the research history of a transferor corporation is taken into account by an acquiring corporation with regard to the research credit. Such attributes are inherited if a person acquires the major portion of a trade or business (or a separate unit of a trade or business) of another person. IRC § 41(f)(3); Treas. Reg. §§ 1.41-7(b), 1.52-2(b).

This discussion of the application of the section 381 rules to tax attributes is a mere summary. The applicable regulations provide numerous examples and illustrations. These should be reviewed in detail when attempting to resolve a material issue.

D. Other Limitation Rules

Sections 382 through 384 and SRLY are not the only provisions that limit the use of NOLs and other tax attributes of a corporation. Some of the other provisions are discussed below.

Section 269 can be used by the IRS to limit (or eliminate) the benefits of NOLs and other tax attributes where a specified type of acquisition has the principal purpose of tax avoidance or evasion. IRC § 269(a), (c)(1). The section 269 regulations state that section 269 can apply even though the benefit of the tax attributes are limited or reduced under section 382 or 383. However, the fact that the benefit of the tax attributes is limited is taken into account in determining the principal purpose of the transaction. Treas. Reg. § 1.269-7. (A more detailed discussion of the application of section 269 where section 382(l)(5) applies can be found below.)

Section 482 can be used by the IRS to distribute, apportion, or allocate gross income, deductions, credits, allowances, or bases (or any other item or element affecting taxable income) between two organizations or businesses that are owned or controlled by the same interests. IRC § 482; Treas. Reg. § 1.482-1(a)(2). Similar authority is available to distribute, apportion or allocate items (in addition to or in tandem with the authority to limit or eliminate benefits described in the previous paragraph) where section 269 applies. IRC § 269(c)(2), (3); Treas. Reg. § 1.269-4. Both such provisions could potentially be used by the IRS (in appropriate circumstances) to reduce or eliminate the benefits of NOLs and other tax attributes. *See* Blue Book, p. 291. The application of these provisions is discretionary and it does not appear that the IRS has ever applied either provision to challenge an NOL deduction. *But see Maxwell Hardware Co. v. Comm'r*, 343 F.2d 713, 721-22 (9th Cir. 1965) (IRS could not challenge an NOL deduction under section 482 since it was not timely raised).

The at risk rules of section 465 and the passive activity loss rules of section 469 can also apply to C corporations in certain circumstances. The at risk rules limit losses from an activity to the amount at risk (e.g., limiting risk through nonrecourse financing or the use of an LLC). IRC § 465(a)(1). The passive activity loss rules limit losses and credits for certain passive business activities. IRC § 469(h)(4); Temp. Reg. § 1.469-1T(g), (h). Under both sets of rules, disallowed tax attributes carryforward indefinitely. IRC §§ 465(a)(2), 469(b).

One of the situations in which the at risk and passive activity rules can apply is where a C corporation is closely held (i.e., more than 50% of the stock (by value) is owned, directly or indirectly by attribution, by five or fewer individuals, certain tax-exempt organizations, or pension funds). IRC §§ 465(a)(1)(B), 469(a)(2)(B), (j)(1); Temp. Reg. § 1.469-1T(g)(1), (2)(ii). If a partnership owns more than 50% of the stock of a corporation, the corporation can be considered to be closely held if any of the partners in the partnership are individuals based on partner-to-partner attribution. IRC § 544(a)(2). The passive activity rules can also apply to a personal service corporation (a corporation whose principal activity is the performance of personal services by employee-owners). IRC §§ 269A(b)(1), 469(a)(2)(C), (j)(2); Temp. Reg. § 1.469-1T(g)(1), (2)(ii).

The dual consolidated loss (DCL) rules apply to prevent a US corporation from using an NOL as a benefit in both the US and in a foreign country. The rules are complicated and apply to (i) a dual resident corporation (i.e., a US corporation that is taxed or treated as a resident of a foreign country, (ii) a foreign insurance company that makes an election to be taxed as a US corporation, (iii) an interest in a hybrid entity (i.e., an entity that is treated as a corporation in a foreign country but not treated as a corporation in the US), or (iv) a foreign branch (including through an LLC, partnership, or checked corporation). IRC § 1503(d); Treas. Reg. § 1.1503(d)-1(a), (b). The rules do not apply to RICs, REITs, or S corporations. Treas. Reg. § 1.1503(d)-1(b)(1). The DCL rules apply SRLY concepts in determining the limitations on use of a DCL. Treas. Reg. § 1.1503(d)-4(c)(3).

II. Ownership Change

The NOLs and other tax attributes of a loss corporation are subject to the limitations of sections 382 and 383 only if an ownership change has occurred. An ownership change occurs if the loss corporation has a cumulative owner shift of greater than 50 percentage points over the testing period. The cumulative owner shift is determined by comparing the percentage of stock owned by 5% shareholders on a testing date with the lowest percentage owned at any time during the testing period. (For this purpose, certain groups of less than 5% shareholders are treated as 5% shareholders.) The cumulative owner shift equals the sum of increases in ownership by the identified 5% shareholders. (Decreases in percentage ownership are ignored.) IRC § 382(g)(1); Temp. Reg. § 1.382-2T(a)(1), (c)(1), (4).

A determination as to whether an ownership change has occurred is made at the end of any testing date. All transactions that occur on a testing date are treated as taking place simultaneously at the end of the testing date. Treas. Reg. § 1.382-2(a)(4)(i). Based on this rule taxpayers generally do not have to worry about the order of steps where multiple transactions occur on the same day.

The determination as to whether an ownership change has occurred is made without regard to whether owner shifts result from related or unrelated transactions. Temp. Reg. § 1.382-2T(c)(3). In addition, all owner shifts that take place before the beginning (or after the end) of the testing period are disregarded. Temp. Reg. § 1.382-2T(d)(4). This is the case, even if the parties are aware of a transaction that may take place more than three years later. Temp. Reg. § 1.382-2T(d)(5)(ii).

To determine whether an ownership change has occurred on a testing date, the loss corporation determines the 5% shareholders whose percentage ownership interest has increased. This is done by first determining the percentage of stock owned (the “percentage ownership interest”) by each 5% shareholder throughout the testing period. The percentage ownership interest at the close of the testing date is compared to the lowest percentage ownership interest during the testing period to determine the amount of any increase. Shareholders whose percentage ownership interest has stayed the same or decreased are treated as having an increase of zero. Temp. Reg. § 1.382-2T(c)(1).

As a practical matter, in determining the lowest percentage ownership interest during a testing period, only the percentages owned on the beginning of the testing period and at the close of any testing date that occurs during the testing period is taken into account. *See* PLR 8945055 (Aug. 16, 1989). Although the regulations do not give any comfort on this point, few practitioners in preparing ownership change analysis try to determine if a 5% shareholder had lower percentage ownership at other points in time.

The analysis described above is performed separately for each 5% shareholder. Each 5% shareholder’s increase is added together to determine the cumulative owner shift. If the cumulative owner shift is greater than 50% then an ownership change has occurred. IRC § 382(g)(1); Temp. Reg. § 1.382-2T(a)(1), (c)(1). Sales of stock between persons that hold (directly, or indirectly by attribution) less than 5% of the stock of the loss corporation are not taken into account in determining the cumulative owner shift. Temp. Reg. § 1.382-2T(e)(1)(ii), (iii) Ex. (3).

Based on the above-described rules, the steps in determining whether an ownership change has occurred are as follows:

- Step 1 – determine whether a corporation is a loss corporation,
- Step 2 – if the corporation is a loss corporation, determine whether a particular date is a testing date,
- Step 3 – determine the testing period for that testing date,

- Step 4 – identify the 5% shareholders with respect to that testing period,
- Step 5 – determine the percentage ownership interest of each 5% shareholder at the close of the testing date and throughout the testing period,
- Step 6 – determine the increase in the percentage ownership interest, if any, for each 5% shareholder based on the information analyzed in Step 5, and
- Step 7 - determine the cumulative owner shift by adding all of the increases determined in Step 6. An ownership change has occurred if the cumulative owner shift exceeds 50%.

Cumulative Owner Shift Example. Lossco is a loss corporation. Lossco has outstanding 200 shares of common stock. Individuals A, B and C, respectively, own 100, 50 and 50 shares of Lossco stock. On January 1, 2008, Individual A sells 60 shares of Lossco stock to Individual B. On January 1, 2009, Individual A purchases Individual C's entire interest in Lossco.

January 1, 2008 is a testing date. Before January 1, 2008, the relative percentage ownership of Lossco was 50% for Individual A, 25% for Individual B, and 25% for Individual C. At the end of the day on January 1, 2008, Individual A's percentage ownership has dropped to 20% and Individual B's has increased to 55%. As a result, Individual B has a 30% increase and Individuals A and C have an increase of zero. The cumulative owner shift is 30% and an ownership change has not occurred.

January 1, 2009 is also a testing date. At the end of the day on January 1, 2009, Individual A's percentage ownership has increased to 45% and Individual C's has decreased to zero. As a result, Individual A has a 25% increase (45% less 20%) and Individual B has a 30% increase. The cumulative owner shift is 55% and an ownership change has occurred. Temp. Reg. § 1.382-2T(c)(4).

Other examples of how to determine if an ownership change has occurred can be found in subparagraphs (e)(1)(iii), (e)(2)(iv), (h)(2)(iv), and (j)(1)(vi) of section 1.382-2T of the temporary Treasury regulations.

Section 1.382-2T of the temporary Treasury regulations serves as one of the key sources of guidance for determining whether an ownership change has occurred pursuant to section 382. It was first issued in 1987, TD 8149, 52 Fed. Reg. 29674 (1987), and has been amended several times over the years.

At the time section 1.382-2T was issued, it was common for temporary regulations to be issued (i) without following the notice and comment procedures (described below), and (ii) with a retroactive effective date. The Taxpayer Bill of Rights 2, PL 104-168 (1996), limits the ability of the Treasury Department to issue retroactive regulations. However, these limitations only apply to regulations which relate to statutory provisions enacted on or after July 30, 1996. PL 104-168, § 1101(a). Based on this effective date, it would appear that retroactive regulations with respect to section 382, which was enacted in 1986, could still be issued. Nonetheless, we understand that the Treasury Department and the IRS have adopted a hands-off policy with respect to section 1.382-2T. Under this policy, they will adopt portions of section 1.382-2T as a final regulation or withdraw portions, in their discretion. However, they will never amend the section.

Before 2011, the Treasury Department and the IRS believed that much of the tax guidance issued by them was not subject to the Administrative Procedure Act (APA). 5 USC §§ 551, 553-559, 701-706. In 2011, the Supreme Court held that the provisions of the APA applied to rules and regulations issued by the Treasury Department and the IRS. *Mayo Foundation for Med. Educ. & Research v. United States*, 562 US 44, 55 (2011) (“we are not inclined to carve out an approach to administrative review good for tax law only”); *see also Cohen v. United States*, 650 F.3d 717, 723 (DC 2011) (*en banc*) (“the IRS is not special in this regard”). Since then, courts have routinely applied the APA to rules and regulations issued by the Treasury Department and the IRS, even if the guidance was issued before 2011. *See, e.g., Mann Constr., Inc. v. United States*, 27 F.4th 1138 (6th Cir. 2022) (invalidating designation of a transaction as a listed transaction).

Section 553 of the APA provides for “notice and comment” procedures for agency rule making. Under the notice and comment procedures, a governmental agency must publish a proposed rule in the Federal Register. Such notice must provide the public with the ability to comment (orally or in writing) on the proposed rule. The notice must also include (i) a reference to the legal authority to be used to adopt the proposed rule, and (ii) “either the terms or substance of the proposed rule or a description of the subjects and issues involved.” 5 USC § 553(b)(1-3). The publication of the notice must generally occur at least 30 days before the effective date of the proposed rule or regulation. 5 USC § 553(d).

After the notice is provided in the Federal Register, the agency must give interested persons an opportunity to submit written comments (and possibly an oral presentation). The agency is required to consider the comments, make appropriate changes, and to include a concise general statement of the basis and purpose of the adopted rule when the final version is issued. 5 USC § 553(d); *Mann Constr.* Where an agency does not follow the notice and comment procedure, a court is required to invalidate the rule or regulation. 5 USC § 706(2)(D); *Mann Constr.*

The notice and comment procedures apply to agency “rules.” The APA defines a “rule” as “whole or a part of an agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy or describing the organization, procedure, or practice requirements of an agency.” 5 USC § 551(4). The term “rule making” is defined as the “agency process for formulating, amending, or repealing a rule.” 5 USC § 551(5).

The notice and comment procedures do not apply to (i) an interpretive rule, (ii) a general statement of policy or procedure, or (iii) rules of agency organization, procedure, or practice. 5 USC § 553(b)(A). In addition, the requirement does not apply if the agency finds (for good cause) that the requirement is “impracticable, unnecessary, or contrary to the public interest” and the agency incorporates the finding (and a brief statement of reasons therefor in the rules issued). 5 USC § 553(b)(B). The exceptions do not apply if a notice or hearing is required by statute. 5 USC § 553(b).

As stated above, the notice and comment procedures are not required to be used for “interpretive rules,” as opposed to “legislative rules.” An interpretive rule does no more than “advise the public of the agency’s construction of the statute and rules which it administers.” *Shalala v. Guernsey Memorial Hosp.*, 514 US 87, 88 (1995). A legislative rule, on the other hand, has the “force of law.” A rule is generally considered to be a legislative rule if (i) in the absence of the rule, there would not be an adequate basis for enforcement, (ii) the agency explicitly applies legislative authority, or (iii) the rule amends a prior legislative rule. *Hemp Indus. Ass’n v. DEA*, 333 F.3d 1082, 1087 (9th Cir. 2003).

Section 1.382-2T was in fact published in the Federal Register. However, other requirements of the notice and comment procedures were not complied with (e.g., the public was not permitted the opportunity to comment on the regulation). The section does not appear to be exempt as an interpretive rule since it was intended by the Treasury Department and the IRS to be binding on taxpayers (i.e., have the force of law).

If a taxpayer were to contend in court that section 1.382-2T was invalid, the government would likely contend that the temporary regulation was exempt from the notice and comment procedures since it was “impracticable, unnecessary, or contrary to the public interest” to comply. They would likely claim that section 382 was very complicated and there was a great need to issue timely guidance to the public as soon as practical after the enactment.

The government would also likely argue that section 7805(b)(2), which was enacted after the promulgation of section 1.382-2T, authorizes retroactive regulations if they are issued within 18 months of the enactment of a statute. Some, but not all, of section 1.382-2T was issued in the 18 month window. Section 7805(e),

also enacted after the promulgation of section 1.382-2T, specifically authorizes temporary regulations if certain procedures are complied with. The government would likely argue that paragraph (b)(2) and subsection (e) of section 7805 overrides the notice and comment procedures of the APA.

So far two district courts have weighed in on whether temporary Treasury regulations must comply with the notice and comment procedures. Both courts sided with the taxpayer and invalidated the temporary regulation. *Liberty Global Inc. v. United States*, 2022 US Dist. Lexis 62482 (D. Colo. Apr. 4, 2022); *Chamber of Commerce v. IRS*, 2017 US Dist. Lexis 175245 (WD Tex. Sept. 29, 2017).

A decision to take a position contrary to section 1.382-2T on a tax return should not be taken lightly, notwithstanding the two taxpayer victories. Tax return positions that are contrary to a regulation are required to be disclosed on Form 8275-R (Regulation Disclosure Statement). Treas. Reg. § 1.6662-4(f)(2); Instructions for Form 8275-R, p. 1 (Rev. Jan. 2021). It would be reasonable to assume that a position that is disclosed on Form 8275-R will likely be audited and challenged by the IRS.

A. Ownership Change Definitions

Understanding the ownership change rules requires the mastery of a variety of definitions. Below is a description of the terms “loss corporation,” “pre-change loss,” “stock,” “testing date,” “percentage ownership interest,” “testing period,” and “owner shift,” as they relate to the determination of whether an ownership change has occurred. In the next section, the term “5% shareholder” is discussed at length.

Loss Corporation

Sections 382 and 383 only apply to loss corporations. A loss corporation is generally defined as a corporation that is entitled to use an NOL carryforward or one of the other tax attributes limited by sections 382 or 383. IRC § 382(k)(1); Treas. Reg. § 1.382-2(a)(1)(i)(A). The definition of a loss corporation also includes a corporation that generates an NOL or other tax attribute subject to sections 382 or 383 in a taxable year that includes a testing date. IRC § 382(k)(1); Treas. Reg. § 1.382-2(a)(1)(i)(B). Additionally, a corporation that has a net unrealized built-in loss (NUBIL) on a testing date is considered to be a loss corporation. IRC § 382(k)(1); Treas. Reg. § 1.382-2(a)(1)(i)(C).

The TCJA amended section 163(j) to limit the deduction of business interest by a corporation to generally 30% (50% in 2019 or 2020, unless an election is made) of adjusted taxable income. IRC § 163(j)(1); Treas. Reg. § 1.163(j)-2(b). The new limitation rules apply to taxable years beginning after December 31, 2017. The disallowed interest is carried forward indefinitely. IRC § 163(j)(2); Treas. Reg. § 1.163-2(c). A corporation has a carryforward of disallowed interest under section 163(j) is considered to be a loss corporation. IRC § 382(k)(1); Treas. Reg. § 1.382-2(a)(1)(i)(A) (as amended by TD 9905, 85 Fed Reg. 56686 (2020)).

The section 163(j) regulations that were issued in 2020, provide rules for determining whether a corporation is a loss corporation with respect to disallowed business interest deductions. A carry forward of disallowed business interest is treated as an attribute that causes the corporation to be a loss corporation. Treas. Reg. § 1.382-2(a)(7)(i). For example, if a corporation carries forward disallowed business interest deductions from 2018 to 2019, the corporation would be a loss corporation in 2019.

In addition, the section 163(j) regulations provide that if a corporation has disallowed business interest in a taxable year that includes a testing date, the corporation is treated as a loss corporation in such year. However, the corporation is only treated as a loss corporation if some of the disallowed business interest is allocated to the pre-change period. Treas. Reg. § 1.382-2(a)(7)(ii). As a result, in the example in the prior

paragraph, the corporation would also be treated as a loss corporation in 2018 (if some of the disallowed business interest is allocable to the pre-change period). This rule is effective for testing dates occurring on or after November 13, 2020. However, a taxpayer can choose (or can be required) to apply these rules to earlier testing dates if the taxpayer (and all related parties) consistently applies the section 163(j) regulations to earlier period in their entirety. Treas. Reg. § 1.382-2(b)(3).

A predecessor or successor to a loss corporation is also considered to be a loss corporation. Treas. Reg. § 1.382-2(a)(1)(ii). Generally, for section 332 liquidations and acquisitive asset reorganizations, the corporation that received the assets in the transaction will be considered a successor to the corporation that transferred the assets. Treas. Reg. § 1.382-2(a)(1)(ii), (5), (6). In addition, a corporation that receives assets from another corporation in a section 351 transaction (or other transferred basis transaction) is considered to be a successor to the corporation that transferred the assets if the basis of the assets received exceeds the value of the assets by a “material” amount (i.e., there is a material built-in loss). Treas. Reg. § 1.382-2(a)(1)(v), (5), (6). The regulations do not give any guidance as to the meaning of the term “material” in this context.

A loss corporation as it existed before an ownership change is generally referred to as the “old loss corporation.” IRC § 382(k)(2); Temp. Reg. § 1.382-2T(f)(2). Similarly, the corporation that exists after an ownership change (including a successor corporation) is generally referred to as the “new loss corporation.” IRC § 382(k)(3); Temp. Reg. § 1.382-2T(f)(3). A single corporation can be both an old loss corporation and a new loss corporation. IRC § 382(k)(3).

The section 382 treatment can be quite interesting if a section 338(g) election is made with respect to the stock acquisition of a loss corporation. Under section 338(g), the “old” target corporation is deemed to sell all of its assets to the “new” target corporation in a taxable transaction at the close of the acquisition date. IRC § 338(a); Treas. Reg. § 1.338-1(a). Unlike with respect to a section 338(h)(10) election, the old target corporation is not deemed to liquidate. *See* Treas. Reg. § 1.338(h)(10)-1(d)(4)(i). As a result, the sale of the target corporation stock is respected to as such and the sellers recognize gain or loss. *See* IRC § 338(h)(10)(A) (sellers do not recognize gain or loss if a section 338(h)(10) election is made). This generally results in an ownership change with respect to the target corporation for section 382 purposes.

The change date with respect to an ownership change caused by a section 338(g) election, in most cases, is also the acquisition date for section 338 purposes. This results in the change date/acquisition date being part of the pre-change period. IRC § 382(d)(1)(B); Treas. Reg. § 1.382-6(g)(2). This generally allows any NOL to offset operating income earned on the change date. However, for NUBIG/NUBIL purposes the change date is part of the “recognition period,” IRC § 382(h)(7)(A), generally subjecting RBIGs and RBILs to the effects of the NUBIG and NUBIL rules. Since old target is treated as having sold all of its assets pursuant to the section 338(g) election, the base annual section 382 limit would appear to be zero as a result of the continuity of business requirement. IRC § 382(c)(1); PLR 8947053 (Aug. 31, 1989). However, the limit is generally increased by the amount of any RBIGs. IRC § 382(c)(2); PLR 9126066 (Mar. 29, 1991). If all goes well, the section 382 limitation is increased to potentially allow tax attributes to offset the net gain recognized pursuant to the section 338(g) election. However, the analysis has so many moving parts that is a challenge to get totally comfortable that section 382 won’t result in a surprise.

There is an open question as to the application of the section 382 rules to S corporations. In the preamble to the section 163(j) regulations, the Treasury Department and the IRS stated that they continue to consider the extent to which section 382 should apply to S corporations (outside of section 163(j)). They have requested comments regarding the proper integration of section 382 and the S corporation rules. TD 9905.

Before the enactment of the TCJA, the only attribute of an S corporation that could potentially be limited by sections 382 and 383 was a NUBIL. Section 382 applies to “loss corporations” and the term includes a corporation with a NUBIL, except as provided in regulations. IRC § 382(k)(1). Further, subchapter C of the Code (which includes section 382) applies to S corporations and their shareholders. However, the provisions of subchapter C do not apply to S corporations if (i) the result is otherwise provided in the Code, or (ii) to the extent inconsistent with the provisions of subchapter S of the Code. IRC § 1371(a). The legislative history suggests that subchapter C rules are not to apply if they are inconsistent with the purpose of treating an S corporation as a pass-through entity. H. Rep. 97-826, p. 14 (1982); S. Rep. 97-640, p. 21 (1982). Further, the taxable income of an S corporation is to be computed “in the same manner as in the case of an individual.” IRC § 1363(b). Based on the words of the statute, it appears that good arguments can be made on both sides as to whether the NUBIL rules of section 382 are to apply to S corporations.

Section 163(j) (as modified by the TCJA) provides for a limitation on business interest. With regard to business interest that is paid or accrued by an S corporation, the limitation is determined at the S corporation level (and not at the shareholder level). To the extent that the S corporation has an amount of business interest that is disallowed the excess is carried forward by the S corporation. IRC § 163(j)(4)(D), Treas. Reg. § 1.163(j)-6(l).

The section 163(j) regulations provide that disallowed business interest of an S corporation is carried forward using the same rules that apply to C corporations. Treas. Reg. § 1.163(j)-6(l)(5), (o)(22), (23). The carried forward amount is subject to section 382 if the S corporation has an ownership change. Treas. Reg. § 1.163(j)-6(l)(10). As a result, the regulations treat an S corporation as a loss corporation if the S corporation has a disallowed business interest deduction.

The section 163(j) regulations with respect to S corporations apply to taxable years beginning or after November 13, 2020. However, a taxpayer can choose (or can be required) to apply these rules to earlier periods if the taxpayer (and all related parties) consistently applies the section 163(j) regulations to such earlier periods in their entirety. Treas. Reg. § 1.163(j)-6(p).

Pre-change loss

A tax attribute that is potentially subject to either section 382 or 383 is a “pre-change loss.” The term pre-change loss is a misnomer since the definition encompasses losses, deductions, and credits.

Section 382 limits the carry forward of an NOL to a taxable year ending on the change date or in which the change date occurs. Similarly, section 382 limits NOLs for the taxable year in which an ownership change occurs if some portion of the NOL is allocable to the pre-change period. IRC § 382(d)(1); Treas. Reg. § 1.382-2(a)(2)(i), (ii). Section 382 also limits any recognized built-in loss (RBIL) taken into account in the five-year period beginning on the change date. Treas. Reg. § 1.382-2(a)(2)(iii).

Section 383 limits the carryforward of a capital loss or tax credit to a taxable year ending on the change date or in which the change date occurs. Similarly, section 383 limits net capital losses and tax credits for the taxable year in which an ownership change occurs if some portion of the capital loss or credit is allocable to the pre-change period. Tax credits subject to section 383 only include foreign tax credits, general business credits, and minimum tax credits. Treas. Reg. § 1.383-1(c)(2)(i), (ii), (3).

The TCJA amended section 163(j) to limit the deduction of business interest expense by a corporation to generally 30% (50% in 2019 and 2020) of adjusted taxable income. IRC § 163(j)(1). The new limitation rules apply to taxable years beginning after December 31, 2017. The disallowed interest is carried forward

indefinitely. IRC § 163(j)(2). A carryforward of disallowed business interest expense is subject to limitation by section 382. IRC § 382(d)(3).

A “section 382 disallowed business interest carryforward” is considered to be a pre-change loss that can be subject to section 382. Treas. Reg. § 1.382-2(a)(2)(vi). A section 382 disallowed business interest carryforward includes a corporation’s disallowed business interest carryforwards as of the change date. In addition, the term includes a corporation’s current-year business interest expense in a taxable year in which an ownership change occurred (but limited to the amount that is allocable to the pre-change period and that is disallowed by section 163(j)). Treas. Reg. § 1.382-2(a)(7). There are complex rules (described below) for allocating the current-year business interest expense between the pre- and post-change periods and for determining the portion of each that is deductible or disallowed.

The regulations that determine the portion of any disallowed business interest expense that is a pre-change loss apply to testing dates that occur on or after November 13, 2020. However, a taxpayer can choose (or can be required) to apply these rules to earlier testing dates if the taxpayer (and all related parties) consistently applies the section 163(j) regulations to earlier periods in their entirety. Treas. Reg. § 1.382-2(b)(3).

Section 163(j) is applied in an unusual way with respect to business interest expense that is incurred by a partnership. The section 163(j) rules apply on an entity basis to a partnership. The disallowed portion of the business interest expense is allocated to the partners (and not carried forward to a future taxable year of the partnership). In such case, the partner is treated as incurring the disallowed business interest expense in a subsequent taxable year but only to the extent of the partner’s share of the sum of (i) any excess taxable income (the amount by which the section 163(j) limitation of the partnership exceeds its deductible business interest), and (ii) excess business interest income (the amount by which the partnership’s business interest income exceeds its business interest expense). The partnership business interest that is deemed to be incurred by the partner is subject to the section 163(j) limitation at the partner level. IRC § 163(j)(4); Treas. Reg. § 1.163(j)-6(a-g), (o)(1-12).

It appears that the disallowed business interest expense of a partnership (defined as excess business interest expense) that is allocated to a corporate partner (C corporation or S corporation) is not considered to be a pre-change loss (and is not generally subject to the section 382 limitation). A partnership’s excess business interest expense is not described in the definition of pre-change loss in the applicable regulations. *See* Treas. Reg. § 1.382-2(a)(2)(vi), (7). Bolstering this position is the fact that the proposed section 382(h) regulations generally treat excess business interest expense as an RBIL if it is attributable to either a pre-change period or a taxable year that ends prior to the change date. Prop. Reg. § 1.382-7(b)(11), (d)(3)(vi). Those same proposed rules did not treat disallowed business interest carryforwards of a corporation as an RBIL. Prop. Reg. § 1.382-7(d)(5) (as proposed before finalization). As a result, it appears that a different treatment of excess business interest expense was intended by the authors of the proposed section 382(h) regulations.

Before the enactment of the TCJA, section 163(j) generally only applied if interest was paid or accrued to a related person who was not subject to US federal income tax on the interest (e.g., tax exempt organizations and foreign persons). IRC § 163(j)(1)(A), (3)(A) (as in effect for taxable years beginning on or before December 31, 2017). Interest that was disallowed under old section 163(j) can be carried forward, but is generally subject to limitation under new section 163(j). The interest that was disallowed under old section 163(j) is referred to in the section 163(j) regulations as “disallowed disqualified interest.” Treas. Reg. §§ 1.163(j)-1(b)(12), -2(c)(1), -5(b)(2), -11(c)(1).

Disallowed disqualified interest is generally not considered to be a pre-change loss (and is not generally subject to limitation under section 382) if the ownership change occurred before November 13, 2020.

However based on a cross-reference to section 382(h)(6), it appears that such interest is treated as a built-in deduction item that could be limited as an RBIL. If a taxpayer or related party chooses to apply the section 163(j) regulations (or the proposed regulations) retroactively, it appears that any disallowed disqualified interest that has been carried forward is a pre-change loss.. See Treas. Reg. § 1.163(j)-11(c)(4)(i).

With respect to ownership changes that occur on or after November 13, 2020, disallowed disqualified interest that is subject to limitation under section 163(j) is a pre-change loss that is potentially subject to limitation under section 382. Treas. Reg. §§ 1.163(j)-11(c)(4)(ii), 1.382-2(a)(7)(ii).

All of the above-described losses, deductions, and credits are considered pre-change losses. Neither section 382 nor section 383 limits the deduction of charitable contributions.

Stock

The determination of which instruments and obligations are considered stock for ownership change purposes is based upon general tax principles (with modifications). As a result, “penny” warrants appear to be treated as stock. Treas. Reg. § 1.382-4(d)(9)(iv); *Morrison v. Comm’r*, 59 TC 248 (1972); Rev. Rul. 82-150, 1982-2 CB 110 (exercise price was 30% of value); see PLR 200622011 (Feb. 2, 2006) (taxpayer treatment of deep-in-the-money warrants as stock for section 382 purposes acknowledged). But see *Victorson v. Comm’r*, 326 F.2d 264 (2d Cir. 1964) (deep in-the-money option respected); *Simmons v. Comm’r*, TC Memo 1964-237 (1964) (same). Similarly, instruments that are denominated as debt can be treated as stock for ownership change purposes if they contain sufficient features of equity (e.g., thin capitalization). See IRC § 385; Notice 94-47, 1994-1 CB 357.

There is some uncertainty as to whether to treat restricted stock (i.e., compensatory stock that is subject to a substantial risk of forfeiture) as outstanding stock (or as an option) for section 382 ownership change purposes. The section 83 regulations state that restricted stock is treated as owned by the transferor (generally, the loss corporation) until the restrictions lapse. Treas. Reg. § 1.83-1(a)(1). However, if the employee (or service provider) makes a section 83(b) election, the shares are treated as owned by the recipient from the date of transfer. Treas. Reg. § 1.83-2(a). Based on these regulations, the better view would appear to be that restricted stock is not treated as outstanding unless a section 83(b) election is made. See PLR 200934002 (May 19, 2009) (restricted stock units); PLR 200520011 (Feb. 18, 2005) (vesting stipulated to be stock issuance). But see PLR 9422048 (Mar. 8, 1994) (restricted stock treated as stock).

The technical analysis of whether restricted stock is treated as outstanding stock or as an option for ownership change purposes is somewhat muddled by the definition of “option” in the Code and regulations. The definition of an option includes “stock subject to a risk of forfeiture.” IRC § 382(l)(3)(A); Treas. Reg. § 1.382-4(d)(9)(i). The definition is ambiguous and could be interpreted as treating the stock as outstanding but subject to an option to sell. Some also use the definition as support for treating stock for which a section 83(b) election was made as an option.

For ownership change purposes, the term “stock” generally means stock other than pure preferred stock. IRC § 382(k)(6)(A); Treas. Reg. § 1.382-2(a)(3)(i). Pure preferred stock is stock that has all of the below features:

- not entitled to vote (except for voting rights that accrued as a result of dividend arrearages),
- dividend rights are both limited and preferred,
- holders do not participate in corporate growth to any significant extent,
- any redemption or liquidation premium is reasonable, and

- there is no right to convert the stock into another class of stock.

IRC § 1504(a)(4); Treas. Reg. § 1.382-2(a)(3).

The applicable regulations provide two special rules that modify the definition of stock for ownership change purposes. Under the “stock recharacterization rule,” an ownership interest that otherwise would be treated as stock is not treated as stock if the likely participation in corporate growth is “disproportionally small when compared to the value of such stock as a proportion of the total value of the outstanding stock of the corporation.” Temp. Reg. § 1.382-2T(f)(18)(ii)(A). The determination is made as of the time of the issuance of the equity interest or at the time of a transfer by or to a 5% shareholder. *Id.*

An example of an instrument that possibly could be recharacterized under this rule is convertible preferred stock where the conversion price is determined based upon the relative values at the time of conversion. Additionally, voting preferred stock could be recharacterized under this rule if the stock has no other (or only de minimis) participation features. *See* Blue Book, p. 301; TD 8149, 1987-2 CB 85.

The Blue Book cites the facts of *Maxwell Hardware Co. v. Commissioner*, 343 F.2d 713 (9th Cir. 1965), as an example of stock that should be recharacterized by regulations. In *Maxwell Hardware*, new investors transferred income-producing property to a corporation with NOLs in exchange for stock. The stock received by the investors was preferred stock which had a 90% participation in earnings attributable to the contributed assets. The pre-existing shareholders continued to own the common stock, which represented more than 50% of the stock of the corporation by value. The Blue Book indicated that it was intended that the common stock in similar fact patterns would not be treated as stock for ownership change purposes. Blue Book, p. 298, 301.

Under the “non-stock recharacterization rule,” an ownership interest that otherwise would not be treated as stock is treated as stock if such interest offers a potential significant participation in corporate growth. The determination is made as of the time of the issuance of the ownership interest or at the time of a transfer by or to a 5% shareholder (or a person that would be a 5% shareholder if the rule applied). Temp. Reg. § 1.382-2T(f)(18)(iii)(A). An ownership interest that is an “option” (for purposes of the option attribution rule) is exempt from the non-stock recharacterization rule (whether or not the option is treated as exercised). Treas. Reg. § 1.382-4(d)(12).

It is possible that debt obligations or pure preferred stock could be treated as equity under this rule if the value of the instrument is significantly less than the redemption price at the time of an acquisition by a 5% shareholder. There is some uncertainty as to whether convertible debt is subject to the non-stock recharacterization rule as a result of the potential overlap with the option attribution rule.

Both the stock recharacterization rule and the non-stock recharacterization rule apply only if (i) applying the rule would result in an ownership change, and (ii) the amount of any pre-change losses is significant. The amount of pre-change losses is significant if it exceeds two times the base annual section 382 limitation. The amount of pre-change losses and the base annual section 382 limitation are determined as if the testing date was a change date. The amount of pre-change losses takes into account any NUBIL that exists on the testing date. Temp. Reg. § 1.382-2T(f)(18)(ii)(B), (C), (iii)(B), (C). In addition, the amount of pre-change losses takes into account pre-change credits on a deduction equivalent basis (applying the maximum effective tax rate under section 11). Treas. Reg. § 1.383-1(h).

The application of the non-stock recharacterization rule became an important issue for many taxpayers as a result of the financial crisis that began in 2008. At that time, many corporations had outstanding debt obligations that were trading on the market at very low prices. There was a concern that if a person acquired

a significant amount of a debt obligation (sufficient to be a 5% shareholder if the debt were recharacterized) at a very low price (e.g., less than 50% of face), then the non-stock recharacterization rule might apply and cause an ownership change. For example, if a loss corporation had outstanding debt of \$100 million that was trading at 25% of face, the value of the debt of \$25 million could be more than the value of the existing equity. If the debt were to be treated as stock, it is possible that an ownership change could occur.

The IRS issued a private letter ruling in 2009 with respect to the non-stock recharacterization rule. In Private Letter Ruling 200938010 (June 11, 2009), the loss corporation in the ruling had outstanding debt that was trading at a significant discount relative to its principal amount. It was also unclear whether the loss corporation's equity had any value. The IRS ruled that the debt would not be treated as stock pursuant to the non-stock recharacterization rule. The IRS also ruled that the debt obligation would not be treated as stock in the future, as long as, (i) the loss corporation (or a related party) is not actively involved in placing any debt obligations with an acquiring person, (ii) an acquiring person does not become the owner of more than 50% of the outstanding debt obligations, and (iii) there is no material change in the terms of the debt obligation. For purposes of the ruling, an acquiring person and all related parties are treated as a single person. Similarly, two or more persons that make a coordinated acquisition of debt obligation are to be treated as a single person. In determining whether a person is related to the loss corporation or an acquiring person, the related party rules of sections 267(b) and 707(b) are to be applied. PLR 200938010. A similar ruling was issued in 2013. PLR 201345023 (Aug. 13, 2014).

Testing Date

A loss corporation is required to determine whether an ownership change has occurred with respect to any day on which a specified transaction has occurred. Any such day is considered to be a "testing date." Treas. Reg. § 1.382-2(a)(4)(i). If an ownership change occurs on a testing date, the date is considered to be a "change date." IRC § 382(j); Temp. Reg. § 1.382-2T(f)(19).

A testing date generally includes any day on which an "owner shift" has occurred. Additionally, a testing date includes any day on which an option is issued or transferred if the option is treated as exercised under the option attribution rule. Treas. Reg. § 1.382-2(a)(4)(i). There are exceptions from the definition of testing date for (i) transactions that are subject to the step-into-the-shoes rule, and (ii) transfers of options between less than 5% shareholders. Treas. Reg. § 1.382-2(a)(4)(ii).

There is some uncertainty as to how to determine the testing dates for a newly-formed corporation. Under general tax principles, a corporation is treated as going into existence when it receives its corporate charter. This is true even if the corporation has not perfected its organization (e.g., by issuing stock and setting up a board of directors), transacted any business, or received any income. Treas. Reg. § 1.6012-2(a)(2). So if a corporation receives its charter on January 1 and issues its first shares of common stock on March 1, is the issuance on March 1 a testing date? If the March 1 issuance is a testing date, an ownership change potentially occurs on that date since the new shareholders own 100% of the stock after the issuance and arguably owned zero percent before.

On first blush, one might ask whether it is purely academic whether a corporation has an ownership change when the first shares are issued. The corporation would not have transacted business before then and would not have a tax attribute that is subject to limitation. The situation where it comes up is for a corporation that has an NOL in its first year. If the corporation had known about the potential for an ownership change, it would have made an election to close-the-books for purposes of allocating the first year NOL between the pre-change and post-change periods. Treas. Reg. § 1.382-6(b). Where this typically comes up is for a loss corporation that has its first ownership change analysis performed years later. In such circumstances, it is too late to make a timely closing-of-the-books election. Some tax practitioners take the position that an

ownership change occurs on the day the shares are issued and that some of the first year NOL is allocated to the pre-change period (and subject to a section 382 limitation of zero). Others treat the corporation as coming into existence for section 382 purposes on the day the initial shares are issued.

The IRS discussed formation stock issuance issues in IRS Legal Memorandum 201432015 (Apr. 21, 2014). In the memorandum, a newly-formed corporation issued stock to certain investors on Date 1. Also on Date 1, two additional investors acquired an option to purchase shares. The two additional investors exercised the options and acquired the shares on Dates 3 and 4. The three stock issuances all occurred before business activity had started.

The taxpayer took the position that Dates 3 and 4 were not testing dates since the three stock issuances should be treated as a single transaction occurring on Date 1 since all of the issuances relate to the initial capitalization of the company. The taxpayer did not want to treat Dates 3 and 4 as testing dates, because those dates were within three years of a subsequent testing date on Date 5. If the transactions on Dates 3 and 4 were part of the testing period on Date 5, then an ownership change occurred. If the stock issued on Dates 3 and 4 were treated as occurring on Date 1 (which occurred before the beginning of the testing period ending on Date 5), then no ownership change occurred.

The IRS took the position that Date 1 is not a testing date on the basis that a testing date or ownership change does not occur on the initial stock issuance after formation. However, the IRS did not come to a conclusion as to whether the stock issuances that occurred on Dates 3 and 4 were to be integrated with the stock issuances on Date 1 (and ignored). However, they did discuss the position with some sympathy since the initial capitalization of a corporation does not raise the loss trafficking issues that section 382 was enacted to prevent. CCA 201432015.

The IRS reluctance to rule on whether Dates 3 and 4 are testing dates in IRS Legal Memorandum 201432015 is surprising. The IRS had ruled that a subsequent issuance of stock pursuant to an integrated plan to form a corporation did not cause an ownership change in Private Letter Ruling 9142018 (July 18, 1991). In the ruling, a corporation was formed on December 29, 1987. On that day, shares were issued to the directors. On February 29, 1988, the corporation issued stock to new investors that amounted to 99% of the outstanding stock. Between the two dates, the corporation has no income and incurred minimal organizational expenses. The ruling of no ownership change was based on the fact that the two issuances were parts of an integral plan to form the corporation and the second issuance was “done with an expedition consistent with the orderly formation” of the corporation.” PLR 9140218.

The IRS dealt with similar issues in Private Letter Ruling 202024013 (Mar. 13, 2020). In the ruling, a new foreign parent was created as a new holding company for a domestic loss corporation. The parent was incorporated in Year 1. In Year 2, the parent issued stock to the public in a section 351 transaction. From the time of formation until the date of the section 351 transaction, the parent corporation only held nominal assets and liabilities and conducted no business activities (other than those related to the section 351 transaction). The IRS ruled that the taxable year of the new foreign parent (for purposes of the small redemption exception) began immediately after the initial issuance of shares (i.e., the issuance of shares was in a prior taxable year). PLR 202024013.

Similar issues can apply to formations of mutual funds. A fund sponsor typically forms a corporation that is destined to become a RIC with seed capital. This is done so that the mutual fund has an investment track record when it eventually goes to market. It is possible that the acquisition of shares by the public could be treated as a testing date (potentially resulting in an ownership change). For a thorough analysis of the application of the ownership change rules to RICs *see* Stephen D. Fisher, “A Loss Cause: Fixing the Rules Governing Mutual Fund Losses,” 165 Tax Notes Federal 1745 (2019).

Percentage Ownership Interest

Determinations of the percentage of stock owned by any person are made based upon the value of the stock owned by the person over the value of all of the outstanding stock. IRC § 382(k)(6)(C); Treas. Reg. § 1.382-2(a)(3)(i). This is considered to be a shareholder's percentage ownership interest.

For purposes of determining the percentage ownership interest of any person, all shares of stock of a single class are treated as having the same value. Shares are treated as part of a single class if they have the same material terms. As a result of this rule, premiums and discounts (such as control premiums and blockage discounts) are ignored to the extent they relate to a single class of stock. Treas. Reg. § 1.382-2(a)(3)(i).

In determining the percentage ownership interest of a 5% shareholder, a direct ownership interest in the loss corporation and any indirect ownership interest (through attribution) are only combined if the interests independently represent a 5% or more interest in the loss corporation. Temp. Reg. § 1.382-2T(g)(3), (4) Ex. (3), (4). In any case, the interests are combined if the loss corporation has actual knowledge of the facts relating to the direct and indirect ownership interest. Temp. Reg. § 1.382-2T(k)(2)(i).

Testing Period

Generally, the testing period with respect to any testing date is the three-year period ending on the testing date. IRC § 382(i)(1); Temp. Reg. § 1.382-2T(d)(1). However, if a prior ownership change occurred, the testing period begins no earlier than the first day following the change date. IRC § 382(i)(2); Temp. Reg. § 1.382-2T(d)(2).

The testing period also does not generally begin before the corporation in question became a loss corporation. This rule applies where the pre-change losses do not pre-date a prior ownership change and are not at least three years old. In such a situation, the testing period does not begin before the earlier of the first day of the taxable year (i) from which there is a loss or credit carryforward to the first taxable year ending after the testing date, or (ii) in which the testing date occurs. IRC § 382(i)(3); Temp. Reg. § 1.382-2T(d)(3)(i). It should be noted that this rule does not have an exception for de minimis tax attributes. Even a loss or credit carryforward of one dollar is enough to lengthen the testing period.

If the loss corporation has a NUBIL on the testing date, the rule described in the previous paragraph will generally not apply. In such case, the testing period will be three years in length (or shorter if there has been a previous ownership change). However, if the loss corporation can establish the taxable year in which the NUBIL first accrued then the testing period does not begin before the first taxable year in which the loss corporation first had a NUBIL (or the first day of the taxable year described in the previous paragraph, if earlier). IRC § 382(i)(3); Temp. Reg. § 1.382-2T(d)(3)(ii).

The section 163(j) regulations provide that the testing period for a loss corporation can begin as early as the first day of the first taxable year from which there is a disallowed business interest carryforward to the first taxable year ending after the testing date. Treas. Reg. § 1.382-2(a)(7), (8) (effective for testing dates occurring on or after November 13, 2020). For example, if a calendar year corporation has disallowed business interest in 2019 that carries forward to 2020, the testing period with respect to a testing period in 2020 would begin at least on January 1, 2019. However, if the first disallowed business interest was in 2020, there would not be a testing period in 2020 as a result of the disallowance of some of the business interest (even if the interest were allocable to the pre-change period).

Owner Shift

An owner shift is an event that causes a testing date. As a result, the determination of which dates have an owner shift is important in ownership change analysis.

An owner shift is any change in the ownership of the stock of a loss corporation that affects the percentage ownership interest of a 5% shareholder. IRC § 382(g)(2); Temp. Reg. § 1.382-2T(e)(1)(i). Based on this definition a change in ownership that does not affect the percentage ownership interest (e.g., a stock split) does not appear to be an owner shift. PLR 201228023 (Apr. 11, 2012). Similarly, a change in the percentage ownership interest that does not affect the number of shares owned (e.g., a fluctuation in value) does not appear to be an owner shift. *See* IRC § 382(l)(3)(C).

The regulations list examples of transactions that can be an owner shift. They are:

- a purchase or sale of stock by a 5% shareholder,
- a section 351 transaction,
- a redemption or recapitalization,
- the issuance of stock by the loss corporation, and
- an acquisitive reorganization. Temp. Reg. § 1.382-2T(e)(1)(i).

Sales of stock between persons that hold (directly, or indirectly by attribution) less than 5% are not owner shifts. Temp. Reg. § 1.382-2T(e)(1)(ii).

Special rules apply to securities loans described in section 1058. The transfer of a security that meets the requirements of section 1058(b) does not cause an owner shift. Temp. Reg. § 1.382-2T(h)(5)(i). Similarly, the return of identical securities does not cause an owner shift. Temp. Reg. § 1.382-2T(h)(5)(ii).

B. Fluctuations in Value

Determinations of a 5% shareholder's percentage ownership interest are made based upon the value of the stock owned by the shareholder over the value of all of the outstanding stock. IRC § 382(k)(6)(C); Treas. Reg. § 1.382-2(a)(3)(i). Where a loss corporation has issued multiple classes of stock, this rule appears to require that the percentage ownership interest be determined on each testing date based upon the value of all shares of all classes held by the 5% shareholder and all shares of all classes that are issued and outstanding as of that date.

Under existing regulations, the rules for determining percentage ownership interests could result in an ownership change caused, wholly or in part, by fluctuations in value. For example, assume that a 5% shareholder purchases 100% of a newly-issued class of convertible preferred stock. At the time of issuance the shareholder's percentage ownership interest equals 20% (i.e., the value of the class equals 20% of the value of all of the stock taken into account for section 382 purposes). Within three years, the preferred stock increases in relative value to greater than 50%. This would appear to result in an ownership change, absent the application of an exception for fluctuations in value, since the shareholder would own more than 50% of the value on the testing date and his lowest percentage ownership interest during the testing period would be zero. Of course, there would need to be a testing date for the ownership change to occur.

The Code provides for special rules relating to the determination of the cumulative owner shift when there have been fluctuations in value among multiple classes of stock. The statute provides that "any change in proportionate ownership which is attributable solely to fluctuations in the relative fair market values of

different classes of stock shall not be taken into account.” IRC § 382(l)(3)(C). This rule applies “except as provided in regulations.” *Id.* The legislative history is not enlightening as to how to apply this provision.

In the early years after the enactment of section 382, many practitioners shared the view that the statutory provisions regarding fluctuations in value only meant that a testing date could not be caused by fluctuations in value. *See* New York State Bar Association (NYSBA), Tax Section, Committee on Net Operating Losses, *Supplemental Report on Section 382*, 88 TNT 42-37 (1988). Under this so-called “full valuation” approach, fluctuations were taken into account once a testing date was triggered by other transactions (e.g., a sale of one share of stock). This limited view appears to have lost adherents over the years.

The existing regulations support the notion that fluctuations in value are never tested except when there has been a change in stock holdings by a 5% shareholder. A testing date generally only occurs when there has been an owner shift. Treas. Reg. § 1.382-2(a)(4)(i). An owner shift only occurs if there is a “change in the ownership of the stock of a loss corporation that affects the percentage of such stock owned by any 5-percent shareholder.” Temp. Reg. § 1.382-2T(e)(1)(i); *see* IRC § 382(g)(2). As a result, it appears that a testing date cannot result from a mere change in a 5% shareholder’s percentage ownership interest caused by a fluctuation in value.

From 2005 through 2010, the IRS issued several private letter rulings to taxpayers that ignored all fluctuations in value during the testing period. Under the so-called “hold constant” approach, the rulings treated the relative value of the stock held by 5% shareholders as having remained constant throughout the testing period. *See, e.g.*, PLR 201043019 (July 23, 2010), *as mod. by*, PLR 201124018 (Mar. 14, 2011); PLR 201032032 (May 7, 2010); PLR 201027030 (Mar. 29, 2010); PLR 201017004 (Jan. 11, 2010); PLR 201017003 (Jan. 11, 2010); PLR 201017002 (Jan. 11, 2010).

Notice 2010-50

The IRS and the Treasury Department has since issued interim guidance with respect to the correct treatment of fluctuations in value. Notice 2010-50, 2010-2 CB 12, generally allows loss corporations to adopt one of two approaches by applying a reasonable methodology. The two approaches are (i) the full valuation approach, and (ii) the hold constant approach. Taxpayers can apply either of the approaches described in Notice 2010-50.

Due to the complexity of the issues involved, the IRS has stated that it would not challenge any reasonable application of either approach that is applied consistently. A taxpayer applying the notice must use a “single methodology” for all testing dates in a “consistency period.” A consistency period with respect to a particular testing date begins on the latest of (i) the first date on which the loss corporation has more than one class of stock, (ii) the first day following a change date, or (iii) the date that is six years before the current testing date. Notice 2010-50, § II.B. To comply with the single methodology requirement, a taxpayer must apply the same approach, methodology, or convention consistently to a given situation (e.g., applying a LIFO convention for all share dispositions) during the consistency period. Notice 2010-50, § II.D.

The notice does provide some restrictions with respect to consistency periods that include closed taxable years (i.e., a year barred by statute of limitation). In such case, a taxpayer may not employ the notice in an open taxable year (i.e., a year not barred by statute of limitation) if using a single methodology would have changed the US federal income tax liability in a closed taxable year in the consistency period. However, the taxpayer can apply the notice if the position taken in the closed year is not a reasonable approach. In such case, the taxpayer may apply a reasonable approach under a single methodology to the open taxable

years if it applies the single methodology consistently to the closed taxable years to the greatest extent permitted by the statute of limitations. Notice 2010-50, § II.C.

In Notice 2010-50, the IRS and the Treasury Department announced that they intend to publish proposed or temporary regulations with respect to fluctuations in value. They have asked for comments on whether the hold constant approach is appropriate and administratively viable. In addition, if the hold constant approach is permitted (or required by future guidance), comments were requested as to, (i) whether to continue or to permit use of a range of methodologies to implement it or to require a single methodology, (ii) the appropriate treatment of the deemed acquisition by non-redeeming shareholders occurring as a result of a redemption, (iii) the appropriate treatment of the deemed disposition by preexisting shareholders occurring as a result of the issuance of other shares, (iv) the amount of stock exempt under the cash issuance exception, and (v) the allocation of exempt stock to direct public groups under the cash and small issuance exceptions.

In May 2012, William Alexander, then IRS Associate Chief Counsel (Corporate), suggested that further guidance on fluctuations in value may not be coming out anytime soon. *ABA Meeting: Private Offering Coordinated Acquisitions Warrant Guidance, Alexander Says*, 2012 TNT 94-4.

Full Value Approach. Notice 2010-50 permits taxpayers to use or adopt the full value approach. Under the full value approach, fluctuations in value are generally taken into account in determining whether an ownership change occurred.

Under the full value approach, a 5% shareholder's percentage ownership interest is determined on the basis of the relative fair market value of the stock owned by the person (directly, or indirectly by attribution) to the total fair market value of the outstanding stock of the loss corporation. Essentially, all shares are marked-to-market on each testing date. Notice 2010-50, § I.B.

Hold Constant Approach. Notice 2010-50 permits taxpayers to use or adopt the hold constant approach. Under the hold constant approach, fluctuations in value are generally ignored in determining whether an ownership change occurred.

Under the hold constant approach, a 5% shareholder's percentage ownership interest with respect to a share of stock (the "hold constant percentage") is determined on the date the share is acquired by the shareholder. On subsequent testing dates, the hold constant percentage represented by that share is determined by ignoring the effect of fluctuations in the relative value of the share that have occurred since the acquisition date. Under this approach, the hold constant percentage of each tranche of shares acquired by a 5% shareholder is determined separately. A tranche of shares would include all of the shares of a single class of stock acquired by a 5% shareholder on a given date.

The hold constant percentage of each tranche of shares held by a 5% shareholder is subject to adjustments each and every time the loss corporation issues or redeems shares. Each time the loss corporation makes a subsequent issuance of shares, the hold constant percentage of the tranche is adjusted downward for the dilutive effects of the issuance. Each time the loss corporation makes a subsequent redemption of shares, the hold constant percentage of the tranche is adjusted upward for the accretive effects of the redemption. Notice 2010-50, § I.C.

Under the hold constant approach, the percentage ownership interest of a 5% shareholder is determined by adding together the adjusted hold constant percentages of each tranche of shares held by the shareholder on a testing date.

Taxpayers are permitted to adopt or use any reasonable application of the hold constant approach. Notice 2010-50 describes two such reasonable applications of the hold constant approach. Alternative 1 applies a methodology that looks back from the testing date. Alternative 2 applies a methodology that applies ongoing adjustments from the acquisition date. According to the notice, both Alternatives 1 and 2 are reasonable applications of the notice. It appears that Alternatives 1 and 2 are not the only approaches that can be applied as reasonable. Notice 2010-50, § II.

Both of these approved methodologies are extraordinarily involved and are difficult to apply to a testing period where other complicated transactions have occurred. In addition, they can result in a situation where the total percentage ownership interests of all of the 5% shareholders on a testing date is something other than 100%. This deviation from 100% increases the possibility of error in preparing these calculations.

Under Alternative 1, the hold constant percentage represented by a tranche of shares is recalculated to factor out changes in its relative value since the share's acquisition date. Notice 2010-50 does not describe the details with respect to Alternative 1. Instead, it cross-references a description in an article. Mark R. Hoffenberg, *Owner Shifts and Fluctuations in Value: A Theory of Relativity*, 106 Tax Notes 1446 (2005).

Under Alternative 1, the numerator in computing the hold constant percentage attributable to a tranche of shares is determined based upon the actual fair market value on the testing date (as it is normally). The denominator, on the other hand, is adjusted to back out the effects of any fluctuations in relative value. According to one commentator, the concept of Alternative 1 is

[i]n essence, while the proportionate value of the tested share may decrease or increase due to subsequent issuances (resulting in dilution of value) or redemptions (resulting in concentration of value), the tested share will be treated as performing equal to all other shares of the loss corporation during the testing period, thus eliminating the effect of fluctuations in relative value on the Section 382(g) ownership change computation.

See NYSBA, Tax Section, *Report on the Treatment of Fluctuations in Value Under Section 382(l)(3)(C)*, p. 32, 2009 TNT 245-16.

Specifically, the mathematical formula used to apply Alternative 1 is as follows: the percentage ownership interest of any 5% shareholder attributable to any tranche of shares is the value of the tranche on the testing date, divided by the sum of (i) the adjusted value (as defined below) of all shares outstanding as of the close of the date the tranche was acquired by the 5% shareholder (the "acquisition date") that remain outstanding on the testing date, and (ii) the adjusted value (as defined below) of any shares issued subsequent to the acquisition date that remain outstanding on the testing date. For purposes of (i) above, the adjusted value is the value that bears the same proportion to the value of all shares outstanding on the acquisition date that remain outstanding on the testing date that the value of the tranche on the testing date bears to its value on the acquisition date. For purposes of (ii) above, the adjusted value is the value that bears the same proportion to the value on its issuance date of each share issued subsequent to the acquisition date that remains outstanding on the testing date, that the value of the tranche on the testing date bears to its value on the date that such subsequently issued share was issued.

Alternative 2 resembles Alternative 1 in many ways but requires fewer calculations. Under Alternative 2, the hold constant percentage attributable to a tranche of shares held by a 5% shareholder is determined based upon the date the tranche is acquired. Thereafter, the hold constant percentage does not change unless the tranche is acquired by a different 5% shareholder or there is a subsequent issuance or redemption of loss corporation stock. Notice 2010-50, § I.C.2. If the tranche is acquired by a different shareholder, the

hold constant percentage attributable to the tranche is recomputed based on the relative fair market value on the acquisition date by the new shareholder.

Upon an issuance or redemption under Alternative 2, the hold constant percentage of all outstanding tranches of stock is adjusted. For example, if the hold constant percentage attributable to a tranche was 10% and the loss corporation issued new shares with a hold constant percentage of 40%, the adjusted hold constant percentage attributable to the tranche would be reduced to 6%.

Notice 2010-50 describes several common elements of Alternatives 1 and 2. Under both alternatives, the hold constant percentage for each tranche of shares is determined based upon the value of the tranche on the day acquired compared to the value of all of the shares on that date. That is, neither alternative factors out fluctuations for actual acquisitions. Notice 2010-50, § I.C.3.a. This methodology for determining the hold constant percentage is required by the notice for all purposes regardless of approach. The notice requires this methodology to be applied under the full value approach as well as any methodology under the hold constant approach (including alternatives to Alternatives 1 and 2).

The notice states that any treatment that is inconsistent with the treatment of acquisitions described in the previous paragraph is inconsistent with section 382(l)(3)(C). The IRS has put itself on record as intending to challenge any position that fixes the relative fair market value of a class of preferred stock on the issue date of the preferred stock (regardless of the actual value of a class on the date of acquisition by a shareholder). Notice 2010-50, § II.A.

Notice 2010-50 permits, but does not require, taxpayers to determine the hold constant percentage at the beginning of the testing period for tranches of shares that were acquired before the beginning of the testing period. In such case, the first day of the testing period is treated as the acquisition date of the tranche of shares. A taxpayer must apply the same convention to all testing dates during the consistency period. Notice 2010-50, § II.B. The notice appears to require taxpayers to determine the hold constant percentage on the date of the first issuance of a second class of shares for shares that were issued earlier. Notice 2010-50, § II.B.

Under both alternatives, the percentage ownership interest of a 5% shareholder is reduced by any disposition of shares. There are several conventions available for accounting for dispositions.

Under the acquisition date convention, the hold constant percentage is reduced for the shares disposed of based upon the hold constant percentage before the disposition. For example, if a 5% shareholder holds 100 shares (with a hold constant percentage of 10%) and sells 60 shares to another 5% shareholder, the hold constant percentage for the retained 40 shares would be reduced to 4%. If a 5% shareholder holds multiple tranches of shares of a single class, the taxpayer must adopt a convention for determining which shares were disposed of. The notice states that taxpayers can determine the source of the shares under the following conventions (i) pro rata from all acquisitions, (ii) most recent acquisitions first (LIFO), or (iii) earliest acquisitions first (FIFO).

Under the fair market value convention, the hold constant percentage of various tranches of shares held by a 5% shareholder is reduced (but not below zero) based upon the relative percentage of the disposed shares on the disposition date. For example, if a 5% shareholder owned a single tranche of shares with a hold constant percentage of 10% and later sold half of the shares at a time when the disposed shares represented 8% of relative value, the hold constant percentage of the retained shares would be reduced to 2% (10%, less 8%).

The share equivalent convention is a variation of the acquisition date convention and can be applied if a 5% shareholder owns multiple classes of shares. Under this convention, the taxpayer determines which shares are disposed of under one of the sourcing conventions described above (pro rata, LIFO, or FIFO). The actual shares disposed of are converted into the share equivalent of the shares deemed disposed of (based upon an earlier acquisition date). Notice 2010-50, § I.C.3.b.

As an example of the share equivalent convention, assume that a 5% shareholder owned 20 shares of preferred stock with a hold constant percentage of 20%. On January 1, 2010, the shareholder acquires 100 shares of common stock for \$10 per share. At the time of the acquisition of the common stock, the hold constant percentage of the 100 common shares is 10% and the preferred shares have a value of \$20 per share. On December 31, 2010, the shareholder sells 10 shares of preferred stock. The taxpayer is using the LIFO convention and the shareholder is treated under the share equivalent convention as selling common stock (since these were the most recent shares acquired). Since 10 preferred shares had a value of \$200 on January 1, 2010, the share equivalent amount is 20 shares of common stock (at \$10 per share). Notice 2010-50, Ex. 3. As a result, the hold constant percentage of the 80 retained shares of common stock would be reduced to 8%. The shareholder would have a percentage ownership interest of 28% (common shares of 8% and preferred shares of 20%). If the taxpayer had used the acquisition date convention, the shareholder would have had a percentage ownership interest of 20% (common shares of 10% and preferred shares of 10%).

Under both alternatives, the hold constant percentage of each tranche of shares is adjusted downward each time the loss corporation issues new shares (or reissues treasury shares). The downward adjustment only applies to tranches that existed before the issuance. Essentially, the hold constant percentage is reduced as if a portion of the pre-existing shares were sold by the old shareholders to new shareholders. For example, if a taxpayer applies Alternative II and there is a 5% shareholder with a hold constant percentage of 10%, an issuance of shares with a relative value of 40% would reduce the hold constant percentage downward to 6%.

The notice allows taxpayers to use either current values of shares at the time of the stock issuance or relative values in effect when the pre-existing shareholders acquired their tranches. This is similar to the difference between the acquisition date and the fair market value conventions described above with respect to stock dispositions by 5% shareholders.

There is some uncertainty as to how to apply the cash issuance and small issuance exceptions under the hold constant approach. The notice implies that the methodologies and conventions applied should be taken into account when applying the two exceptions and in allocating shares among public groups.

Under both alternatives, the hold constant percentage of each tranche of shares is adjusted upward each time the loss corporation redeems shares (or purchases shares for the treasury). The upward adjustment only applies to tranches that existed before the redemption. Essentially, the hold constant percentage is increased as if a portion of the pre-existing shares were purchased from the redeemed shareholders by the remaining shareholders. For example, if a taxpayer applies Alternative II and there is a 5% shareholder with a hold constant percentage of 6%, a redemption of shares with a relative value of 40% would increase the hold constant percentage upward to 10%.

The notice allows taxpayers to use either current values of shares at the time of the stock issuance or relative values in effect when the pre-existing shareholders acquired their tranches. This is similar to the difference between the acquisition date and the fair market value conventions described above with respect to stock dispositions by 5% shareholders. Notice 2010-50, § I.C.3.c.

Under both alternatives, the owner of stock is not treated as disposing or acquiring stock in certain circumstances. This exception applies if the owner is treated as continuing to own the stock of the loss corporation (or a successor) under various stock ownership conventions of section 382 and the regulations thereunder. The notice describes the following as examples of situations where the exception applies, (i) a value-for-value stock-for-stock recapitalization, (ii) an exchange of loss corporation stock for acquiring stock in an equity structure shift, and (iii) a holding company formation. Where the exception applies, the original acquisition date and other hold constant characteristics of the tranche of shares are preserved. Notice 2010-50, § I.C.3.d.

It is possible that the exception for value-for-value recapitalizations may not be contained in the final guidance. IRS personnel have questioned the exceptions appropriateness at various public forums.

There is some uncertainty as to whether the hold constant approach can be used to identify 5% shareholders. For example, there is uncertainty as to whether a shareholder who acquired 4% of the stock of a loss corporation but who later went over 5% due to fluctuations is a 5% shareholder. The IRS has ruled that the hold constant approach could be used to identify 5% shareholders. PLR 201039013 (June 29, 2010). As a result, it appears reasonable to identify 5% shareholders by taking into account (or not taking into account) fluctuations in value.

There is also some uncertainty as to how to treat transactions at higher tier entities. For example, what happens when an entity that holds more than 5% of the stock issues shares in a segregation transaction. Does the public group acquire shares based upon the entity's hold constant percentage (historic values) or based upon current values? Since the notice seems to allow taxpayers a choice of historic or current values in other areas liberally, it would appear that both positions are reasonable.

Fluctuation in Value Example. Lossco has outstanding 100 million shares of publicly-traded common stock (the only class of stock). Public A owns all of the shares (and has owned all of the shares for over three years). On January 1, 2009, Lossco issues 200 thousand shares of a new class of convertible preferred stock to Individual B. The preferred has a redemption and liquidation value of \$20 million. The preferred stock requires the payment of non-cumulative dividends in cash on a quarterly basis. On the day the preferred stock is issued, the common stock has a fair market value of \$80 million and the preferred stock has a fair market value of \$20 million.

On July 1, 2009, Individual C exercises an outstanding employee option and acquires 100 shares of common stock. On the day the option is exercised, the common stock has a fair market value of \$15 million and the preferred stock has a fair market value of \$20 million. (Lossco has performed poorly in the intervening six months, resulting in a significant drop in the value of the common stock.)

On September 1, 2009, Individual D purchases 20 million shares of common stock from existing investors for \$3 million. The value of the two classes of outstanding stock has not changed since July 1, 2009.

On December 31, 2009, Lossco acquires 100% of the stock of Targetco. As consideration for the purchase, Lossco issues to the Targetco shareholders ("Public E") 50 million shares of common stock with a value of \$20 million. On the day before the acquisition, the common stock has a fair market value of \$40 million and the preferred stock has a fair market value of \$20 million.

Under the full value approach, on January 1, 2009, Public A has a percentage ownership interest of 80% and Individual B has a percentage ownership interest of 20%. Since Individual B's lowest percentage ownership interest was zero, there is a cumulative owner shift of 20%.

The issuance on July 1 is a small issuance. Nonetheless it is a testing date that appears to require a revaluation under existing regulations. (Hopefully, the IRS in forthcoming guidance will exempt de minimis transactions. On these facts, an exemption for de minimis testing dates would only move the change date to September 1.) On July 1, Public A has a percentage ownership interest of 43% and Individual B has a percentage ownership interest of 57%. Since Individual B's lowest percentage ownership interest was zero, there is a cumulative owner shift of 57% and an ownership change.

On December 31, 2009, Public A owns approximately 80 million common shares with a value of approximately \$32 million (40%), Individual B owns the preferred stock with a value of \$20 million (25%), Individual D owns 20 million common shares with a value of \$8 million (10%), and Public E owns 50 million shares with a value of \$20 million (25%). Since Individual D and Public E's lowest percentage ownership interest is zero, the cumulative owner shift is 35%.

Under Alternative I, an ownership change would not occur on July 1. Public A would be treated as having a percentage ownership interest of 80.0% ($\$15/(\$100 * \$15/\$80)$) and Individual B would be treated as having a percentage ownership interest of 20.0% ($\$20/(\$100 * \$20/\$20)$). As a result, the cumulative owner shift on July 1 would only be 20.0% (same as on January 1).

Individual D would be treated as having a percentage ownership interest of approximately 8.6% on September 1 (\$3 million divided by approximately \$35 million). Individual B would be treated as having a percentage ownership interest of 20.0% ($\$20/(\$100 * \$20/\$20)$). As a result, the cumulative owner shift on September 1 would be approximately 28.6% (Individual B – 20.0%, Individual D – 8.6%). It should be noted that the total percentage ownership interests are not 100%. Since Public A sold 20% of its 80% interest to Individual D, its percentage ownership interest equals 64.0% ($\$12/(\$100 * \$12/\$64)$) resulting in a total of approximately 92.6%.

Public E would be treated as having a percentage ownership interest of approximately 25% on December 31 (\$20 million divided by approximately \$80 million). The percentage ownership interest of the other three 5% shareholders needs to be adjusted to take into account the dilution caused by the issuance of stock to Public E. The adjusted percentage ownership interests are 45.7% for Public A ($\$32/(\$100 * \$32/\$64 + \$20 * \$32/\$32)$), 16.7% for Individual B ($\$20/(\$100 * \$20/\$20 + \$20 * \$20/\$20)$), 7.1% for Individual D ($\$8/(\$35 * \$8/\$3 + \$20 * \$8/\$8)$). As a result, the cumulative owner shift on December 31 would be approximately 48.8% (Individual B – 16.7%, Individual D – 7.1%, and Public E - 25%). The total percentage ownership interests increased to 94.5%.

Under Alternative II, an ownership change would not occur on July 1. Public A would be treated as having a percentage ownership interest of 80% and Individual B would be treated as having a percentage ownership interest of 20%. As a result, the cumulative owner shift on July 1 would only be 20% (same as on January 1).

Individual D would be treated as having a percentage ownership interest of approximately 8.6% on September 1 (\$3 million divided by approximately \$35 million). As a result, the cumulative owner shift on September 1 would be approximately 28.6% (Individual B – 20%, Individual D – 8.6%). It should be noted that the total percentage ownership interests are not 100%. Since Public A sold

20% of its 80% interest to Individual D, its percentage ownership interest equals 64% resulting in a total of approximately 92.6%.

Public E would be treated as having a percentage ownership interest of approximately 25% on December 31 (\$20 million divided by approximately \$80 million). The percentage ownership interest of the other three 5% shareholders needs to be adjusted to take into account the dilution caused by the issuance of stock to Public E. The adjusted percentage ownership interests are 48% for Public A (down from 64%), 15% for Individual B (down from 20%), 6.4% for Individual D (down from 8.6%). As a result, the cumulative owner shift on December 31 would be approximately 46.4% (Individual B – 15%, Individual D – 6.4%, and Public E - 25%). The total percentage ownership interests increased to 94.4%.

The below chart summarizes the results under the three methodologies:

	Jul. 1	Sept. 1	Dec. 31
Full value	57.0% *	10.0%	35.0%
Alternative I	20.0%	28.6%	48.8%
Alternative II	20.0%	28.6%	46.4%

Note that an asterisk (“*”) denotes that an ownership change occurred.

Other Approaches. Other approaches that have been applied by practitioners include:

- the innocent bystander approach; and
- the constant value approach.

An approach that appears to be supported by the words of the statute is the “innocent bystander” approach. Under this approach, a 5% shareholder’s change in ownership is ignored if it resulted solely from fluctuations. As an example, an individual purchased one million shares of common stock before the beginning of the testing period. At the beginning of the testing period, the shareholder had a percentage ownership interest of 10%. The shareholder’s percentage ownership interest increased during the testing period and was 15% on the testing date. Under the innocent bystander approach, the shareholder would be treated as having no increase in ownership since there was no activity (other than fluctuations in value) that contributed to the change in the percentage ownership interest. If the shareholder had purchased additional shares during the testing period, the fluctuation in value rule would not have applied under the innocent bystander approach since the increase was partly related to the purchase and only partly related to fluctuations in value. (It is possible that under the innocent bystander approach de minimis changes in stock ownership are ignored.)

The technical argument for the innocent bystander approach is reliance on the use of the word “solely” in the statute. The approach does suffer from a policy standpoint as a small change in a 5% shareholder’s stock holdings could result in significant changes in the loss corporation’s cumulative owner shift analysis.

One approach that was favored by practitioners years ago, but that is no longer widely used, is the constant value approach. (Some now call this the “common stock equivalent approach.”) Under this approach, the shares of each class are treated as having the same value throughout the testing period. Typically, either the value at the beginning or end of the testing period is used. Some practitioners set the relative values when

the stock is issued (even if it is before the beginning of the testing period). Where the loss corporation has issued convertible preferred stock, some practitioners apply the constant value approach by treating the holders of the convertible preferred stock as having converted their shares into common stock.

The constant value approach has the advantage of being simple to apply. However, it seems difficult to reconcile the approach with the words of either section 382(l)(3)(C) or section 1.382-2(a)(1)(i) of the Treasury regulations. The IRS has stated that it intends to challenge the use of the constant value approach. Notice 2010-50, § II.A.

C. Worthless Stock Deduction

In certain cases, an owner shift can result from a worthless stock deduction that is taken into account by a shareholder. A deemed owner shift occurs if a “50% shareholder” treats stock of a loss corporation as worthless and the shareholder holds the stock at the end of the shareholder’s taxable year that includes the worthlessness event. IRC § 382(g)(4)(D).

A 50% shareholder is a person that owns 50% or more of the stock of the corporation at any time during the three-year period ending on the last day of the taxable year of the shareholder that includes the worthlessness event. IRC § 382(g)(4)(D). Presumably, the constructive ownership rules apply in determining whether a shareholder is a 50% shareholder. In attempting to resolve specific attribution rule issues, it may be instructive to look at how the attribution rules apply with respect to the control test (option owned by a potential more than 50% stockholder) of the option attribution rules. *See* Treas. Reg. § 1.382-4(d)(4)(ii)(B).

If a deemed owner shift occurs as a result of the shareholder’s worthless stock deduction, the shareholder is treated as acquiring the stock it still holds on the first day after the shareholder’s taxable year that includes the worthlessness event. The shareholder is treated as not having previously owned the stock. IRC § 382(g)(4)(D).

Worthless Stock Example. Individual A files a tax return on a calendar year basis. A has been a long-time shareholder of Lossco. Individual A’s ownership of Lossco has varied over the years. However, for a brief moment during 2005, Individual A’s ownership of Lossco reached exactly 50%. In 2007, Lossco filed for bankruptcy and Individual A reported a worthless stock deduction on its 2007 return. On January 1, 2008, Individual A owned 30% of Lossco’s stock. As a result of the worthless stock deduction, Individual A’s percentage ownership interest in Lossco is treated as increasing by 30% on January 1, 2008.

If a 50% shareholder does not treat the shares as worthless on its return, a deemed owner shift does not occur. As a result, it appears that the impact to the loss corporation is avoided if the shareholder is not entitled to a worthless stock deduction or chooses not to report one on the return. *See* Treas. Reg. 1.1502-19(g) Ex. 5(b) (shareholder not entitled to worthless stock deduction due to excess loss account).

There is uncertainty as to how to apply these rules with respect to worthless stock deductions taken by higher tier entities with respect to stock of first tier entities. One possible interpretation is to apply the rule with respect to the first tier entity stock if the higher tier entity owned 50% or more of the first tier entity during the requisite three-year period.

It should be noted that it is possible that shareholders may be prohibited under corporate law in some states from taking a worthless stock deduction, if it has the effect of diminishing or eliminating the value of the corporation’s NOLs pursuant to section 382. *A.W. Chesterton Co. v. Chesterton*, 128 F.3d 1 (1st Cir. 1997)

(shareholder injunction to prevent loss of S corporation status). In addition, on several occasions bankruptcy courts have enjoined shareholders from taking worthless stock deductions due to the potential effect under section 382. *See, e.g., In re Prudential Lines*, 119 BR 430 (SDNY 1990), *aff'd*, 928 F.2d 565 (2nd Cir.), *cert. denied*, 502 US 821 (1991).

D. Predecessor and Successor Rules

For purposes of section 382, an entity and any predecessor or successor entity are generally treated as a single entity. IRC § 382(l)(8). Applicable regulations provide rules for determining whether a corporation is a predecessor or successor of another corporation. However, the regulations do not specify if, and under what circumstances, a corporation can be a predecessor or successor of another type of entity (for example, a partnership).

Generally, for section 332 liquidations and acquisitive asset reorganizations, the corporation that received the assets in the transaction will be considered a successor to the corporation that transferred the assets. Treas. Reg. § 1.382-2(a)(1)(ii), (5), (6). In addition, a corporation that receives assets from another corporation in a section 351 transaction (or other transferred basis transaction) is considered a successor to the corporation that transferred the assets if the basis of the assets received exceeds the value of the assets by a “material” amount (i.e., has a material built-in loss). The regulations do not give any guidance as to the meaning of the term “material” in this context other than that materiality is determined in the “aggregate.” Treas. Reg. § 1.382-2(a)(1)(v), (5), (6).

Private Letter Ruling 202024013 (Mar. 13, 2020) involved a change in domicile of a foreign parent of a group of corporations. After the new parent corporation was formed, the stock of the old parent corporation was transferred to the new parent corporation in a section 351 transaction. (The old parent corporation survived and the transaction was not treated as a reincorporation.) For SEC purposes, the new parent corporation was a successor to the old parent corporation. The IRS ruled that the taxable year of the new parent corporation for purposes of the small redemption exception began immediately after the section 351 transaction. The ruling does not make any reference to the section 382 predecessor and successor rules. PLR 202024013

Special rules apply with respect to the determination of whether an ownership change has occurred after a section 332 liquidation or acquisitive asset reorganization. Generally, the predecessor corporation is treated as continuing in existence until the pre-transaction NOLs and other tax attributes expire. In addition, the stock of the successor corporation is treated as the stock of the predecessor corporation for purposes of determining whether an ownership change occurs after the transaction. These rules apply even where the predecessor corporation ceases to exist under state law. Treas. Reg. § 1.382-2(a)(1)(ii).

In addition to the rules described in the previous paragraph, the NOLs and other tax attributes of the predecessor corporation are accounted for separately from the NOLs and other tax attributes of the successor corporation. As a result, owner shifts of each corporation are separately tracked. Treas. Reg. § 1.382-2(a)(1)(iii).

The separate tracking of owner shifts described in the previous paragraph ends when a “fold-in event” occurs. An ownership change with respect to the predecessor corporation is a fold-in event. In addition, if the predecessor corporation does not have an ownership change with respect to the transaction and in the subsequent five-year period, the fifth anniversary of the transaction is a fold-in event. Treas. Reg. § 1.382-2(a)(1)(iv).

After a fold-in event, the NOLs and other tax attributes of the predecessor corporation are treated as tax attributes of the successor corporation for purposes of determining whether an ownership change occurs with respect to the tax attributes of the predecessor corporation. If the tax attributes of the predecessor corporation are subject to limitation, the tax attributes continue to be subject to limitation notwithstanding the occurrence of a fold-in event. Treas. Reg. § 1.382-2(a)(1)(iv).

Fold-in Example. Two loss corporations (Target and Acquiring) with NOL carryforwards merge in a corporate reorganization. Acquiring is the surviving corporation in the merger. As a result, the ownership change calculations are performed separately with respect to Target and Acquiring. If the owner shift resulting from the merger causes an ownership change with respect to Acquiring but not Target, section 382 limits the use of Acquiring's NOLs. Target's NOLs would not be subject to a limitation. *See* Temp. Reg. § 1.382-2T(e)(2)(iv) Ex. (2). Since the transaction resulted in an ownership change with respect to Acquiring (but not Target), a fold-in event has not occurred. Thereafter, separate ownership change calculations are necessary for Acquiring, both as successor corporation of Target and in its own right. These separate calculations would be necessary for five years unless an ownership change occurred with respect to Target on or before the end of the five-year period beginning on the transaction date.

The rules described above with respect to section 332 liquidations and acquisitive asset reorganizations also apply to transactions in which a corporation becomes the successor corporation in a section 351 transaction (or other transferred basis transaction). Treas. Reg. § 1.382-2(a)(1)(v).

There is a great deal of uncertainty as to how to apply the predecessor/successor rules to a transferred basis transaction (such as a section 351 transaction). Section 382(l)(8) provides that the predecessor and successor corporations are treated as a single entity for section 382 purposes. For tax purposes (other than section 382), the predecessor and successor after a transferred basis transaction will generally be treated as separate entities (and in many cases, separate taxpayers). This situation does not arise in a section 332 liquidation or acquisitive asset reorganization, since the predecessor and successor corporations generally become a single corporation in the transaction.

The regulations treat the recipient of the assets in a transferred basis transaction as a successor corporation, potentially without limiting the application of the rule to the assets transferred. For example, if a parent corporation transfers \$1 million of assets (with a material built-in gain or loss) in a section 351 transaction to a subsidiary with \$100 million of gross assets, it is possible that the subsidiary is treated as a successor corporation without limiting the rule to the assets transferred. Treating the parent as continuing to own only the assets transferred for section 382 would make sense from a policy standpoint. However, the words of the statute and regulations are not helpful in resolving the issue. Of course, if *the* principal purpose of the transfer is to reduce federal income tax then the IRS could challenge the availability of the tax benefits of the transaction under section 269(a)(2).

There is uncertainty as to whether the predecessor/successor rule apply to a transfer of net built-in loss assets in a section 351 transaction or capital contribution. In such situation, section 362(e)(2) generally eliminates the net built-in loss in the basis in the hands of the transferee (i.e., the aggregate basis is limited to fair market value). IRC § 362(e)(2)(A); Treas. Reg. § 1.362-4. However, the predecessor/successor rules are not clear as to whether a material built-in loss is determined in the hands of the transferor or the transferee (i.e., immediately before or after). Applying the rule based on the transferee's basis would seem to be more appropriate as it seems absurd to apply a built-in loss rule when the built-in loss has disappeared. It should be noted that a different answer may apply if the transferor and transferee make a joint election to reduce the basis of the transferor's stock in the transferee. *See* IRC § 362(e)(2)(C); Treas. Reg. § 1.362-

4(d). In addition, section 362(e)(2) only applies to section 351 transactions and capital contributions and does not apply to other transferred basis transactions.

To illustrate the complexities of the application of the rules, assume that a corporation transfers assets to a newly-formed subsidiary corporation in a section 351 transaction before an ownership change occurs. If the assets transferred had a material built-in gain, then it appears that the parent and subsidiary are treated as a single corporation for section 382 purposes. The parent corporation would have the tax attributes (NOLs, etc.) that could be subject to section 382 but the subsidiary generally would not. How does one apply section 382 where we treat the two corporations as a single entity for section 382 purposes, but as separate entities for purposes of applying the rules regarding the use of attributes? One possible solution would be to apply rules that are similar to the elective CFC group rules that apply to CFCs for GILTI purposes. *See* Treas. Reg. § 1.163(j)-7. In such case, the taxpayers could determine a combined section 382 limitation for parent and subsidiary as a group and then allocate the combined limitation between the two taxpayers (using a reasonable allocation methodology). The Tax Court's decision in *Occidental Petroleum Corp. v. Comm'r*, 82 TC 819 (1984), potentially provides taxpayers with support for filling in gaps in a regulatory or statutory scheme in the absence of guidance. *See* CCA 201009013 (Nov. 24, 2009) (analysis of *Occidental Petroleum* doctrine).

E. Defensive Measures

Section 382 is one of the few provisions of subchapter C of the Code in which a transaction entered into by unrelated third parties can impact the tax treatment of a corporation. For example, an ownership change can be caused by transactions among shareholders or shareholders of higher tier entities. This section discusses steps that a loss corporation can take to gain some measure of protection from an ownership change caused by actions of third parties.

Owner shifts can be caused by transactions engaged in by the loss corporation itself, as well as transactions by direct and indirect shareholders. Loss corporations generally do not seek protection from the former type since they generally have the ability not to engage in owner shifts if that is necessary to protect against an ownership change. However, minority shareholders and creditors may seek to prevent a loss corporation from entering into transactions that could cause an ownership change. This type of restriction could be implemented in a corporate charter or shareholder agreement.

One of the simplest ways of reducing the possibility of an ownership change is to contact the 5% shareholders of a loss corporation and inform them of what could happen if they were to sell their stock. If the shareholder is planning on keeping some interest in the loss corporation they have an interest in helping the loss corporation protect the NOLs (and other tax attributes). Another method of reducing the possibility of an ownership change is an agreement among shareholders not to sell their stock if the tax attributes of the loss corporation would be put in jeopardy.

Even if the shareholder has no interest in protecting tax attributes, a shareholder that has knowledge of the section 382 situation may decide not to sell their stock if a sale would cause (or contribute to) an ownership change. There is uncertainty as to whether shareholders have liability under corporate law if their actions contribute to an ownership change. It is possible, in some states, that a shareholder could be liable for damages if they knowingly contribute to an ownership change. *See A.W. Chesterton Co. v. Chesterton*, 128 F.3d 1 (1st Cir. 1997) (shareholder injunction to prevent loss of S corporation status); *Smith v. Atlantic Properties*, 12 Mass. App. Ct. 201 (1981) (minority shareholder who consistently voted against the payment of dividends was liable for corporation's accumulated earnings tax). *But see Merriam v. Demoulas Super Mkts.*, 985 NE2d 388 (Mass. 2013) (S corporation shareholder permitted to terminate status where corporation declined to redeem shares); *Sery v. Federal Bus. Ctrs.*, 616 F.Supp.2d 496, 501-03 (DNJ 2008)

(shareholder permitted to transfer S corporation shares in good faith in an economically reasonable manner). If the loss corporation is in bankruptcy, the tax attributes of the loss corporation are also generally protected from interference by shareholders (and others). *See, e.g., In re Prudential Lines*, 119 BR 430 (SDNY 1990), *aff'd*, 928 F.2d 565 (2nd Cir.), *cert. denied*, 502 US 821 (1991). *But see In re UAL Corp*, 412 F.3d 775 (7th Cir. 2005) (shareholders were injured by issuance of injunction preventing sale of stock but were not entitled to damages).

A protection technique that has been in use almost since the enactment of the current version of section 382 is a restriction on transfers in the corporate charter. The IRS has issued several private letter rulings to taxpayers that such provisions can be used to prevent an ownership change. The rulings generally hold that a transaction in violation of the restrictions is ignored for section 382 purposes, provided the transfer restrictions are enforceable under state law and enforced according to their terms. *See, e.g.,* PLR 201010009 (Dec. 4, 2009); PLR 200841021 (Apr. 29, 2008); PLR 200837027 (Mar. 14, 2008); PLR 200622013 (Jan. 27, 2006).

If the loss corporation is in bankruptcy, it is not unusual for the loss corporation to request a court order restricting trading of shares (and debt claims where section 382(l)(5) is a possibility). Such relief is typically granted by the bankruptcy courts. *See, e.g., in re: General Motors Corp*, 2009 TNT 131-19 (Bankr. SDNY), (order providing for trading restrictions). *But see in re: DJ Christie, Inc.*, 2012 Bankr. Lexis 1839 (Bankr. D. Kans.) (court would not prohibit stock transfer that would cause ownership change where debtor had no active business).

The IRS has issued several private letter rulings that respect these transfer restrictions. PLR 200934002 (May 19, 2009); PLR 200605003 (Oct. 28, 2005). Some loss corporations also restrict trading in debt to allow for the possibility of qualification under section 382(l)(5) or to avoid potential issues in case the debt is treated as stock for section 382 purposes.

The rulings in the above two paragraphs involve hypothetical violations of transfer restrictions. Private Letter Ruling 200713015 (Dec. 20, 2006) involves the overturning of an actual transaction by a court. In order to prevent a bankrupt loss corporation from undergoing an ownership change, a bankruptcy court ordered that a portion of a shareholder's purchase of loss corporation stock be declared void *ab initio*. As a result, the shareholder was required to sell some of its shares and donate any gain to a charity of its choice. The IRS ruled that the shareholder would not be treated as having acquired ownership of the disposed of shares, as long as the court order remained in effect and was not later set aside by a final order of a court of competent jurisdiction. PLR 200713015; *see also* PLR 201010009 (similar holding).

Poison Pills

A relatively new technique for protecting tax attributes is the section 382 poison pill. According to one source, about 75 public companies have adopted them in some form (as of July 2019). Mackenzie Hargrave, *Revealing Motives for NOL Poison Pill Adoption* Several commentators have noted that there was a surge of adoptions of poison pills (including section 382 poison pills) in 2020 during the height of downturn caused by the COVID-19 pandemic. During 2020, 22 additional section 382 poison pill plans were adopted. Mara Elyse Goodman, Spencer Klein, Michael O'Brien, Joseph Sulzbach,, [2020 Poison Pill Recap And Current Trends | Morrison & Foerster LLP - JDSupra](#), (Feb. 25, 2021) (last accessed May 28, 2022).

Under these types of plans, if an unauthorized person becomes a 5% shareholder, the remaining shareholders have the right to purchase additional shares at a bargain price (or receive shares for no consideration). As a result, the new shareholder would find his interest diluted down below 5%. The board

of directors typically can waive the rights offer or stock issuance. Some section 382 poison pills are triggered at ownership percentages below 5% (e.g., 4.75%).

Many companies that have adopted section 382 poison pills already had conventional poison pills in place. The existing program was triggered when a shareholder acquired a large stake (typically, 10-20%) in the company. These programs have been amended to go into effect at lower ownership percentages that are relevant to section 382. Some critics believe that these provisions are being adopted more to reduce the risk of a hostile corporate takeover and less to protect tax attributes.

The use of aggressive poison pills were dealt a blow by the Delaware courts in 2021. The Court of Chancery held the plan put in place by the Williams Companies was invalid and unenforceable. The court held that the board of directors breached their fiduciary duty to the shareholders. The plan in question used 5% as a trigger, but was not based on the need to protect NOLs from an ownership change. The company was required by the court to rescind the poison pill plan. *In re Williams Cos. Stockholder Litig.*, 2021 Del. Ch. Lexis 34 (Feb. 26, 2021), *aff'd*, No. 139.2021 (Del. Nov. 3, 2021) (*en banc*).

Since the Delaware Supreme Court had previously approved a section 382 poison pill plan with a 5% trigger, it appears that the *Williams Companies* case stands for the proposition that the 5% level can only be used when used to protect NOLs under section 382. Companies that are considering adopting a section 382 poison pill should consider the experiences of Selectica, Inc. ("Selectica"). In 2008, Selectica amended its conventional poison pill program to lower the triggering threshold to 4.99%. There was a cumulative owner shift of approximately 40% at the time. Existing shareholder were generally grandfathered, except if they acquired an additional 0.5% of the stock.

One of Selectica's competitor (Trilogy) was actively acquiring shares of Selectica during the time that Selectica was considering the amendment of its poison pill plan. Trilogy acquired a greater than 5% stake six days before the adoption of the amended plan. About one month after the amendment was adopted, Trilogy announced that they had purchased enough shares to trigger the poison pill. (Selectica claims that Trilogy first threatened to trigger the poison pill provisions unless Selectica granted concessions.)

After learning of Trilogy's acquisition of additional shares, the board of directors of Selectica choose to allow the provisions of the poison pill to go into effect. Under Selectica's plan, all shareholders (other than Trilogy and its affiliates) became entitled to one additional share for each share held in exchange for their rights under the poison pill plan. Selectica then adopted a new poison pill plan and issued it to all shareholders (other than Trilogy). Trading in Selectica's shares were suspended for a month so that the Selectica (and its transfer agent) could determine who was entitled to additional shares (i.e., was not related to Trilogy). As a result of the triggering of the plan, Trilogy's interest was diluted from 6.7% to 3.3%. *Selectica, Inc. v. Versata Enterprises*, 2010 Del. Ch. Lexis 39 (Feb. 26, 2010), *aff'd*, 5 A.3d 586 (Del. 2010).

Selectica also filed a lawsuit in Delaware Court of Chancery seeking a declaratory judgment that its actions were valid under Delaware corporate law. On February 26, 2010, the court ruled in favor of Selectica. The court ruled that the adoption of the plan with a 4.99% threshold was valid since preservation of tax attributes is a valid corporate objective. The court thought the tax attributes were worth protecting even though the value was speculative. The court noted that the board of directors believed that the value of the NOLs was material relative to the then-market value of the company's stock and that the NOLs, if preserved, would not expire for years. It also held that Selectica's actions in dealing with the intentional trigger of the plan by Trilogy were reasonable. The court noted that preservation of tax attributes could be used by corporations as a pretext for unreasonable anti-takeover provisions. As a result, it held that plans designed to protect tax attributes will be subject to careful review. *Selectica*. The Delaware Supreme Court subsequently affirmed

the judgment. *Versata Enterprises v. Selectica, Inc.*, 5 A.3d 586 (Del. 2010). As a result, it appears that reasonable section 382 poison pills are generally safe from attack from a corporate law standpoint.

Conventional poison pill plans are not treated as stock under general tax principles and are generally exempted from the section 382 option attribution rules. *See* Rev. Rul. 90-11, 1990-1 CB 10. There is no reason to believe that the answer is different for a section 382 plan since the key difference is a lower shareholder threshold. No case or ruling has been found as to the treatment under section 382 of the actual issuance of stock under a plan as happened with respect to Selectica. It is certainly possible that the issuance of shares by Selectica under the poison pill plan increased the cumulative owner shift (possibly in a greater amount than if they had allowed Trilogy to retain their greater stock interest).

It should be noted that all of the techniques for protecting the tax attributes of the loss corporation generally involve protection against transactions entered into by direct shareholders. In many cases, there is little that can be done to protect against owner shifts caused by indirect shareholders. For example, if a publicly-traded corporation owns 25% of the stock of a loss corporation, there may not be any practical way to prevent shareholders of the higher tier entity from causing an ownership change. Similarly, if the loss corporation is a US subsidiary of a foreign corporation, it may not be possible to enter into measures to protect against an ownership change.

F. Records and Information Reporting

Loss corporations are required to maintain records with respect to the determination of (i) the identity of 5% shareholders, (ii) the percentage of stock owned by 5% shareholders, and (iii) whether an ownership change has occurred. These records must be maintained as long as they are relevant to an open taxable year. Temp. Reg. § 1.382-2T(a)(2)(iii).

A loss corporation is required to attach an information statement to its tax return for any tax year that it is a loss corporation in which an owner shift, equity structure shift, or certain issuances or transfers of options occur. Treas. Reg. § 1.382-11(a). The information that is required to be attached to the return can be found in section 1.382-11(a) of the Treasury regulations. Generally, loss corporations are only required to disclose whether they have had any testing dates during the taxable year and, if so, whether an ownership change occurs. The regulations do not require that loss corporations disclose the amount of any section 382 limitation or whether there are RBILs subject to limitation.

III. 5% Shareholder

An important component of any ownership change analysis is a determination of the 5% shareholders. A 5% shareholder is an individual (or group of individuals) that owns 5% of the stock of the corporation (directly, or indirectly by attribution). IRC § 382(k)(7); Temp. Reg. § 1.382-2T(g)(1).

It may seem odd to describe the owners of a corporation as including only individuals and groups of individuals. In many cases, all of the shareholders will be entities. However, under the aggregation and constructive ownership rules, entities are treated as one or more groups of individuals. Some call this the “ultimate human” rule. Said another way, a loss corporation is treated as owned by actual human beings even if they cannot be identified and their connection is tenuous due to multiple layers of corporations (or other entities).

An individual is generally considered to be a 5% shareholder if the person owns 5% or more of the stock of the loss corporation at any time during the testing period. Temp. Reg. § 1.382-2T(g)(1)(i). An individual

is still considered to be a 5% shareholder even if his percentage ownership interest drops below 5% on or before the testing date. Temp. Reg. § 1.382-2T(g)(1).

The 5% ownership requirement for an individual to be a 5% shareholder can be met either through (i) a direct ownership interest in the loss corporation of 5% or more, or (ii) an indirect ownership interest (through attribution from an entity) of 5% or more. Temp. Reg. § 1.382-2T(g)(1)(i).

Generally, a person that does not have either a direct ownership interest or an indirect ownership interest of 5% or more is not considered to be a 5% shareholder even if the two ownership interests when added together exceed 5%. Temp. Reg. § 1.382-2T(g)(3). However, the two interests are combined to determine 5% shareholder status if the loss corporation has actual knowledge of the facts. Temp. Reg. § 1.382-2T(k)(2)(i). This is how the temporary Treasury regulations state the rule. A more practical way of describing the rule is a person is treated as a 5% shareholder if they own 5% or more (taking into account all direct and indirect strands of ownership) unless the loss corporation does not have actual knowledge of the facts.

Special rules apply if the ownership interests in a loss corporation are structured by a person with an interest in a loss corporation to avoid treating the person as a 5% shareholder for a principal purpose of circumventing a section 382 limitation. In such case, the shareholder's actual ownership (including by attribution) is taken into account. Temp. Reg. § 1.382-2T(k)(4)(ii). This anti-avoidance provision only applies if the application results in an ownership change. Temp. Reg. § 1.382-2T(k)(4).

A public group (i.e., a group of individuals) is considered to be a 5% shareholder. A public group consists of individual shareholders that are grouped together under either of the aggregation or segregation rules, described below. Temp. Reg. § 1.382-2T(g)(1)(ii–iv).

A. Operating and Presumption Rules

The regulations provide several rules relating to presumptions as to stock ownership. In some cases, these presumptions are optional (taxpayer may choose whether to apply the presumption). In other cases, these presumptions are mandatory but can be overcome (at the taxpayer's option) with actual knowledge.

SEC Filings

If the loss corporation has stock that is registered with the Securities and Exchange Commission (SEC), the loss corporation can rely upon the existence (or absence) of filings of Schedules 13D and 13G to determine which shareholders have a direct ownership interest of at least 5% on any date. Similarly, if a first tier or higher tier entity is registered with the SEC, the loss corporation can also rely upon the existence (or absence) of filings of Schedules 13D and 13G to determine which shareholders have an indirect ownership interest of at least 5% on any date. Temp. Reg. § 1.382-2T(k)(1)(i).

Both Schedules 13D and 13G are referred to as “beneficial ownership reports.” They are generally used to report ownership of stock of a public company which exceeds 5% of the total shares of a class of registered securities. Such reports are generally necessary when a holder first holds more than 5% of the stock and when, at a later time, the ownership percentage changes materially (e.g., more than 1%).

Under current rules, Schedule 13D is required to be filed within ten days of a transaction. Schedule 13G is an optional shorter version of Schedule 13D, with fewer reporting requirements and is only available to certain holders. Under the current rules, Schedule 13G is required to be filed by specified investors within 45 days of the end of the year (or within ten days of a month in which the holder first holds more than 10%

of the stock). Passive investors are required to file within ten days of a transaction. 17 CFR §§ 240.13d-1, -2.

The annual nature of Schedule 13G can make planning very difficult. If a loss corporation is close to an ownership change, there will be no way of knowing whether an institutional investor has acquired 5% of the stock until the beginning of the following calendar year. In certain cases, Forms 13F (described below) can be used to provide information for some institutions before the Schedule 13G is filed.

In February 2022, the SEC proposed a rule to “modernize” the filing deadlines for Schedules 13D and 13G. The most significant proposed change from a section 382 standpoint is that investors that can now file Schedule 13G annually will be required to file monthly (i.e., five business days after the month in which a transaction occurs). The amended rules would also shorten the deadline for other filings from ten days to five days (and to one day after a material change occurs). Prop. Rule §§ 240.13d-1, -2; SEC RIN 3235-AM93, 87 CFR 13846 (2022). The proposed rule does not specify a proposed effective date.

This reliance rule also applies to schedules that are similar to Schedules 13D and 13G. Temp. Reg. § 1.382-2T(k)(1)(i). As a result, it is possible that filings of SEC Forms 3, 4, or 5 can be similarly relied upon. Forms 3, 4, and 5 are filed by “insiders” (i.e., officers, directors, and individuals who hold more than 10% of a class of securities). Insiders use these forms to report becoming an insider (Form 3) and transactions with respect to securities of the company (Forms 4 and 5).

It is also possible that SEC Form 13F can be relied upon. Institutional investment managers with investment discretion (such as the manager of a mutual fund) are required to report their holdings on a quarterly basis. These filings only apply to larger institutions (fair market value of at least \$100 million).

Schedules 13D and 13G and Forms 3, 4, 5, and 13F are all available on EDGAR (the Electronic Data Gathering, Analysis, and Retrieval system). This is a free searchable database maintained by the SEC. [SEC.gov | Filings & Forms](https://www.sec.gov/filings) (last accessed May 28, 2022). This makes searching for these documents relatively easy.

The regulations only state that SEC filings can be relied upon to determine the existence or absence of a 5% shareholder. There is no indication that a loss corporation can rely upon the percentage ownership interest reported in an SEC filing. However, most practitioners do rely on the percentages reported for ownership change purposes. William Alexander, then IRS Associate Chief Counsel (Corporate), suggested in May 2012 that taxpayers could not rely on the percentages shown in SEC filings but those percentages could be treated as some evidence of the percentage ownership interest. He said that “it may be that in some cases you could say there's enough information on this form that I can in effect say that I've sent them a letter and they've answered it.” *ABA Meeting: Private Offering Coordinated Acquisitions Warrant Guidance, Alexander Says*, 2012 TNT 94-4.

The regulations do not have a similar rule for corporations that are registered with a foreign equivalent of the SEC. *See* Temp. Reg. § 1.382-2T(k)(6) [reserved]. A position may be available that foreign filings (in appropriate circumstances) can be relied upon. *See* Temp. Reg. § 1.382-2T(k)(1)(i) (reliance upon “rule or regulation to generally the same effect” as SEC Rule 13d-1(d) of Regulation 13D-G). In any case, such filings would be considered evidence of ownership by a person that could be taken into account.

In Private Letter Ruling 200747016 (Aug. 20, 2007), the IRS ruled on several issues regarding reliance upon SEC filings. Below is a list of some of the more important conclusions made by the IRS in the ruling.

- If a loss corporation chooses to rely on SEC filings, it must rely on all of such filings (except if reliance is contradicted by actual knowledge).
- Taxpayers can ordinarily ignore the difference between the SEC filing threshold (more than 5%) and the definition of 5% shareholder (5% or more) when relying upon the SEC filings. For example, a statement in a filing that no person owns more than 5% can be relied upon for purposes of determining whether a person owns 5% or more.
- If a loss corporation has actual knowledge of stock ownership it can use that knowledge to clarify an ambiguous SEC filing. In determining whether the information is of sufficient “weight and probity,” the loss corporation should take into account the source of the information. Generally, information filed with the SEC under penalties of perjury is given greater weight than information received from less formal sources (e.g., information received by telephone or e-mail from a filer).
- If an SEC filing is unambiguous that the person filing does not have “economic ownership” (i.e., the right to dividends and proceeds from the sale of stock) of the reported shares of 5% or more, the loss corporation can disregard the reported stock ownership. The ability to disregard the reported stock ownership only applies if the filing also makes clear that no other person with respect to the reported shares has an economic ownership of 5% or more of the stock. *See also* PLR 201403007 (Sept. 19, 2013); PLR 200902007 (Oct. 7, 2008); PLR 200822013 (Feb. 12, 2008); PLR 200818020 (Jan. 29, 2008); PLR 200806008 (Nov. 7, 2007). This situation can occur where an investment advisor files because it has “beneficial ownership” (i.e., the right to vote or dispose of the shares) over shares for which its clients have economic ownership.
- If an SEC filing is ambiguous or inconsistent as to whether the filer has economic ownership, then the shares reported by the filer are taken into account for section 382 purposes. However, if the filer clarifies the facts (by telephone and/or e-mail) then the information received directly can be taken into account instead of the ownership percentage reported on the SEC filing. (This information cannot be used to contradict an SEC filing that is unambiguous.)

PLR 200747016.

Written Statements

A loss corporation can generally rely upon a written statement made by a first tier or higher tier entity to establish the extent to which changes in ownership of the entity making the statement have occurred. To be able to rely on the statement, it must be signed under penalties of perjury by an officer, director, partner, trustee, or similar responsible person on behalf of the entity. Temp. Reg. § 1.382-2T(k)(1)(ii).

A written statement cannot be relied upon by the loss corporation, if it knows the statement to be false. In addition, such a statement cannot be relied upon if the signing entity owns 50% or more of the stock of the loss corporation (directly, or indirectly by attribution). For purpose of the 50% ownership test, any first tier entities or higher tier entities that are members of the same controlled group (based on the knowledge of the loss corporation), are treated as a single corporation. Temp. Reg. § 1.382-2T(k)(1)(ii). For this purpose, a “controlled group” is defined in section 1563(a), as modified by section 267(f)(1). Under this definition, two corporations are generally treated as members of a controlled group if a corporation or group of individuals owns (directly, or indirectly by attribution) more than 50% of the stock (by vote or value) of both corporations.

It appears that a written statement cannot be relied upon to establish (i) the existence or absence of segregation rule transactions at the level of the first tier or higher tier entity, or (ii) an individual or first tier entity’s direct ownership interest in the loss corporation. However, such a written statement may help substantiate the position taken as to the identity of the 5% shareholders and the percentage ownership interest. *See* Temp. Reg. § 1.382-2T(a)(2)(iii).

Actual Knowledge

In certain cases, actual knowledge of stock ownership by a loss corporation must be taken into account. In other cases, actual knowledge is permitted to be applied by the taxpayer (or ignored). *See* Temp. Reg. § 1.382-2T(k)(2). The regulations generally use “must” for the former and “may” for the latter.

The IRS has not issued any guidance as to the meaning of the term “actual knowledge.” In Private Letter Ruling 201024037 (Mar. 11, 2010), the IRS ruled that a private corporation’s procedures for determining the ownership of its shareholders constituted an acceptable method of determining “actual knowledge.” The taxpayer had information as to the persons that invested in various private offerings of its stock. The taxpayer then identified a representative of each investor who was knowledgeable about the investment in the taxpayer. Once identified, the taxpayer would make written inquiries regarding the ownership (taking into account various section 382 rules). After sending a written inquiry, the taxpayer would arrange a teleconference between its tax advisor, itself, and the investor representative, supplemented by e-mails. PLR 201024037; *see also* PLR 202146003 (Aug. 25, 2021) (determining “overlapping” shareholders in a merger); PLR 201110006 (Sept. 10, 2010) (same). The procedures adopted by this taxpayer appear to be a “best practice.”

Generally, a loss corporation must take into account any actual knowledge it has that an individual would be a 5% shareholder. Actual knowledge, if it exists, overrides certain limitations on the application of the entity and family attribution rules. Temp. Reg. § 1.382-2T(k)(2)(i). For example, if an individual owns 4% of a loss corporation directly and 2% indirectly, by attribution, the individual is ordinarily not treated as a 5% shareholder. However, if the loss corporation has actual knowledge of the two interests, the individual is treated as a 5% shareholder owning 6%. *See* Temp. Reg. § 1.382-2T(j)(1)(vi) Ex. (5).

A loss corporation must take into account any actual knowledge as to the stock ownership of a 5% shareholder. Actual knowledge, if it exists, overrides certain limitations on the application of the entity and the family attribution rules. Temp. Reg. § 1.382-2T(k)(2)(ii). For example, if an individual owns 5% of a loss corporation directly and 2% indirectly, by attribution, the individual is ordinarily treated as a 5% shareholder owning 5% of the stock. However, if the loss corporation has actual knowledge of the 2% interest, the individual is treated as owning 7%. *See* Temp. Reg. § 1.382-2T(g)(4) Ex. (3).

A loss corporation must take into account any actual knowledge it acquires after the testing date on the tax return for the taxable year that includes the testing date. However, actual knowledge acquired after the return is filed does not necessarily need to be taken into account. In such case, the taxpayer may take such information into account and may file an amended return to reflect such knowledge (if the statute of limitations is open). Temp. Reg. § 1.382-2T(k)(2).

The above actual knowledge rules override any presumptions with regard to stock ownership with respect to reliance upon SEC filings or written statements received from a first tier or higher tier entity. Temp. Reg. § 1.382-2T(k)(1). However, the loss corporation has no duty of inquiry as to direct or indirect ownership of the stock of the loss corporation (other than as described below). Temp. Reg. § 1.382-2T(k)(3).

The actual knowledge rules do not override the rules relating to a change in 5% shareholder status (i.e., 5% shareholders that drop below the 5% level and persons that become 5% shareholders during the testing period). Temp. Reg. § 1.382-2T(k)(2).

Duty of Inquiry

A loss corporation is required to determine the stock ownership on each testing date of:

- any individual with a 5% or more direct ownership interest in the loss corporation,
- any first tier entity,
- any higher tier entity with a 5% or more indirect ownership interest in the loss corporation,
- any individual with a 5% or more direct interest in a first tier or higher tier entity who also has a 5% or more indirect ownership interest in the loss corporation.

Temp. Reg. § 1.382-2T(k)(3).

The loss corporation does not have any obligation to inquire or determine the facts with respect to any other shareholders. In addition, the loss corporation does not have any obligation to inquire or determine the facts with respect to the correctness of any of the presumptions of stock ownership contained in the section 382 regulations. Temp. Reg. § 1.382-2T(k)(3).

Change in 5% Shareholder Status

If an individual is a 5% shareholder on the testing date but did not own 5% or more at all times during the testing period, the taxpayer can treat the individual as having had a zero percentage ownership interest in the loss corporation during the period before it became a 5% shareholder. The stock owned by the 5% shareholder before reaching the 5% level is considered to be owned by a public group. Temp. Reg. § 1.382-2T(g)(5)(i)(A), (ii) Ex. (shareholder increases ownership from 2.5% to 7.5% but treated as having a 7.5% increase). This is an optional rule which is generally not taxpayer-favorable as it results in a larger owner shift than could result using actual knowledge. However, the rule is useful when the stock ownership before an individual reached 5% is not (or cannot be) determined. The rule can also be useful where an earlier ownership change is more beneficial than a later one.

If a 5% shareholder's percentage ownership interest in the loss corporation is reduced to below 5%, the taxpayer can treat the shares owned (immediately after the reduction) as continuously owned by the 5% shareholder for the remainder of any testing period that includes the day the interest dropped below 5% (i.e., the share ownership is frozen). Temp. Reg. § 1.382-2T(g)(5)(i)(B). This is an optional rule which is generally taxpayer-favorable as it results in a smaller owner shift than could result using actual knowledge. Of course, the taxpayer always has the option to ignore the presumption and take into account the actual ownership during the period the 5% shareholder owns less than 5%.

The presumption that a 5% shareholder's share ownership is frozen only applies "as long as such shareholder continues to own less than five percent of the stock of the loss corporation." Temp. Reg. § 1.382-2T(g)(5)(i)(B). The language of the regulation suggests that the share ownership can be treated as frozen during the period in which the shareholder is below 5% and the actual shares owned are taken into account once the 5% mark is again reached.

The presumption that a 5% shareholder's share ownership is frozen does not apply if the ownership interests in the loss corporation are structured to allow the loss corporation to rely on the presumption for a principal purpose of circumventing a section 382 limitation. In such case, the shareholder's actual ownership is taken into account. Temp. Reg. § 1.382-2T(k)(4)(iii). This anti-avoidance provision only applies if the application results in an ownership change.

If a 5% shareholder's share ownership is frozen, the shareholder is treated as a public group for certain purposes under the segregation rules. Generally, for purposes of any segregation rule in which share ownership would be reduced (e.g., a redemption, an acquisition by a 5% shareholder or first tier entity from a less than 5% shareholder), the 5% shareholder is treated as a public group. However, for purposes of any segregation rule in which share ownership would be increased (e.g., a small issuance of shares, a sale by a

5% shareholder or first tier entity to a less than 5% shareholder), the 5% shareholder is not treated as a public group. Temp. Reg. § 1.382-2T(g)(5)(i)(B), (j)(2)(vi); PLR 200841021 (Apr. 29, 2008); PLR 200837027 (Mar. 14, 2008).

Status Change Example. Individual A owns 700 thousand shares of Lossco common stock (a 7% percentage ownership interest). All of the remaining shares of Lossco are owned by less than 5% shareholders. On January 1, 2013, A sells 300 thousand shares to less than 5% shareholders. On June 30, 2013, A sells 100 thousand shares to less than 5% shareholders. On January 1, 2014, Lossco redeems 5% of its stock (in a small redemption transaction). On June 30, 2014, Lossco reissues the shares redeemed in the prior transaction (in a small issuance transaction).

After A sells 300 thousand shares, A only owns 400 thousand shares (a 4% percentage ownership interest). Lossco can choose to freeze A's ownership at 400 thousand shares. In which case, the sale of 100 thousand shares would be ignored and A would continue to be treated as owning 400 thousand shares. For purposes of the redemption, A would be treated as a public group. As a result, the shares A is treated as owning would be reduced by 5% to 380 thousand. However, since the redemption was pro rata among the two public groups, A's percentage ownership interest remains at 4%. For purposes of the stock reissuance, A would not be treated as a public group. As a result, A is treated as continuing to own 380 thousand shares. However, A percentage ownership interest dropped to 3.8% based upon dilution.

B. Entity

For ownership change purposes, the term "entity" includes "any corporation, estate, trust, association, company, partnership, or similar organization." Treas. Reg. § 1.382-3(a)(1)(i). The term is relevant for purposes of determining the public groups and for purposes of the constructive ownership rules.

Group of Investors

In certain cases, a group of shareholders can be treated as an entity. Two or more shareholders are treated as an entity if there is a "formal or informal understanding among themselves to make a coordinated acquisition of stock." Treas. Reg. § 1.382-3(a)(1)(i). There is an exception to this rule for creditors that receive stock in satisfaction of debt in a bankruptcy or similar proceeding. *Id.*

The regulations state that the principal factor in determining whether shareholders have the requisite "understanding" is "whether the investment decision of each member of a group is based upon the investment decision of one or more members." Treas. Reg. § 1.382-3(a)(1)(i). In other words, is the shareholder acquiring shares independently or based on the knowledge that others are also buying stock. *See* Treas. Reg. § 1.382-3(a)(1)(ii) Ex. 2 (group of friendly investors assembled by management). Although not explicitly stated in the regulations, it appears that an additional important factor is whether the investors have an intent to influence management, policies, or business operations. *See* PLR 201126002 (Mar. 29, 2011) (investors in private placement not treated as a group); PLR 201010009 (Dec. 4, 2009) (same).

Group Example. Twenty individuals, who previously were not shareholders, each acquire 3% of the stock (totaling 60%) of a public company. The motivation of each individual was to be part of a group of shareholders that would control the actions of the board of directors. The group is treated as an entity for ownership changes purposes. Under the aggregation rules, the twenty shareholders are treated as a public group that is treated as a 5% shareholder. Since the group increased its ownership from zero to 60%, an ownership change occurred on the date shares were acquired. *See* Treas. Reg. § 1.382-3(a)(1)(ii) Ex. 1.

A group of investors are not treated as an entity if they invest independently of each other. This is the case even if the shareholders are acting upon the recommendation of a single investment advisor or underwriter. Treas. Reg. § 1.382-3(a)(1)(ii) Ex. 3.

Investment Advisors. In certain cases, an investment advisor does more than just recommend that a client invest in a loss corporation. Investment advisors sometimes are also given the right to buy or sell client securities without client approval (but within certain parameters or guidelines). Such an advisor could purchase shares of a loss corporation for the accounts of multiple clients. In such case, the clients of the advisor will not be treated as an entity as long as the investment decision for one client is not made based upon the investment decision made for the other clients. Treas. Reg. § 1.382-3(a)(1)(ii) Ex. 3 (trustee of multiple pension trusts). Factors that may be relevant in determining whether the clients of an investment advisor are treated as a group could include (i) is the investment advisor attempting to acquire a minimum amount of shares to acquire certain rights (e.g., a 20% block allows the holder to nominate a director), and (ii) is the investment advisor deciding independently whether the investment is appropriate for one client but not appropriate for another.

The IRS has ruled on several occasions that two or more mutual funds from the same fund family are not treated as an entity even if the funds have the same investment advisor. PLR 201902022 (Oct. 4, 2018); PLR 201305001 (Oct. 31, 2012); PLR 9725039 (Mar. 26, 1997); PLR 9610012 (Dec. 5, 1995).

There is a great deal of uncertainty as to when private investment funds are treated as a group when the funds are managed by the same investment advisor. Funds of this sort include private equity funds, distressed investment funds (sometimes called “vulture funds”), hedge funds, and venture capital funds. Some taxpayers take the position that such funds are not a group unless the funds (in the aggregate) attempt to acquire enough shares to acquire rights to influence management or the choice of one or more directors. Others treat such funds as a group unless substantiation is received from the fund manager that there was no attempt to make a coordinated acquisition.

In a 2012 legal memorandum, the IRS treated several private investment funds with a common investment advisor as a group. The taxpayer was in bankruptcy. The funds had previously acquired shares of the taxpayer (but less than 5% in the aggregate). The funds sought to acquire additional shares (that would in the aggregate increase the ownership above 5%). The taxpayer agreed to allow the funds to acquire a certain number of shares (in the aggregate) as long as (i) each fund continued to separately own less than 5%, and (ii) the funds were not properly treated as a group. If the funds were to be treated as a group, the ownership of the funds in excess of 5% were to be void ab initio and the funds would generally be required to sell the excess shares. After the agreement was reached, the funds acquired the additional shares. CCA 201215007 (Jan. 5, 2012),

The IRS treated the funds in CCA 201215007 as a group since the number of shares acquired by the funds was not limited on a separate fund basis. Instead the limit was determined on an aggregate basis. In the IRS’ mind, this necessitated coordination between the funds to determine if the aggregate limit was reached. CCA 201215007. It is possible that the IRS might have come to a different conclusion if the parties had allocated shares that each fund could have acquired in advance. In Private Letter Ruling 200902007 (Oct. 7, 2008), the IRS provided additional insight regarding when a group of investors constitute an entity. The ruling relates to the treatment of an investment advisor that files a Schedule 13D or 13G on behalf of two or more economic owners of shares where the aggregate ownership is more than 5%. If the Schedule 13D or 13G does not affirm the existence of a “group” (under section 13(d)(3) of the Securities Exchange Act of 1934) and the economic owners do not independently file a Schedule 13D or 13G, then the loss corporation can rely on the filings (and absence of filings) to determine that the economic owners are not members of a group that are treated as an entity. The IRS further ruled that two or more economic owners

are not treated as an entity merely because employees and directors of the investment advisor are also employees and directors of the economic owners. In addition, the IRS listed permissible activities that the investment advisor could engage in without causing entity treatment (absent other factors). The investment advisor was allowed to have the authority to (i) vote the shares of the loss corporation, (ii) acquire or dispose of the shares (including batch trading or cross trading), (iii) use a common custodian to hold the stock, (iv) file a Schedule 13D or 13G with respect to the stock (unless the form states that the economic owners are acting in concert or engaged in a coordinated acquisition), (v) communicate with management of the loss corporation regarding operations, management, or capital structure, (vi) adhere to an investment advisor's general policy on how to vote shares, and (vii) have certain communications by an investment advisor with clients or prospective clients. PLR 200902007; *see also* PLR 201902022 (Oct. 4, 2018) (Advisor A); PLR 201403007 (Sept. 19, 2013). Based on the above cited rulings, it appears reasonable to use Schedules 13D and 13G as a tool for determining group status. A brief discussion of the applicable SEC rules follows.

The SEC has issued rules for when two or more investors will be treated as a “group” for purposes filing Schedules 13D and 13G (and the disclosures therein). Two or more persons are treated as a group for purposes of Schedule 13D and 13G if they “agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer.” 17 CFR § 240.13d-5(b)(1). However, concerted actions can be ignored if they related to the purchase of equity securities directly from the issuer in a transaction not involving a public offering and the purchase is in the ordinary course of the person's business and not with a purpose (or effect) of changing or influencing control of the issuer (and other requirements are met. 17 CFR § 240.13d-5(b)(2).

In February 2022, the SEC proposed changes to the group rules. One significant change would eliminate the current definition of when two or more persons are treated as a group. Under the proposed language two or more persons that “act as a group” under the statute will be treated as a group. Prop. Rule. § 240.13d-5(b)(1)(i), RIN 3235-AM93 __ CFR __ (Feb. 10, 2022). The intent of the proposed change is “to remove the potential implication that it sets forth the exclusive legal standard for group formation” under the statute. RIN 3235-AM93, p. 71.

A different proposed change relates to a disclosure of non-public information regarding a potential filing of Schedule 13D or 13G. The two parties will be treated as a group if the purpose of the disclosure is to cause the other person to acquire equity securities of the issuer. Prop. Rule. § 240.13d-5(b)(1)(ii).

There is a great deal of uncertainty as to how these proposed change, if they are finalized, will affect the ability of taxpayers to use Schedules 13D and 13G as a tool for determining group status. It should be noted that the proposed rule does not specify a proposed effective date.

There is some uncertainty as to the treatment of participant-directed plans. For example, an employer's section 401(k) plan could allow employees to invest in various mutual funds (i.e., RICs) chosen by the employer. Similarly, an insurance company could allow holders of variable insurance products to invest in various funds chosen by the insurance company. There is a concern that the holders could be treated as a group since the employer or insurance company makes the decision as to which funds to offer in the plan.

On November 23, 2011, the IRS and the Treasury Department requested comments as to the circumstances under which a group of investors should be treated as a single entity. REG-149625-10, 2012-1 CB 279. Various comments were submitted. On October 22, 2013, the IRS and the Treasury Department announced that after considering the comments received, further study was warranted. TD 9638, 2013-2 CB 487.

C. Aggregation Rule

Under the aggregation rules, all individuals that own less than 5% of the stock of the loss corporation (directly, or indirectly by attribution) during the entire testing period are assigned to a public group. The members of these public groups are aggregated and each public group is treated as a single 5% shareholder. IRC § 382(g)(4)(A); Temp. Reg. § 1.382-2T(j)(1)(i). The aggregation rules generally provide rebuttable presumptions of no cross-ownership as to the ownership of stock among public groups. Temp. Reg. § 1.382-2T(j)(1)(iii).

A public group under the aggregation rules is treated as a 5% shareholder. Temp. Reg. § 1.382-2T(g)(1)(ii), (iii). For ownership change purposes, a public group is treated as a single individual. Temp. Reg. § 1.382-2T(j)(1)(ii).

Determination of Public Groups

In order to apply the aggregation rules, the loss corporation must first determine which entities directly owned at least 5% of the stock of the loss corporation at any time during the testing period. These entities are first tier entities. Temp. Reg. § 1.382-2T(f)(9).

After identifying the first tier entities, the loss corporation then determines the entities that own at least 5% of the stock of a first tier entity at any time during the testing period. These entities are higher tier entities. Temp. Reg. § 1.382-2T(f)(14).

The loss corporation then determines all entities that own at least 5% of the stock of a higher tier entity at any time during the testing period. These entities are also higher tier entities. Temp. Reg. § 1.382-2T(f)(14).

After identifying all of the higher tier entities, the loss corporation then determines which first tier entities and higher tier entities have not been owned at any time during the testing period by a higher tier entity. These entities are highest tier entities. Temp. Reg. § 1.382-2T(f)(16).

The aggregation rule analysis begins with the highest tier entities. Each person that owns a direct interest in a highest tier entity but is not a 5% shareholder is a member of a public group of that highest tier entity. Temp. Reg. § 1.382-2T(j)(1)(iv)(A). For example, if a highest tier entity owns 50% of a loss corporation and an individual owns 20% of the entity, the shareholders owning 80% of the highest tier entity are aggregated into a public group that is treated as a 5% shareholder owning 40% of the loss corporation.

After analyzing the ownership of all the highest tier entities, a similar analysis is performed for the entity below the highest tier entity. Temp. Reg. § 1.382-2T(j)(1)(iv)(B). This entity is a next lower tier entity. Temp. Reg. § 1.382-2T(f)(17). This process is repeated for each next lower tier entity until applied to a first tier entity. Temp. Reg. § 1.382-2T(j)(1)(iv)(B). Each person that owns a direct interest in a next lowest tier entity but is not a 5% shareholder or higher tier entity is a member of a public group of that next lower tier entity. Temp. Reg. § 1.382-2T(j)(1)(iv)(B).

After all of the first tier entities and higher tier entities are analyzed, an analysis is performed at the loss corporation level. Each person that owns a direct interest in a loss corporation but is not a 5% shareholder or first tier entity is a member of a public group of the loss corporation. Temp. Reg. § 1.382-2T(j)(1)(iv)(C). Each such person is a public shareholder. Temp. Reg. § 1.382-2T(f)(11).

The next step in the process is to determine which of the public groups of the first tier entities and the higher tier entities own at least 5% on the testing date of the loss corporation (indirectly by attribution). Any public

group that owns at least 5% on the testing date is treated as a 5% shareholder. Temp. Reg. § 1.382-2T(g)(1)(ii).

For those public groups that owned less than 5% of the loss corporation (directly, or indirectly by attribution) throughout the testing period, the members of the public group are treated as members of the public group of the next lowest tier entity or the loss corporation, as the case may be. If the members of the public group of the next lowest tier entity owned less than 5% throughout the testing period (including the less than 5% public group of the higher tier entity), the members of the public group of that next lowest tier entity are treated as members of the public group of the next lowest tier entity or the loss corporation, as the case may be. This analysis is performed successively down the entity chain. Temp. Reg. § 1.382-2T(j)(1)(iv)(A), (C). For example, if a first tier entity owns 10% of a loss corporation and an individual owns 60% of the entity, the shareholders owning the remaining 40% of the entity are aggregated into a public group that includes the direct public group of the loss corporation.

The public group at the loss corporation level is treated as a 5% shareholder. IRC § 382(g)(4)(A); Temp. Reg. § 1.382-2T(g)(1)(iii). This is the case, even if the public group owns less than 5% at all times during the testing period (including the testing date). Temp. Reg. § 1.382-2T(j)(1)(iv)(C).

For purposes of the aggregation rule, any transitory ownership of stock by an underwriter of an issuance is disregarded. Treas. Reg. § 1.382-3(j)(7).

Change in Status

If a public group of a first or higher tier entity is treated as a 5% shareholder on the testing date but did not own 5% or more at all times during the testing period (i.e., the group increases from below 5% to 5% or more during the testing period), the taxpayer can treat the group as having had a zero percentage ownership interest in the loss corporation during the period before it acquired 5%. The stock owned by the group before reaching the 5% level is considered to be owned by a public group of the next lowest tier entity or the loss corporation. Temp. Reg. § 1.382-2T(g)(5)(A), (j)(1)(v)(A). This is an optional rule which is generally not taxpayer-favorable as it results in a larger owner shift than could result using actual knowledge. However, the rule is useful when the stock ownership before a public group reached 5% is not (or cannot be) determined. The rule can also be useful where an earlier ownership change is more beneficial than a later one.

If a public group of a first or higher tier entity is treated as a 5% shareholder before the testing date but did not own 5% or more on the testing date (i.e., the group decreases from 5% or more to below 5% during the testing period), the taxpayer has three alternative available approaches. First, the taxpayer can apply any actual knowledge of share ownership by the public group. Second, the taxpayer can freeze the stock ownership of the group (similar to the freeze approach described above with respect to individual shareholders that decrease from 5% or more to below 5%). Third, the taxpayer can treat the members of the public group as members of the public group of the next lowest tier entity for the entire testing period.

If the public group of a first or higher tier entity decreases its ownership from 5% or more to below 5% during the testing period, the taxpayer can treat the shares owned (immediately after the reduction) as continuously owned by the group for the remainder of any testing period that includes the day the interest dropped below 5% (i.e., the share ownership is frozen). However, this presumption does not apply if the public group reaches the 5% level again later in the testing period. Temp. Reg. § 1.382-2T(g)(5)(B), (j)(1)(v)(B). Where this rule applies, the members of the public group are not treated as members of the next lower tier entity or the loss corporation. This is an optional rule which is generally taxpayer-favorable as it results in a smaller owner shift than could result using actual knowledge.

The presumption that a public group's share ownership is frozen does not apply if the ownership interests in the loss corporation are structured to allow the loss corporation to rely on the presumption for a principal purpose of circumventing a section 382 limitation. In such case, the shareholder's actual ownership is taken into account. Temp. Reg. § 1.382-2T(k)(4)(iii). This anti-avoidance provision only applies if the application results in an ownership change.

If a public group's share ownership is frozen, the group is treated as a public group for certain purposes under the segregation rules. Generally, for purposes of any segregation rule in which share ownership would be reduced (e.g., a redemption, an acquisition by a 5% shareholder or first tier entity from a less than 5% shareholder), the 5% shareholder is treated as a public group. However, for purposes of any segregation rule in which share ownership would be increased (e.g., a small issuance of shares, a sale by a 5% shareholder or first tier entity to a less than 5% shareholder), the 5% shareholder is not treated as a public group. Temp. Reg. § 1.382-2T(g)(5)(i)(B), (j)(2)(vi); PLR 200841021 (Apr. 29, 2008); PLR 200837027 (Mar. 14, 2008).

If the public group of a first or higher tier entity decreases its ownership from 5% or more to below 5% during the testing period, the taxpayer can choose to treat the members of the public group as members of the public group of the next lowest tier entity for the entire testing period (the "tier down approach"). Temp. Reg. § 1.382-2T(j)(1)(iv)(A). In such case, the shares owned by the public group of the first or higher tier entity are treated as owned by the public group of the next lowest tier entity. Temp. Reg. § 1.382-2T(j)(1)(iv)(C). The taxpayer can apply its actual knowledge of ownership by the public group of the first or higher tier entity for the period for which it owned 5% or more of the stock, in determining the lowest percentage ownership interest of the public group of the next lowest tier entity. Treas. Reg. § 1.382-3(j)(16) Ex. 8; PLR 200024047 (Mar. 21, 2000), *supp. by*, PLR 200207002 (July 17, 2001). For example, if Fund has owned 5.1% of the stock of a loss corporation for more than three years but its ownership drops to 4.9% due to dilution, the owners of Fund can be treated under the tier down approach as members of the public group of the loss corporation. If the only public group of the loss corporation has owned 10% of the stock for more than three years (before taking into account the owners of Fund), the public group would be treated as owning 14.9% on the testing date (and 15.1% prior to the testing date).

Public Group Example. Lossco is a loss corporation. The stock of Lossco is owned as follows:

- Individual A owns 20%,
- Corp B owns 10%,
- Partnership C owns 20%, and
- Less than 5% shareholders own the remaining 50%.

The stock of Corp B is owned as follows:

- Individual D owns 15%, and
- Less than 5% shareholders own the remaining 85%.

The partnership interests of Partnership C are owned as follows:

- Corp E owns 30%, and
- Corp F owns 70%.

All of the stock of Corp E is owned by less than 5% shareholders.

The stock of Corp F is owned as follows:

- Individual G owns 60%,
- Corp H owns 30%, and
- Less than 5% shareholders own 10%.

All of the stock of Corp H is owned by less than 5% shareholders.

The treatment of the various parties under the aggregation rules is as follows:

- Individual A is a 5% shareholder that owns 20% of the stock.
- Corp B and Partnership C are first tier entities since each has a direct ownership interest of at least 5%. Corp B is also a highest tier entity since there are no entities that have a direct ownership interest in Corp B of at least 5%.
- Individual D is not a 5% shareholder since the indirect ownership interest is only 1.5% (15% interest in Corp B multiplied by Corp B's 10% interest). As a result, Individual D is included in a public group that includes all of Corp B's shareholders (the "Corp B Shareholder Group"). The Corp B Shareholder Group is a 5% shareholder that owns 10% of the stock.
- Corp E is a higher tier entity since it has a direct ownership interest of 30% in Partnership C. It is also a highest tier entity since there are no entities that have a direct ownership interest in Corp E of at least 5%. All of the Corp E shareholders are members of a public group (the "Corp E Shareholder Group") since no shareholder has an indirect ownership interest of at least 5%. The Corp E Shareholder Group is a 5% shareholder that owns 6% (30% interest in Partnership C multiplied by Partnership C's 20% interest) of the stock.
- Corp F is a higher tier entity since it has a direct ownership interest of 70% in Partnership C. Individual G is a 5% shareholder since it has an indirect ownership interest of 8.4% (60% interest in Corp F multiplied by 70% interest in Partnership C multiplied by Partnership C's 20% interest).
- Corp H is a higher tier entity of Corp F since it has a direct ownership interest of 30% in Corp F. Corp H is also a highest tier entity since there are no entities that have a direct ownership interest in Corp H of at least 5%. All of the Corp H shareholders are members of a public group (the "Corp H Shareholder Group") since no shareholder has an indirect ownership interest of at least 5%. The Corp H Shareholder Group is not a 5% shareholder since the group has an indirect ownership interest of only 4.2% (30% interest in Corp F multiplied by 70% interest in Partnership C multiplied by Partnership C's 20% interest) of the stock. As a result, the members of the Corp H Shareholder Group are grouped with members of the public group of the next lowest tier entity.
- Corp F is a next lowest tier entity with respect to Corp H. All of the Corp F shareholders (other than Individual G) are members of a public group (the "Corp F Shareholder Group") since no shareholder has an indirect ownership interest of at least 5%. The members of the Corp H Shareholder Group are included in the Corp F Shareholder Group. The Corp F Shareholder Group is a 5% shareholder that owns 5.6% (40% interest in Corp F multiplied by 70% interest in Partnership C multiplied by Partnership C's 20% interest) of the stock.
- The next lowest tier entity with respect to Corp B and Partnership C is Lossco. All of the shareholders of Lossco other than Individual A, Corp B and Partnership C, are members of a public group (the "Lossco Shareholder Group"). The Lossco Shareholder Group is a 5% shareholder that owns 50% of the stock.

In summary, the 5% shareholders of Lossco and their percentage ownership interests are as follows:

Individual A	20.0%
Corp B Shareholder Group	10.0%
Corp E Shareholder Group	6.0%
Individual G	8.4%
Corp F Shareholder Group	5.6%
Lossco Shareholder Group	<u>50.0%</u>
Total	<u>100.0%</u>

See Temp. Reg. § 1.382-2T(g)(4) Ex. (2), (j)(1)(vi) Ex. (4).

Other examples of the application of the aggregation rules can be found in paragraph (g)(4) and subparagraph (j)(1)(vi) of section 1.382-2T of the temporary Treasury regulations.

D. Segregation Rules

Under the segregation rules, public groups identified under the aggregation rules are generally divided into two or more public groups if certain transactions occur. The segregation rules generally provide rebuttable presumptions of no cross-ownership as to the ownership of stock amongst the members of each public group. IRC § 382(g)(4)(B), (C); Temp. Reg. § 1.382-2T(j)(1)(iii).

A public group under the segregation rules is generally treated as a 5% shareholder (even if the group does not own 5% at any time during the testing period). Temp. Reg. § 1.382-2T(g)(1)(iv), (j)(2)(iii)(A), (iv)(B) Ex. (iv). For ownership change purposes, a public group is treated as a single individual. Temp. Reg. § 1.382-2T(j)(1)(ii).

The loss corporation has the option of combining certain de minimis public groups. In such case, the combined groups are treated as a single 5% shareholder. This option is available with respect to public groups created under the segregation rules to the extent the public group owns less than 5% of the loss corporation stock at the time the group is identified. Two or more less than 5% groups that are identified in the same taxable year can be combined. This ability to combine de minimis public groups does not apply to groups identified with respect to redemptions and similar transactions. Temp. Reg. § 1.382-2T(j)(2)(iv)(A), (B) Ex. (iv) (combination of three groups).

The segregation rules only apply if the entity has at least one public group before the transaction. Temp. Reg. § 1.382-2T(j)(2)(ii). The segregation rules will generally not apply to entities that are entirely owned by individuals that each own at least 5% of the loss corporation.

The segregation rules apply to the following transactions:

- equity structure shifts,
- section 1032 transactions,
- redemptions and similar transactions,
- deemed acquisitions of stock under the option attribution rule, and
- issuances of stock rights.

The application of the segregation rules is different for each of the above-described transactions and is described below. Where two or more transactions occur on the same day or as part of the same plan, the segregation rules are applied separately to each transaction. For example, if a corporation redeems some of its common stock and also, on the same day and as part of a plan, recapitalizes its preferred stock, the

segregation rules are separately applied to the redemption and the recapitalization. Temp. Reg. § 1.382-2T(j)(2)(A), (v)(B) Ex.

It is possible that a transaction (or part of a transaction) can be described in more than one category. In which case, rules are applied in a manner that results in the largest cumulative owner shift. Temp. Reg. § 1.382-2T(j)(2)(v)(A).

On October 22, 2013, the IRS and the Treasury Department finalized amendments to the section 382 regulations regarding the application of the segregation rules to small shareholders (the “amended segregation rules”). The amended rules provide for exceptions to the segregation rules. TD 9638, 2013-2 CB 487.

The changes described in the amended segregation rules generally apply to testing dates occurring on or after October 22, 2013. However, taxpayers can apply the amended rules, in their entirety, to earlier testing dates in limited circumstances. A taxpayer that chooses to apply the amended segregation rules, in their entirety, retroactively can generally apply the rules to all testing dates that are included in a testing period beginning before (and ending on or after) October 22, 2013. Treas. Reg. § 1.382-3(j)(17) (as amended by TD 9638). For example, with respect to a testing period ending on December 31, 2013, the taxpayer could generally choose to apply the amended segregation rules to testing dates after December 31, 2010 (the beginning of the three-year testing period). Alternatively, the taxpayer could choose to just apply the amended rules to testing dates that are on or after October 22, 2013.

The ability to apply the amended segregation rules retroactively are limited in circumstances if the application of the rules retroactively would affect whether or when an ownership change occurred under prior rules. As a result, the amended segregation rules cannot be applied to a testing date that is on or before a change date that occurred before October 22, 2013 (by applying prior regulations). Similarly, the amended segregation rules cannot be applied retroactively if the application would result in an ownership change occurring before October 22, 2013 that would not have occurred by applying prior regulations. Treas. Reg. § 1.382-3(j)(17) (as amended by TD 9638). For example, if an ownership change occurred on October 1, 2012 (by applying prior rules), the amended segregation rules cannot be applied retroactively to testing dates that are on or before October 1, 2012. TD 9638, 2013-2 CB 487.

Application to first tier and higher tier entities

The segregation rules can also apply to the transactions of first tier and higher tier entities. However, the segregation rules only apply to higher tier entities that have a 5% or greater indirect ownership interest in the loss corporation. Temp. Reg. § 1.382-2T(j)(3)(iii).

The regulations are unclear as to whether the segregation rules apply to transactions that occur at a time within the testing period in which their ownership interest of the first tier or higher tier entity is below 5%. A first tier entity is defined as an entity that directly owns 5% or more of the loss corporation at any time during the testing period. Temp. Reg. § 1.382-2T(f)(9). This would suggest that the segregation rules apply to the transactions of a first tier or higher tier entity even if they do not have a 5% or greater stock interest in the loss corporation at the time of the transaction.

The amended segregation rules revise the segregation rules with respect to first tier and higher tier entities. The amendments exempt from the segregation rules transactions with respect to first tier and higher tier entities that own 10% or less (by value) of the loss corporation (directly or indirectly by attribution) after the transaction (and all other transactions occurring on the transaction date). Treas. Reg. § 1.382-3(j)(15)(i)

(as amended by TD 9638). In determining whether the entity owns 10% or less of the loss corporation, pure preferred stock is treated as stock. Treas. Reg. § 1.382-3(j)(16) Ex. 11 (as amended by TD 9638).

The exemption from the segregation rules for first tier and higher tier entities that own 10% or less of the loss corporation generally applies to transactions that occur on or after October 22, 2013. Treas. Reg. § 1.382-3(j)(17) (as amended by TD 9638).

In determining whether the entity owns 10% or less of the loss corporation, fluctuations in value are taken into account. For example, if an entity acquired preferred stock with a percentage ownership interest of 9%, a later entity-level transaction will be subject to the segregation rules if the percentage ownership interest had grown to 40% (through fluctuations) at the time of the transaction. Treas. Reg. § 1.382-3(j)(16) Ex. 10 (as amended by TD 9638).

In determining whether an entity owns 10% or less of the loss corporation, the entity will be treated as owning any loss corporation stock that it actually owns. In addition, the attribution rules of section 318(a) apply, instead of the attribution rules that normally apply under section 382 (i.e., the entity attribution rules of section 1.382-2T(h)(2) of the temporary Treasury regulations). For this purpose, the option attribution rule of section 318(a)(4) is not applied unless the option is treated as exercised under the section 382 option attribution rules of section 1.382-4(d) of the Treasury regulations. Treas. Reg. § 1.382-3(j)(15)(iv)(A), (B) (as amended by TD 9638).

The attribution rules of section 318(a) apply very differently from the attribution rules mentioned above that normally apply for section 382 purposes. Under the section 318(a) rules it is possible to attribute ownership due to ownership of pure preferred stock. The section 318(a) rules also provide for attribution from owners to entities (i.e., downward attribution). IRC § 318(a)(3). In addition, attribution from or to a corporation only applies under the section 318(a) rules if the owner owns 50% or more of the stock of the corporation. IRC § 318(a)(2)(C), (3)(C).

Example 12 of the amended segregation rules illustrates the application of the section 318(a) attribution concepts. In the example, two entities (X and Y) each own 6% of a loss corporation (L). An individual (A) owns 100% of the stock of X and pure preferred stock in Y (which represents 50% of the value of the Y stock). Under the section 318(a) attribution rules, A is considered to own 6% of the stock of L by attribution from X since A owns 100% of the X stock. IRC § 318(a)(2)(C). A's indirect ownership in L of 6% (through X) is then attributed downward to Y. IRC § 318(a)(3)(C), (5)(A). As a result, Y is treated as owning 12% of L (6% directly and 6% by attribution from A and X). Since Y owns more than 10% of L, the exception to the segregation rules would not apply. Treas. Reg. § 1.382-3(j)(16) Ex. 12 (as amended by TD 9638). It should be noted that if A had owned less than 50% of Y's stock (by value), the downward attribution rule would not have applied and Y would have only owned 6% of L (and the exception to the segregation rules would apply).

A loss corporation can establish that an entity owns 10% or less of the loss corporation through actual knowledge. Alternatively, the loss corporation can use the normal section 382 stock ownership presumptions (absent actual knowledge to the contrary). Treas. Reg. § 1.382-3(j)(15)(iv)(C), (v) (as amended by TD 9638).

Under an anti-avoidance rule, the exemption from the segregation rules does not apply if the loss corporation, directly or through one or more persons, had participated in planning or structuring a transaction involving an ownership interest in a first tier or higher tier entity "with a view to avoiding the application of the segregation rules." Treas. Reg. § 1.382-3(j)(15)(ii) (as amended by TD 9638). For this purpose, a "transaction" includes an event that would otherwise be a segregation transaction, as well as an

event that occurs as part of the same plan as a potential segregation transaction. For example, forming a holding company to effect the application of the section 318(a) attribution rules could be considered an avoidance transaction. Other anti-avoidance rules (e.g., general anti-avoidance and coordinated acquisition rules) continue to apply. Treas. Reg. § 1.382-3(j)(15)(ii) (as amended by TD 9638).

A transaction involving an ownership interest in a first tier or higher tier entity will not violate the anti-avoidance rule (and will be eligible for exemption from the segregation rules) if the loss corporation does not participate in planning or structuring the transaction. A loss corporation is permitted to request (and receive or not receive) information regarding the transaction without violating the anti-avoidance rule. For example, if Target Corporation owns exactly 10% of the stock of a loss corporation and is planning on merging with Acquiring Corporation, the loss corporation is permitted to request information from Target Corporation for details of the merger and the potential stock ownership of the loss corporation by Acquiring Corporation after the merger. The anti-avoidance rule will not apply if the loss corporation does not make any suggestions as to potential changes to the structure. Treas. Reg. § 1.382-3(j)(16) Ex. 13 (as amended by TD 9638).

If the exemption from the segregation rules applies to combine two or more public groups, then the continuing public group's increase in percentage of stock ownership equals the sum of the continuing group's increase and a proportionate amount of any increase of any public group that is combined with the continuing public group. Similarly, the continuing public group's lowest percentage ownership interest equals the group's lowest percentage ownership interest, increased by a proportionate amount of the lowest percentage ownership interest of any group that is combined with the continuing public group. Treas. Reg. § 1.382-3(j)(15)(iii) (as amended by TD 9638).

Segregation Rule Exemption Example. P1 is a corporation that owns (and has owned throughout the testing period) 8% of L, a loss corporation. The remaining shares of L are owned (and have been owned throughout the testing period) by a public group ("Public L"). P1's stock is owned by a public group ("Public P1").

On May 22, 2014, P1 merges with and into P2. Before the merger, A, an individual, owned 90% of the P2 stock and a public group ("Public P2") owned the remaining 10%. P2 did not own any L stock before the merger. In the merger, the P1 shareholders received 25% of the P2 stock. As a result of the merger, A owned 67.5% of P2 and the former members of Public P2 owned 7.5% of P2.

Since P2 owned less than 10% of L after the transaction, the segregation rules do not apply to segregate Public P1 from Public P2 (assuming that L can substantiate the exemption). As a result, Public P2 would be treated as owning 32.5% of P2 (25% owned by former members of Public P1, plus 7.5% owned by former members of Public P2). Under the attribution rules, Public P2 would be treated as only owning 2.6% of L (32.5% multiplied by 8%). Since Public P2 no longer owns 5% of L (directly or indirectly by attribution), under the aggregation rules, the members of Public P2 (as well as the former members of Public P1) join Public L. It should be noted that A became a 5% shareholder as a result of the merger since A is treated as owning 5.4% of L, indirectly by attribution (67.5% multiplied by 8%).

Before the merger, Public L owned 92% of L. After the merger and combined with the former members of Public P1 and Public P2, L has a percentage ownership interest of 94.6%. Before the merger, Public L's lowest percentage ownership interest was 92%. The lowest percentage ownership is increased by a proportionate amount of former Public P1's lowest percentage ownership interest. Since Public P2 owned 32.5% of P2 after the merger, its proportionate amount

of former Public P1's lowest percentage ownership interest is 2.6% (32.5% multiplied by 8%). As a result, Public L's lowest percentage ownership interest increases from 92% to 94.6%. Treas. Reg. § 1.382-3(j)(16) Ex. 8 (as amended by TD 9638).

As a result, the merger of P1 with P2 causes a cumulative owner shift of 5.4%. After the merger, A owns 5.4% (with a lowest percentage interest of zero) and Public L owns 94.6% (with a lowest percentage interest of 94.6%). Accordingly, L has a cumulative owner shift of 5.4% (based upon A's increase). Treas. Reg. § 1.382-3(j)(16) Ex. 8.

If, in the above example, P1 had acquired its interest in L during the testing period that includes the merger, Public P1's lowest percentage ownership interest would have been zero. In such case, Public L would have an increase in its ownership interest of 2.6% (94.6% less 92%). Treas. Reg. § 1.382-3(j)(16) Ex. 9 (as amended by TD 9638). As a result, L has a cumulative owner shift of 8% (A's increase of 5.4%, plus Public L's increase of 2.6%). Equity structure shifts

The segregation rules apply to transactions that are equity structure shifts, but only if the transaction qualifies as an acquisitive asset reorganization in which the loss corporation (or first tier or higher tier entity) is a party to the reorganization. Temp. Reg. § 1.382-2T(j)(2)(iii)(B)(1)(i).

An equity structure shift is an acquisitive reorganization (other than a type F reincorporation or a type E recapitalization). IRC § 382(g)(3)(A); Temp. Reg. § 1.382-2T(e)(2)(i). Based on this definition and limiting it to asset transactions, the segregation rules will generally apply to (i) type A reorganizations (mergers), (ii) type C reorganizations (stock for assets), (iii) acquisitive type D reorganizations (controlled corporations), and (iv) acquisitive type G reorganizations (bankruptcy). A loss corporation (or a first tier or higher tier entity) will generally be a party to the reorganization if it is the corporation (i) acquiring the assets, (ii) transferring the assets, or (iii) issuing the stock. IRC § 368(b).

It should be noted that the exceptions to the section 1032 transaction segregation rule described below (the small issuance and cash issuance exceptions) are not exceptions under the equity structure shift segregation rule. Treas. Reg. § 1.382-3(j)(6).

Where the segregation rules apply to an equity structure shift, each direct public group that exists after the transaction is segregated into two or more components. The shareholders that own stock as a result of being a shareholder of the acquiring corporation are segregated from shareholders that own stock as a result of being a shareholder of the transferring corporation (or target). There is a rebuttable presumption that there is no cross-ownership between the two groups. Temp. Reg. § 1.382-2T(j)(2)(iii)(B)(1).

As an example, if Corp A merges with Corp B in a reorganization and the shareholders of Corp A receive 40% of the stock of the acquiring corporation, the shareholders that previously owned Corp B are treated as owning 60% of Corp B after the transaction and the shareholders that previously owned Corp A are treated as owning 40% of Corp B. On these facts, Corp A undergoes an ownership change and Corp B has a 40% owner shift. *See* Temp. Reg. § 1.382-2T(j)(2)(iii)(B)(2) Ex. (1), (3)(iv) Ex. (1). The same result would apply if Corp A merged with a sub of Corp B in a triangular forward merger reorganization (section 368(a)(2)(D) reorganization). *See* Temp. Reg. § 1.382-2T(j)(3)(iv) Ex. (3).

Section 1032 Transactions

The segregation rules apply to any transfer of stock of the loss corporation (or first tier or higher tier entity) by the issuing corporation to which section 1032 applies. This rule applies to issuances of newly-issued stock, as well as reissuances of treasury stock. The rule also applies to the issuance of a non-stock interest

that is treated as stock under the non-stock recharacterization rule. Temp. Reg. § 1.382-2T(j)(2)(iii)(B)(1)(ii).

Section 1032 applies to any receipt of money or other property in exchange for stock of such corporation. IRC § 1032(a). As a result, the segregation rules will generally apply to any issuance or reissuance of stock in exchange for money or other property. Temp. Reg. § 1.382-2T(j)(2)(iii)(B)(2) Ex. (5) (issuance of stock in a type B reorganization), (3)(iv) Ex. (4) (same). For this purpose, an exchange for money or other property includes an exchange for services, *see* Treas. Reg. § 1.382-3(j)(16) Ex. 1(i), or debt obligations of the issuer. *See* Treas. Reg. § 1.382-3(j)(16) Ex. 3, 4.

It appears that the section 1032 segregation rule applies to transfers of equity for money or other property by a first tier or higher tier entity that is not a corporation. *See* Treas. Reg. § 1.382-3(j)(12). As a result, the issuance of a partnership interest by a partnership that is a first tier entity would appear to be a segregation transaction.

There is an exemption from the section 1032 transaction segregation rule for shares issued by certain “open-ended” mutual funds (i.e., RICs) to the extent shares are issued in the ordinary course of business. Treas. Reg. § 1.382-3(k)(1).

Where the segregation rules apply to a section 1032 transaction, each direct public group that exists after the transaction is segregated into two or more components. The shareholders that receive stock in the section 1032 transaction are segregated from the other shareholders. There is a rebuttable presumption that there is no cross-ownership between the two groups. Temp. Reg. § 1.382-2T(j)(2)(iii)(B)(1). For this purpose, any transitory ownership of stock by an underwriter of an issuance is disregarded. Treas. Reg. § 1.382-3(j)(7).

As an example, if a loss corporation issues 40% of its stock in exchange for property, the shareholders that previously owned the loss corporation are treated as owning 60% after the transaction and the shareholders that acquired the newly issued shares are treated as owning 40%. *See* Temp. Reg. § 1.382-2T(e)(1)(iii) Ex. (5), (j)(2)(iii)(B)(2) Ex. (3).

There are two important exceptions to the section 1032 transaction segregation rule, (i) the small issuance exception, and (ii) the cash issuance exception. For many loss corporations, the existence of the exceptions will exempt all of the stock issuances within a testing period from the section 1032 transaction segregation rule.

The two exceptions do not appear to be elective. However, the IRS has granted permission to apply actual knowledge about stock ownership in place of the cash issuance exception. It is interesting to note that the reason the taxpayer asked for the ability to apply the segregation rules (instead of the cash issuance exception) was to cause an earlier ownership change (due to a subsequent drop in stock value). PLR 201024037 (Mar. 11, 2010).

Small Issuance Exception. Under the small issuance exception, stock issued by a loss corporation (or first tier or higher tier entity) is exempt from the section 1032 transactions segregation rule. The exception applies to “small issuances” of stock and the amount of stock exempted in a taxable year is limited to the “small issuance limitation.” Treas. Reg. § 1.382-3(j)(2)(i), (11). If a first tier or higher tier entity is not a corporation, the rules apply to any ownership interest in the entity as if it were stock. Treas. Reg. § 1.382-3(j)(12).

The small issuance limitation is relevant for determining whether a transaction is a small issuance and the limitation on the number of shares that are eligible for exemption in a taxable year. As described in more

detail below, the small issuance limitation generally equals either 10% of the number of shares of the class issued or 10% of the value of the stock, depending upon the approach chosen by the taxpayer. In both cases, the limitation is determined at the beginning of the taxable year.

The small issuance limitation can be determined on either a “corporation-wide” or on a “class-by-class” basis. Treas. Reg. § 1.382-3(j)(2)(iii)(A). It appears that the loss corporation can determine which approach to use in one taxable year without affecting the approach to use in another taxable year. The class-by-class approach cannot be used if during a taxable year more than one class of stock is issued in a single transaction (or in multiple issuances for a principal purpose of minimizing the effects of or avoiding an owner shift). Treas. Reg. § 1.382-3(j)(2)(iii)(D).

Stock issued by a loss corporation (or first tier or higher tier entity) is a small issuance if the total amount of stock issued in the transaction does not exceed the small issuance limitation. All of the stock issued in the transaction is taken into account (including stock issued to 5% shareholders). Treas. Reg. § 1.382-3(j)(2)(ii). For example, if the small issuance limitation is 100 shares and the loss corporation in a single transaction sells 60 shares to the general public and 50 shares to a 5% shareholder, the transaction is not a small issuance since the total shares issued (110) exceeds the small issuance limitation.

The amended segregation rules clarify how to determine the small issuance limitation with respect to the issuance of stock (or non-stock equity) by a first tier or higher tier entity. The small issuance limitation is determined based upon the value and classes of the issuing entity. Treas. Reg. § 1.382-3(j)(11)(ii) (as amended by TD 9638). For example, if a first tier entity’s stock has a fair market value of \$150 million (at the beginning of the taxable year), the small issuance limitation with respect to an issuance of the first tier entity’s own stock (computed on a corporation-wide basis) would equal \$15 million. The small issuance limitation with respect to a first tier or higher tier entity is not affected by the fair market value of the loss corporation’s stock. TD 9638. This clarification generally applies to transactions after October 22, 2013. Treas. Reg. § 1.382-3(j)(17) (as amended by TD 9638).

Multiple issuances are treated as a single issuance for purposes of determining if a transaction is a small issuance if (i) the issuances occur at approximately the same time under the same plan or arrangement, or (ii) a principal purpose of issuing stock in two or more separate issuances (as opposed to a single issuance) is to minimize the effects of (or avoid) an owner shift. Treas. Reg. § 1.382-3(j)(8). It appears that issuances by separate entities (e.g., by a loss corporation and a first tier entity) can be treated as a single issuance under this rule.

An issuance of stock in an acquisitive reorganization cannot qualify as a small issuance. However, an issuance of stock in a type E recapitalization can qualify as a small issuance. Treas. Reg. 1.382-3(j)(6).

If the loss corporation applies the “corporation-wide” approach, the small issuance limitation equals 10% of the total value of the loss corporation’s (or first tier entity’s or higher tier entity’s) stock outstanding at the beginning of the taxable year. For this purpose, the value of pure preferred stock is not taken into account. Treas. Reg. § 1.382-3(j)(2)(iii)(A)(1).

If the loss corporation applies the “class-by-class” approach, the small issuance limitation equals 10% of the number of shares of the class outstanding at the beginning of the taxable year. Treas. Reg. § 1.382-3(j)(2)(iii)(A)(2). For this purpose, a class of stock includes all stock with the same material terms. Treas. Reg. § 1.382-3(j)(2)(iii)(B). Adjustments to the number of shares outstanding at the beginning of the taxable year are required to take into account (i) stock splits, (ii) reverse stock splits, (iii) stock dividends to which section 305(a) applies, (iv) recapitalizations, and (v) similar transactions that occur during the taxable year. Treas. Reg. § 1.382-3(j)(2)(iii)(C).

If the taxable year in which shares are issued has less than 365 days, the small issuance limitation is reduced based on a fraction of the number of days in the taxable year over 365. Treas. Reg. § 1.382-3(j)(2)(iv).

If an issuance is a small issuance, the shares issued are exempt from the section 1032 transaction segregation rule up to the small issuance limitation for the taxable year (taking into account all previous issuances during the year). Treas. Reg. § 1.382-3(j)(2)(i). For example, if the small issuance limitation equals 100 shares and the loss corporation issues 75 shares to public shareholders twice in the same taxable year, the first issuance qualifies entirely for the small issuance exception, but only 25 shares of the second issuance qualifies. The 50 shares that exceed the small issuance limitation are subject to the section 1032 transaction segregation rule (to the extent they are not exempt under the cash issuance exception). *See* Treas. Reg. § 1.382-3(j)(16) Ex. 1(iii).

Stock issuances that are exempt under the small issuance exception are treated as acquired by each public group with a direct ownership interest that exists before the stock issuance. The shares that are exempt are allocated proportionately to each such public group based on the amount of stock held before the issuance. Treas. Reg. § 1.382-3(j)(5)(i).

Cash Issuance Exception. The cash issuance exception is available to the extent some or all of the shares issued by a loss corporation (or first tier or higher tier entity) does not qualify for the small issuance exception. Treas. Reg. § 1.382-3(j)(3)(iii), (11). The cash issuance exception applies to such shares to the extent the shares are issued solely for cash. Treas. Reg. § 1.382-3(j)(3)(i). If a first tier or higher tier entity is not a corporation, the rules apply to any ownership interest in the entity as if it were stock. Treas. Reg. § 1.382-3(j)(12).

The cash issuance exception does not apply if the acquirer of the shares is required to purchase other stock for non-cash consideration and the non-cash acquisition is a condition of the cash acquisition. Treas. Reg. § 1.382-3(j)(3)(ii)(A)(1). The cash issuance exception also does not apply to the exercise of an option if the option was not issued solely for cash or distributed with respect to stock. Treas. Reg. § 1.382-3(j)(3)(ii)(A)(2). Presumably employee options do not qualify for the cash issuance exception since the options were issued in whole or in part for services. For purposes of the cash issuance exception, any transitory ownership of stock by an underwriter of an issuance is disregarded. Treas. Reg. § 1.382-3(j)(7).

Multiple issuances are treated as a single issuance for purposes of determining if a transaction is issued solely for cash if a principal purpose of issuing stock in two or more separate issuances (as opposed to a single issuance) is to minimize the effects of (or avoid) an owner shift. Treas. Reg. § 1.382-3(j)(3)(ii)(B), (8). It appears that issuances by separate entities (e.g., by a loss corporation and a first tier entity) can be treated as a single issuance under this rule.

Multiple issuances are not treated as a single issuance if the above principal purpose test is not met even if the issuances are related or occur on the same day. For example, if pursuant to the same plan and on the same day, a loss corporation issues stock to creditors in satisfaction of debt and issues newly-issued shares to public shareholders for cash, the shares issued for cash can qualify for the cash issuance exception. *See* Treas. Reg. § 1.382-3(j)(16) Ex. 3(iii). However, if the creditors who exchanged debt-for-cash were given the right to purchase additional shares solely for cash, none of the shares issued to creditors would qualify for the cash issuance exception. Treas. Reg. § 1.382-3(j)(16) Ex. 4.

If the cash issuance exception applies, the public groups that have a direct ownership interest in the loss corporation (or first tier or higher tier entity) are treated as acquiring a percentage of stock in the offering (that does not qualify under the small issuance exception) that equals 50% of the percentage ownership interest owned by all direct public groups before the issuance. The remaining shares (i.e., the shares that

are not treated as acquired by such direct public groups) are treated as not exempt from the section 1032 transaction segregation rule. Treas. Reg. § 1.382-3(j)(3)(i), (iii). For example, if a loss corporation has a single public group that has a direct ownership interest of 30% of the loss corporation before the stock issuance, the group is treated as acquiring 15% of the stock issued. The remaining shares are subject to the section 1032 transaction segregation rule. *See* Treas. Reg. § 1.382-3(j)(16) Ex. 1(iii).

The total amount of stock that can be exempted from the section 1032 transaction segregation rule equals the number of shares issued in the transaction less the total number of such shares owned by 5% shareholders (other than a public group with a direct ownership interest) after the transaction. For this purpose, any increase in the amount of stock owned by a 5% shareholder on the day of the transaction is considered to be an acquisition of shares issued in the transaction. However, any actual knowledge the loss corporation has related to such 5% shareholders is taken into account. Treas. Reg. § 1.382-3(j)(4).

The loss corporation can optionally apply its actual knowledge of shares acquired by public groups instead of the small and cash issuance exceptions. The use of actual knowledge can only be used if it results in a larger allocation to the direct public groups in the aggregate than would otherwise be allowed under the combined small and cash issuance exceptions. Treas. Reg. § 1.382-3(j)(5)(ii). For example, if the only direct public group would otherwise have been treated as acquiring 45 out of 50 issued shares (40 under the small issuance exception and 5 under the cash issuance exception), then actual knowledge can only be used if it results in the group acquiring 46 shares or more. *See* Treas. Reg. § 1.382-3(j)(16) Ex. 1(iv), (v).

Stock Issuance Example. L Corp is a loss corporation. It has three 5% shareholders; A (an individual) owns 40%, the public owners of B Corp (a first tier entity) owns 30%, and the public shareholders of L Corp (“Public Group L”) owns 30%. At the beginning of the taxable year, L Corp has one thousand shares outstanding of a single class of stock. L Corp chooses to apply the class-by-class approach of the small issuance exception.

On May 1, L Corp issues 60 shares to the public shareholders. This transaction qualifies for the small issuance exception. As a result, Public Group L is treated as increasing its share ownership from 300 shares to 360 shares and their percentage ownership interest from 30% to 34% (360 divided by 1,060).

On July 1, L Corp issues 100 shares for cash. Of these shares, A acquires 55 shares and public shareholders acquire the remaining 45 shares. The transaction is a small issuance but only 40 of the shares qualify for the small issuance exception. (The small issuance limitation is 100 shares and 60 of that was applied in the earlier transaction.) The remaining 60 shares are partially eligible for the cash issuance exception. Public Group L previously had a 34% interest in L Corp. As a result, 17% of the stock (10 shares) is eligible for the cash issuance exception (60 shares multiplied by 17%). Before limitation, 50 shares are eligible for exemption (40 under the small issuance exception and 10 under the cash issuance exception). However, the exemption is limited to 45 shares (the 100 shares issued less the 55 shares acquired by A). As a result, Public Group L is treated as increasing its share ownership from 360 shares to 405 shares and its percentage ownership from 34% to 35% (405 divided by 1,160). *See* Treas. Reg. § 1.382-3(j)(16) Ex. 1, 2.

Redemptions and similar transactions

The segregation rules apply to any acquisition of stock of the loss corporation (or first tier or higher tier entity) by the issuing corporation in exchange for property (i.e., a redemption). This rule also applies to certain stock-for-stock exchanges (e.g., a recapitalization) if (i) the stock issued by the corporation in the transaction is not treated as stock for section 382 purposes (pure preferred stock and stock that is governed

by the stock recharacterization rule), and (ii) the stock that is retired in the transaction is treated as stock for section 382 purposes. Temp. Reg. § 1.382-2T(j)(2)(iii)(C)(1). For example, an issuance of pure preferred stock in retirement of common stock is a transaction governed by this segregation rule. Temp. Reg. § 1.382-2T(j)(2)(iii)(C)(2) Ex. (2).

The redemption segregation rule can also apply to any transaction that has the effect of a redemption. An example of a transaction with that effect is an acquisition by the loss corporation of stock in a first tier entity. Temp. Reg. § 1.382-2T(j)(3)(iii).

It appears that the redemption segregation rule applies to acquisitions of equity for money or other property by a first tier or higher tier entity that is not a corporation. *See* Treas. Reg. § 1.382-3(j)(14)(vi). (as amended by TD 9638). As a result, the acquisition of a partnership interest by a partnership that is a first tier entity would appear to be a segregation transaction.

There is an exemption from the redemption segregation rule for shares redeemed by certain “open-ended” mutual funds (i.e., RICs) to the extent shares are redeemed in the ordinary course of business. Treas. Reg. § 1.382-3(k)(1). This exemption has been applied to redemptions from related mutual funds pursuant to a change in strategy. PLR 201305001 (Oct. 31, 2012).

Where the segregation rules apply to a redemption or similar transaction, each direct public group that exists before the transaction is segregated into two or more components. The shareholders that transfer stock to the corporation in the transaction are segregated from the other shareholders. There is a rebuttable presumption that there is no cross-ownership between the two groups. Temp. Reg. § 1.382-2T(j)(2)(iii)(C)(1).

As an example, if a loss corporation redeems 40% of its stock in exchange for property, the shareholders that continue to own the loss corporation are treated as owning 60% before the transaction (and 100% after the transaction) and the shareholders that were redeemed are treated as owning 40% before the transaction. This transaction would result in a 40% owner shift since the continuing group has gone from 100% percentage ownership interest to 60% and then back up to 100%. That is, the post-redemption amount of 100% is compared to the lowest percentage of 60% (for a moment in time). *See* Temp. Reg. § 1.382-2T(j)(2)(iii)(C)(2) Ex. (1).

Where more than one public group exists before the transaction (e.g., as a result of previous applications of the segregation rules), the shares redeemed are treated as acquired proportionately from each public group that existed before the redemption. However, either the taxpayer or the IRS can establish a different proportion. Temp. Reg. § 1.382-2T(j)(2)(vi), (3)(v).

Under the stock ownership rules, the loss corporation is permitted to treat a shareholder (individual or entity) whose ownership interest goes from 5% or more to below 5% during a testing period as continuing to own the stock owned after the reduction. Where this rule applies, the shareholder is treated as a public group for purposes of the rule described in the previous paragraph. Temp. Reg. § 1.382-2T(g)(5)(i)(B); PLR 200841021 (Apr. 29, 2008); PLR 200837027 (Mar. 14, 2008).

There is some uncertainty as to how to apply the redemption segregation rule where there are multiple redemptions in a testing period. The public groups that are created by this rule are treated as in existence immediately before the transaction (and thereafter). Temp. Reg. § 1.382-2T(j)(2)(iii)(C)(1). If the rule is applied literally the cumulative effects of multiple redemptions does not affect the amount of the cumulative owner shift. For example, if a loss corporation redeems 1% of its stock on 30 occasions within a testing period and has a single public group otherwise owning 100% of the stock, the continuing public group’s

percentage ownership interest would be reduced to 99% immediately before the first redemption and would be increased to 100% immediately after the first redemption. The same effect would result from the subsequent redemptions and the public group's lowest percentage ownership interest would never go below 99%. Applying the redemption segregation rule this way, is called the "immediately before" approach.

Some practitioners are hesitant to apply the immediately before approach to multiple redemptions. They are concerned about the large difference in results between multiple redemptions and a single large redemption. For example, a single redemption of 30% generally results in a 30% owner shift. For some, it is difficult to justify only a 1% owner shift where there have been 30 1% redemptions. To deal with these concerns, some practitioners treat the redeemed public group as acquiring their shares at the beginning of the testing period. This approach is called the "retroactive" approach. In the example described in the previous paragraph, there would be two public groups at the beginning of the testing period, one owning 70% (the continuing group) and one owning 30% (the redeemed group). Over time the redeemed group's shares are all cancelled and they end up with a percentage ownership interest of zero percent. The continuing group increases its percentage ownership interest from 70% to 100%, resulting in a cumulative owner shift of 30%. Some apply the retroactive approach in a way that breaks the redeemed public group into multiple public groups every time there is a segregation transaction. The later methodology is very complicated and can result in a very large number of public groups.

Small Redemption Exemption. The amended segregation rules revise the segregation rules with respect to redemptions. The amendments exempt "small redemptions" from the segregation rules. Treas. Reg. § 1.382-3(j)(14) (as amended by TD 9638). This exemption for small redemptions is similar to the existing small issuance exception to the segregation rules contained in section 1.382-3(j)(2) of the Treasury regulations. The small redemption exemption from the segregation rules generally apply to transactions that occur on or after October 22, 2013. Treas. Reg. § 1.382-3(j)(17) (as amended by TD 9638). The amended segregation rules do not provide for an exemption for redemptions in cash that would be the equivalent of the cash issuance exemption.

The amended segregation rules exempt certain "small redemptions." Under the small redemption exception, stock redeemed by a loss corporation (or first tier or higher tier entity) is exempt from the redemption segregation rule. The exception applies to "small redemptions" of stock and the amount of stock exempted in a taxable year is limited to the "small redemption limitation." Treas. Reg. § 1.382-3(j)(14)(i)(vii)(A) (as amended by TD 9638). If a first tier or higher tier entity is not a corporation, the rules apply to any ownership interest in the entity as if it were stock. Treas. Reg. § 1.382-3(j)(14)(vi) (as amended by TD 9638).

The small redemption limitation is relevant for determining whether a transaction is a small redemption and the limitation on the number of shares that are eligible for exemption in a taxable year. As described in more detail below, the small redemption limitation generally equals either 10% of the number of shares of the class issued or 10% of the value of all classes of the stock (excluding pure preferred stock), depending upon the approach chosen by the taxpayer. In both cases, the limitation is determined at the beginning of each taxable year.

Similar to the small issuance limitation, the small redemption limitation can be determined on either a "corporation-wide" or on a "class-by-class" basis. Treas. Reg. § 1.382-3(j)(14)(iii)(A) (as amended by TD 9638). It appears that the loss corporation can determine which approach to use in one taxable year without affecting the approach to use in a different taxable year. The class-by-class approach cannot be used if during a taxable year more than one class of stock is redeemed in a single transaction (or in multiple redemptions that are treated as a single redemption under rules described below). Treas. Reg. § 1.382-3(j)(14)(iii)(D) (as amended by TD 9638).

Stock redeemed by a loss corporation (or first tier or higher tier entity) is a small redemption if the total amount of stock redeemed from members of a public group does not exceed the small redemption limitation. Treas. Reg. § 1.382-3(j)(14)(ii) (as amended by TD 9638). The definition of small redemption differs from the definition of small issuance in that transactions with 5% shareholders appear to be ignored in determining the size of the redemption.

In Private Letter Ruling 202024013 (Mar. 13, 2020), a new foreign holding company was created to indirectly hold the stock of a domestic loss corporation. The holding company was incorporated in Year 1. In Year 2, the new foreign holding company issued stock to the public in a section 351 transaction. The corporation only held nominal assets before that transaction. Later in Year 2, the holding company entered into two redemption transactions. The IRS allowed the holding company to treat its taxable year (for small redemption purposes) as beginning immediately after the section 351 transaction. This appears to have allowed the taxpayer to take into account the shares issued in the section 351 transaction in computing the small redemption limitation. PLR 202024013.

Multiple redemptions are treated as a single redemption for purposes of determining if a transaction is a small redemption if (i) the redemptions occur at approximately the same time under the same plan or arrangement, or (ii) a principal purpose of redeeming stock in two or more separate redemptions (as opposed to a single redemption) is to minimize or avoid an owner shift. Treas. Reg. § 1.382-3(j)(14)(v) (as amended by TD 9638). It appears that redemptions by separate entities (e.g., by a loss corporation and a first tier entity) can be treated as a single redemption under this rule. In Private Letter Ruling 202024013, the IRS accepted a representation that the two redemptions in the same taxable year were not planned (or undertaken pursuant to the same plan) and were not separated in time to avoid an owner shift.

The amended segregation rules do not provide any guidance as to when redemptions are treated as having occurred at approximately the same time and under the same plan or arrangement. Generally, such determinations will be highly factual.

Many loss corporations that are subject to SEC regulation have restrictions on when they can repurchase shares on the open market. These are designed to avoid issues regarding insider trading and market manipulation. Typically, an open trading window starts on the third full trading day following the release of earnings for the prior quarter and ends a number of trading days later (generally a month or less). The IRS has treated stock repurchases that were completed during a given open trading window (and certain transactions that were entered into during the window but completed afterwards) in one ruling as occurring at approximately the same time and pursuant to the same plan or arrangement. The IRS also treated transactions that occurred pursuant to different open trading windows as not occurring at approximately the same time. PLR 201451015 (Sept. 17, 2014).

If the loss corporation applies the “corporation-wide” approach, the small redemption limitation equals 10% of the total value of the loss corporation’s (or first tier or higher tier entity’s) stock outstanding at the beginning of the taxable year. For this purpose, the value of pure preferred stock (stock described in section 1504(a)(4)) is not taken into account. Treas. Reg. § 1.382-3(j)(14)(iii)(A)(1) (as amended by TD 9638).

If the loss corporation applies the “class-by-class” approach, the small redemption limitation equals 10% of the number of shares of the class outstanding at the beginning of the taxable year. Treas. Reg. § 1.382-3(j)(14)(iii)(A)(2) (as amended by TD 9638). For this purpose, a class of stock includes all stock with the same material terms. Treas. Reg. § 1.382-3(j)(14)(iii)(B) (as amended by TD 9638). Adjustments to the number of shares outstanding at the beginning of the taxable year are required to take into account (i) stock splits, (ii) reverse stock splits, (iii) stock dividends to which section 305(a) applies, (iv) recapitalizations,

and (v) similar transactions that occur during the taxable year. Treas. Reg. § 1.382-3(j)(14)(iii)(C) (as amended by TD 9638).

With respect to the redemption of stock (or non-stock equity) by a first tier or higher tier entity, the small redemption limitation is determined based upon the value and classes of the issuing entity. Treas. Reg. § 1.382-3(j)(14)(vii)(b) (as amended by TD 9638). For example, if a first tier entity's stock has a fair market value of \$150 million (at the beginning of the taxable year), the small redemption limitation with respect to a redemption of the first tier entity's own stock (computed on a corporation-wide basis) would equal \$15 million. The small redemption limitation is not affected by the fair market value of the loss corporation's stock. TD 9638.

If the taxable year in which shares are issued has less than 365 days, the small redemption limitation is reduced based on a fraction of the number of days in the taxable year relative to 365. Treas. Reg. § 1.382-3(j)(14)(iii)(E) (as amended by TD 9638).

If a redemption is a small redemption, the shares issued are exempt from the redemption segregation rule up to the small redemption limitation for the taxable year (taking into account all previous redemptions). Treas. Reg. § 1.382-3(j)(14)(i) (as amended by TD 9638). For example, if the small redemption limitation equals 100 shares and the loss corporation redeems 75 shares from public shareholders twice in the same taxable year, the first redemption qualifies entirely for the small redemption exception, but only 25 shares of the second redemption qualifies. The 50 shares that exceed the small redemption limitation are subject to the redemption segregation rule. As a result, a new public group is treated as owning the 50 shares immediately before the redemption. Treas. Reg. § 1.382-3(j)(16) Ex. 7 (as amended by TD 9638).

Stock redemptions that are exempt under the small redemption exception are treated as redeemed from each public group with a direct ownership interest that exists before the stock redemption. The shares that are exempt are treated as being redeemed proportionately from each such public group based on the amount of stock held before the redemption. Treas. Reg. § 1.382-3(j)(14)(iv)(A) (as amended by TD 9638).

The loss corporation can optionally use a different allocation based on actual knowledge. In such case, one or more groups can be treated as having a larger number of shares redeemed based on actual knowledge. Treas. Reg. § 1.382-3(j)(14)(iv)(B) (as amended by TD 9638). Presumably, the excess allocated to one or more groups is allocated away from the remaining groups proportionately.

Deemed Exercise of Options

The segregation rules apply to any deemed acquisition of stock of the loss corporation (or first tier or higher tier entity) as a result of the application of the option attribution rule. The option segregation rule only applies to rights to acquire stock that are issued by the corporation that issued the stock. Temp. Reg. § 1.382-2T(j)(2)(iii)(D)(1).

Where the segregation rules apply to a deemed exercise of an option, each direct public group that exists after the transaction is segregated into two or more components. The shareholders that receive stock in the deemed exercise are segregated from the other shareholders. There is a rebuttable presumption that there is no cross-ownership between the two groups. Temp. Reg. § 1.382-2T(j)(2)(iii)(D)(1). Both the small issuance exception and the cash issuance exception (described above with respect to the section 1032 transaction segregation rule) apply with respect to the option segregation rule. Treas. Reg. § 1.382-3(j)(9).

Issuance of stock rights. Special rules apply if the loss corporation (or first tier or higher tier entity) issues rights to acquire stock. If either the section 1032 transaction segregation rule or the option segregation rule

applies to the deemed or actual exercise of such rights, the rights are presumed to be exercised pro rata by each public group that received the rights. Temp. Reg. § 1.382-2T(j)(2)(iii)(F)(1).

The rule described in the previous paragraph does not apply if the stock rights are transferable by the holders. In such case, either the section 1032 transaction or the option segregation rule applies without modification. Generally, this results in the shareholders that exercise the rights being treated as the members of a new public group. However, the loss corporation can take into account actual knowledge as to which public groups acquired the shares. Treas. Reg. § 1.382-3(j)(10).

E. Shareholder Transaction Rules

The shareholder transaction rules provide rules with respect to transactions between 5% shareholders and shareholders that own less than 5% of the stock of the loss corporation.

Where stock in a loss corporation (or first tier or higher tier entity) is acquired by an individual or entity that owns 5% or more of the loss corporation directly, or indirectly by attribution, from public shareholders, special rules apply. Where more than one public group exists before the transaction (e.g., as a result of previous applications of the segregation rules), the shares are treated as acquired proportionately from each public group that existed before the transaction. However, either the taxpayer or the IRS can establish a different proportion. Temp. Reg. § 1.382-2T(j)(2)(vi), (3)(v).

Where stock in a loss corporation is disposed of by a person that owns 5% or more of the loss corporation (before applying attribution rules) to public shareholders, special rules apply. For transfers that take place on or after October 22, 2013 (or earlier, in certain cases, if the taxpayer applies the amended segregation rules retroactively), the shares are treated as acquired proportionately from each public group that existed before the transaction. Treas. Reg. § 1.382-3(j)(13), (17) (as amended by TD 9638). Unlike with respect to acquisitions of stock, there does not seem to be an ability for the taxpayer or the IRS to establish a different proportion. As an example, assume that a loss corporation has two public groups, one owning 60% and one owning 40%. If an individual acquires 10% of the stock and then sells it within the same testing period, the two public groups would end up once again owning 60% and 40% (with a lowest percentage ownership interest of 54% and 36%, respectively). Treas. Reg. § 1.382-3(j)(16) Ex. 5 (as amended by TD 9638).

Where such stock is disposed of before October 22, 2013, each direct public group that exists after the transaction is generally segregated into two or more components. The public shareholders that acquired stock in the transaction are segregated from the other public shareholders. There is a rebuttable presumption that there is no cross-ownership between the two groups. If the new public group has a less than 5% interest, the group can be combined with other de minimis public groups created during the taxable year. Temp. Reg. § 1.382-2T(j)(3)(i). As an example, if an individual that owns 20% of the loss corporation sells 25% of his stock in a secondary offering, a new public group is created that is treated as owning 5% of the loss corporation. The individual is treated as having an interest of 15% after the sale. *See* Temp. Reg. § 1.382-2T(j)(3)(ii) Ex.

The principles of the rules regarding a transfer of loss corporation stock from a person with a 5% interest to public shareholders also apply to transfers of ownership interests in a first tier entity (or higher tier entity that owns 5% or more of the loss corporation directly, or indirectly by attribution). Temp. Reg. § 1.382-2T(j)(3)(i). For transfers that take place on or after October 22, 2013 (or earlier, in certain cases, if the taxpayer applies the amended segregation rules retroactively), if the transferor is a 5% owner (that is a 5% shareholder of the loss corporation) or a higher tier entity (owning 5% or more of the loss corporation directly, or indirectly by attribution), the equity is treated as acquired proportionately from each public group of the entity that existed before the transaction. Treas. Reg. § 1.382-3(j)(13), (16) Ex. 6, (17) (as

amended by TD 9638). Where such stock is disposed of before October 22, 2013, the public shareholders that acquired stock in the transaction are segregated from the other public shareholders.

If a public shareholder (i.e., a person that is not a 5% shareholder or higher tier entity that owns 5% or more of the loss corporation) transfers an interest in first tier or higher tier entity to another public shareholder, the transaction is generally disregarded. Temp. Reg. § 1.382-2T(e)(1)(ii); Treas. Reg. § 1.382-3(j)(13) (as amended by TD 9638). At one point, there was some uncertainty as to whether transfers by 5% owners of a first tier or higher tier entity (to persons with a less than 5% interest) were disregarded. Proposed regulations issued in 2011 would have clarified that such transactions were disregarded. Prop. Reg. § 1.382-3(i)(1) (Nov. 23, 2011) (withdrawn). The amended segregation rules did not finalize this provision. However, the IRS has stated that it will not challenge a taxpayer that applies the clarification in the proposed regulations. TD 9638.

F. Public Group Operating Rules

Each member of a public group is generally presumed not to be a member of another public group. It also is presumed that each member is unrelated to all other shareholders. In other words, there is a presumption of no cross-ownership. Temp. Reg. § 1.382-2T(j)(1)(iii).

If the loss corporation has actual knowledge of cross-ownership among public groups, the loss corporation may take such information into account. However, the loss corporation is permitted to ignore the information if it so chooses. Temp. Reg. § 1.382-2T(k)(2). The loss corporation has no duty of inquiry to determine whether there is (or, the amount of any) cross-ownership among public groups. Temp. Reg. § 1.382-2T(k)(3).

Public Group Example. Holdco is a corporation that is 100% owned by a public group. Holdco owns 100% of the stock of Sub. Holdco distributes the stock of Sub pro rata to its shareholders. After the distribution, the public group that owns 100% of Holdco is presumed to have no cross-ownership with the public group that owns 100% of Sub. In this case, Holdco has actual knowledge that there is 100% cross-ownership between the two groups. If Holdco chooses to apply its actual knowledge, the transaction would not be an owner shift with respect to Sub. Temp. Reg. § 1.382-2T(j)(1)(vi) Ex. (2). If Holdco does not apply its actual knowledge, then the distribution of the Sub stock would cause an ownership change with respect to Sub. *See* PLR 201350006 (Sept. 13, 2013).

The regulations provide other examples of the use of actual knowledge to take into account cross-ownership between public groups. *See* Temp. Reg. § 1.382-2T(j)(2)(iii)(B)(2) Ex. (2) (equity structure shift), Ex. (4) (Section 1032 transaction), (3)(iv) Ex. (2) (formation of new holding company).

In Private Letter Ruling 201110006 (Sept. 10, 2010), the IRS permitted the taxpayer to use actual knowledge to determine cross-ownership in a merger. In the ruling, the acquiring corporation acquired 100% of the stock of a target corporation in a corporate reorganization (type A/(a)(2)(E) or type B). The taxpayer treated the shareholders that owned both the acquiring corporation and the target corporation before the transaction as a separate public group (the “overlapping group”). The IRS ruled that the taxpayer did not have to determine the stock ownership of the overlapping group throughout the testing period. PLR 201110006; *see also* PLR 202146003 (Aug. 25, 2021). Presumably, this means that the taxpayer determined the stock ownership both immediately before and immediately after the transaction and used the lowest of the two to determine the lowest percentage ownership interest during the testing period. Temp. Reg. § 1.382-2T(j)(2)(iii)(B)(2) Ex. (2) (overlapping group owned 66 2/3% of each corporation in a merger).

Transfers of stock by one member of a group to another are disregarded even if the loss corporation has actual knowledge of the transfer. Temp. Reg. § 1.382-2T(e)(1)(iii) Ex. (6).

IV. Constructive Ownership

An important component of determining whether an ownership change has occurred is the determination of the percentage ownership interest of the various 5% shareholders. The percentage ownership interest can be a direct ownership interest or an indirect ownership interest. This section discusses the attribution rules (constructive ownership) that apply in determining whether a shareholder has (and the amount of) an indirect ownership interest.

As a general rule, the constructive ownership rules of section 318 apply. IRC § 382(l)(3)(A); Temp. Reg. § 1.382-2T(h)(1). However, there are many modification to those rules (some significant).

There are generally three types of attribution for section 382 purposes, (i) attribution from an entity (entity attribution), (ii) constructive exercise of an option or similar interest (option attribution), and (iii) attribution from members of a person's family (family attribution). In addition, there are "step-into-the-shoes" rules by which one shareholder takes on the ownership attributes of another.

A. Entity Attribution

Under the entity attribution rule, stock owned directly (or indirectly by attribution) by an entity is generally treated as owned by the owners of the entity. IRC § 382(l)(3)(A)(ii); Temp. Reg. § 1.382-2T(h)(2)(i). Stock of a loss corporation that is owned by a shareholder is not attributed to other entities that the shareholder has an interest in (i.e., no downward attribution). Temp. Reg. § 1.382-2T(h)(3).

Stock that is attributed to an owner of the entity under the entity attribution rule is generally treated as no longer being owned by the entity itself. IRC § 382(l)(3)(A)(ii)(II); Temp. Reg. § 1.382-2T(h)(2)(i)(A). This rule applies solely for purposes of determining whether an ownership change has occurred. Treas. Reg. § 1.382-4(b)(2).

The entity attribution rule does not apply to attribute ownership by a corporation to a person that holds pure preferred stock or an ownership interest that is not treated as stock under the stock recharacterization rule. IRC § 382(l)(3)(A)(v)(I); Temp. Reg. § 1.382-2T(h)(2)(ii)(A), (B), (iv) Ex. (3). Similar rules apply to entities that are not corporations. IRC § 382(l)(3)(A)(v)(II); Temp. Reg. § 1.382-2T(h)(2)(ii)(C). The ownership interests that are exempt from the entity attribution rule are ignored for purposes of determining a person's percentage ownership interest in an entity. Temp. Reg. § 1.382-2T(h)(2)(ii).

The entity attribution rule generally applies to (i) a first tier entity, and (ii) a higher tier entity that has an indirect ownership interest of 5% or more on the testing date. The entity attribution rule does not apply with respect to an ownership interest in an entity that directly or indirectly owns less than 5% of the loss corporation at all times during the testing period. Similarly, the entity attribution rule does not apply to a higher tier entity that had an indirect ownership interest of 5% or more at some time during the testing period but did not have a 5% interest directly (or indirectly by attribution) on the testing date. Temp. Reg. § 1.382-2T(h)(2)(iii)(A). This exemption from the entity attribution rule does not apply to the extent the loss corporation has actual knowledge that an individual would be a 5% shareholder if the rule were not applied. Temp. Reg. § 1.382-2T(k)(2)(i).

Certain entities are exempt from the entity attribution rule. The list of exempt entities include (i) a qualified trust under section 401(a) (a US stock bonus, pension, or profit-sharing plan), (ii) any State or the District

of Columbia (or political subdivision thereof), (iii) the United States (or any agency or instrumentality, or political subdivision thereof), or (iv) any foreign government (or political subdivision thereof). Temp. Reg. § 1.382-2T(h)(2)(iii)(B), (C). These entities are treated as individuals that are unrelated to any other owner of the loss corporation. Temp. Reg. § 1.382-2T(h)(2)(iii). This exemption from the entity attribution rule does not apply to the extent the loss corporation has actual knowledge that an individual would be a 5% shareholder if the rule were not applied. Temp. Reg. § 1.382-2T(k)(2)(i).

There is uncertainty as to whether a transfer among related governmental entities or to citizens is an owner shift that could result in an ownership change. The Blue Book indicates that a privatization transaction (a transfer of stock ownership by a government to its citizens) is an owner shift. Blue Book, p. 311 (transfer of 100% causes an ownership change).

The Blue Book also indicates that “Governmental units, agencies, and instrumentalities that derive their powers, rights, and duties from the same sovereign authority” are to be treated as a single 5% shareholder. Blue Book, p. 311. An example of this would include stock that is owned by a country’s sovereign wealth fund and by its central bank. The applicable regulations are silent on this point. As a result, there is uncertainty as to whether the language in the Blue Book has continuing relevance. There is also uncertainty as to whether a political subdivision (or subdivisions) of a country are treated as a single 5% shareholder with the governmental authority. For example, if the federal government and a state both own stock in the same loss corporation, are they treated as a single 5% shareholder?

Generally, the entity attribution rule does not apply to any ownership interest in an entity that is less than 5% of the entity. Temp. Reg. § 1.382-2T(g)(2). This rule does not apply to the extent the loss corporation has actual knowledge that an individual would be a 5% shareholder if the rule were not applied. Temp. Reg. § 1.382-2T(k)(2)(i).

A person’s percentage ownership interest in a higher tier entity that is a corporation is generally determined based upon rules that are similar to the rules for determining the percentage ownership interest in the loss corporation. IRC § 382(k)(6)(C), (l)(3)(A)(v)(I); Temp. Reg. § 1.382-2T(f)(24)(i). Similar rules (described below) apply to higher tier entities that are not corporations.

The percentage ownership interest in a partnership is determined based upon the relative value of such person’s partnership interest to the total value of all of the outstanding partnership interests. However, an interest in a partnership that is limited and preferred is ignored for this purpose if it has characteristics that are similar to pure preferred stock or stock that would be ignored for ownership change purposes under the stock recharacterization rule. IRC § 382(l)(3)(A)(v)(II); Temp. Reg. § 1.382-2T(f)(24)(ii), (h)(2)(ii)(C).

The percentage ownership interest in a trust (other than a grantor trust) is generally determined in proportion to the actuarial ownership interests of the beneficiaries in the trust. IRC § 318(a)(2)(B)(i); Temp. Reg. § 1.382-2T(f)(24)(iii). The percentage ownership interest in a grantor trust is generally determined as if the grantor owned directly the property attributed to the grantor under the grantor trust rules. IRC § 318(a)(2)(B)(ii); Temp. Reg. § 1.382-2T(f)(24)(iii). The percentage ownership interest in an estate is generally determined in proportion to the ownership interests of the beneficiaries in the estate. IRC § 318(a)(2)(A); Temp. Reg. § 1.382-2T(f)(24)(iv).

For other entities (not described above), the percentage ownership interest is determined based upon the person’s relative economic interest in the entity. The relative economic interest is determined by taking into account all of the relevant facts and circumstances. Temp. Reg. § 1.382-2T(f)(24)(v).

There is uncertainty as to how to apply the attribution rules to entities that are exempt from tax pursuant to section 501(c)(3). Such entities typically do not have a person that could be described as the owner of the equity. Presumably, the rule described in the prior paragraph applies to tax-exempt entities that are not exempt from the attribution rule.

In Private Letter Ruling 201549010 (Aug. 24, 2015), the IRS ruled that an ownership change did not occur when the stock of a loss corporation was transferred from one section 501(c)(3) organization to another. One of the tax-exempt entities was a subsidiary of the other (i.e., one entity owned all of the membership interests in the other). The subsidiary entity sold 100% of the stock of loss corporation (that was not a tax-exempt entity) to the parent entity. The IRS ruled that that the transfer did not cause an ownership change with respect to the loss corporation.

Examples of the application of the entity attribution rules can be found in subsection (g)(4) and subparagraph (h)(2)(iv) of section 1.382-2T of the temporary Treasury regulations.

Special rules apply if a person with a direct or indirect ownership interest in a loss corporation structures the ownership interest to avoid treatment as a 5% shareholder for a principal purpose of circumventing a section 382 limitation. In such case, several of the exemptions from the application of the entity attribution rules do not apply and the shareholder's actual ownership (including by attribution) is taken into account. This anti-avoidance provision only applies if the application results in an ownership change. Temp. Reg. § 1.382-2T(k)(4)(i), (ii).

As an example of the application of this anti-abuse rule, an individual indirectly acquires a 16% interest by forming four subsidiaries to acquire 4% each. If stock was acquired through corporations (as opposed to directly) for a principal purpose of avoiding an ownership change, then the individual could be treated as a 5% shareholder that acquired an indirect ownership interest of 16%. *See* Temp. Reg. § 1.382-2T(k)(5) Ex.

B. Option Attribution

Under the option attribution rule, an option with respect to stock can be treated as exercised by the holder of the option. The shares that are subject to the option are attributed to or away from the holder depending upon the type of option. The option attribution rule only applies for purposes of determining whether an ownership change has occurred. Treas. Reg. § 1.382-4(d)(1), (2)(i), (ii); *see* IRC § 382(k)(6)(B)(i), (l)(3)(A)(iv).

In applying the option attribution rules, general tax principles must be applied first. For example, an option with relatively low exercise price might not be respected and the owner of the option would be treated as owning the stock that is subject to the option. In that situation, due to the fact that option holder could choose not to exercise, the transaction might be treated as a put right (i.e., the holder of the option has the ability to force ownership of the stock on the title owner of the stock). *See* the above discussion of ownership of stock under general tax principles in the ownership change section of this paper.

Attribution Rule

The option attribution rule applies if the option satisfies one of three tests (the "ownership test," the "control test," or the "income test"). Treas. Reg. § 1.382-4(d)(2)(i). There is a principal purpose requirement of each of the three tests. As a result, the option attribution rule can only apply if "a principal purpose of the issuance, transfer, or structuring of the option (alone or in combination with other arrangements) is to avoid or ameliorate the impact of an ownership change of the loss corporation." Treas. Reg. § 1.382-4(d)(3), (4)(i)(A), (5).

A determination as to whether the option attribution rule applies is made on the date of its issuance or transfer. Treas. Reg. § 1.382-4(d)(2)(i). A contract to acquire stock that is treated as an option under these rules (i.e., not eligible for the safe harbor) is considered “issued” on the date the contract is entered into and “transferred” on the date the contract is assigned. Treas. Reg. § 1.382-4(d)(8)(i).

Certain “transfers” of options are exempt from the requirement that a determination as to whether the option attribution rule applies is made on the date of any transfer. A transfer of an option that is between two persons that are not 5% shareholders (taking into account all options) is exempt. Treas. Reg. § 1.382-4(d)(11)(i). Similarly, a transfer is exempt if it is between members of different public groups created under one or more of the segregation rules. Treas. Reg. § 1.382-4(d)(11)(ii). A transfer of an option is exempt if it is a transfer that would otherwise qualify for the step-into-the-shoes rule had it been a transfer of stock. Treas. Reg. § 1.382-4(d)(11)(iii).

If the option satisfies one of the three tests on the date of issuance or transfer, the option is treated as exercised on that date. Treas. Reg. § 1.382-4(d)(2)(i). Generally, the holder of the option is treated as acquiring stock on that date and the issuer of the option is treated as transferring the stock. In the case of a put, the holder of the option is treated as transferring the stock and the issuer of the put is treated as acquiring the stock. Treas. Reg. § 1.382-4(d)(8)(iv). If an option is treated as exercised on the date of its issuance or transfer under the option attribution rule, it is also treated as exercised on any subsequent testing date. Treas. Reg. § 1.382-4(d)(2)(ii).

If an option is treated as exercised on a change date under the option attribution rule, the option is generally not deemed to be exercised on any testing date after the change date. However, if the option is transferred after the change date, the option is re-tested under the ownership, control, or income tests at the time of the transfer. For this purpose, any principal purpose for the issuance or pre-change transfers is disregarded. Treas. Reg. § 1.382-4(d)(10)(i)(A).

If an option is actually exercised after having been deemed exercised, the actual exercise is ignored for ownership change purposes if it takes place after a change date. In other words, the actual exercise does not contribute to a second ownership change if the deemed exercise contributed to a prior ownership change. This exemption only applies if the person exercising the option is the same person (or a permitted transferee described in section 1.382-4(d)(11) of the Treasury regulations) who owned the option immediately after the ownership change. Treas. Reg. § 1.382-4(d)(10)(i)(B).

An alternative treatment is available if an option is actually exercised within three years of a change date. This alternative treatment only applies if (i) the loss corporation reports an ownership change on an original tax return, (ii) the loss corporation treated the option as exercised pursuant to the option attribution rule on the change date, and (iii) the application of the option attribution rule on the original tax return was proper. In such case, the taxpayer can treat the option as actually exercised on the change date for purposes of determining whether a second ownership change occurred. If the alternative treatment is applied by the taxpayer, (i) the rules described in the previous two paragraphs do not apply, (ii) any transfer of the option after the change date is treated as a transfer of stock, and (iii) the actual exercise of the option is not taken into account for purposes of determining if a second ownership change occurred. Treas. Reg. § 1.382-4(d)(10)(ii).

An option is not treated as exercised if a principal purpose of the issuance, transfer, or structuring is to avoid an ownership change by applying the option attribution rule. Treas. Reg. § 1.382-4(d)(6)(i).

Under an anti-abuse rule, the option attribution rule applies if an entity is formed or availed of for “a principal purpose of facilitating an indirect transfer of an option by issuing or transferring interests in the

entity.” Treas. Reg. § 1.382-4(d)(8)(ii). In such case, the issuance or transfer of equity in the entity is treated as a transfer of an option for purposes of the option attribution rule. *Id.*

As a general rule, an “option” for purposes of the option attribution rule includes an instrument that is considered to be an option to acquire stock under general tax principles. Treas. Reg. § 1.382-4(d)(9)(iv). In addition, the term includes “any contingent purchase, warrant, convertible debt, put, stock subject to a risk of forfeiture, contract to acquire stock, or similar interests.” IRC § 382(l)(3)(A); *see* Treas. Reg. § 1.382-4(d)(9)(i). An item described in the previous sentence is treated as an option without taking into account whether or not it is currently exercisable or contingent. Treas. Reg. § 1.382-4(d)(9)(i).

For purposes of the option attribution rules, an option to acquire an option to acquire stock (and any series of such options) is treated as an option to acquire stock. Treas. Reg. § 1.382-4(d)(9)(iii).

Convertible stock is generally not treated as an option for purposes of the option attribution rules. However, convertible stock is treated as an option if the terms of the conversion feature allow (or require) consideration other than stock to be paid (i.e., the converted stock plus other property or cash). In such case, the convertible stock is treated as both stock and an option. Treas. Reg. § 1.382-4(d)(9)(ii).

The definition of an option includes any option to acquire or transfer an equity interest in an entity (other than a corporation). In such case, appropriate adjustments are made in applying the rules to take into account the non-stock equity interest. Treas. Reg. § 1.382-4(d)(8)(iii).

Ownership Test. An option satisfies the ownership test if the principal purpose requirement is met and the arrangement provides the holder of the option with a “substantial portion of the attributes of ownership of the underlying stock” before the option is exercised (or transferred). Treas. Reg. § 1.382-4(d)(3). The applicable regulations list factors (in addition to the general factors described below) in determining whether the ownership test is met. They are:

- the relationship between the exercise price of the option and the value of the underlying stock (determined at the time of issuance or transfer),
- whether the holder (or a related person) receives a right to participate in management of the loss corporation as a result of holding the option (or other right) that would normally be afforded to owners of stock,
- the existence of reciprocal options (e.g., a call option held by one party and put option held by the owner of the stock), and
- the ability of the holder of an option with a fixed exercise price to share in future appreciation.

Treas. Reg. § 1.382-4(d)(6)(ii). The applicable regulations state that the last factor (future appreciation) alone is not enough to satisfy the ownership test. Conversely, the fact that the holder may not have the risk of economic loss with respect to declines in stock value does not prevent an option from meeting the ownership test. *Id.*

Control Test. An option satisfies the control test if the principal purpose requirement is met and the holder of the option has, in the aggregate, a direct or indirect ownership interest in the loss corporation of more than 50%. The 50% requirement is determined by taking into account (i) any increase in the holder’s percentage ownership interest that would result from the exercise of the tested option and any other option held by that person, and (ii) any other intended increases in the holder’s percentage ownership interest. Treas. Reg. § 1.382-4(d)(4)(i).

It should be noted that the ownership interest of more than 50% of the stock is determined based on the general rules of section 382. As a result, an option that would give the owner more than 50% of the vote but less than 50% of the value of the stock of the loss corporation potentially may not meet the control test. However, it should be noted that influence of the holder over management is listed as a factor (described below) that is used to determine if the control test is met.

A holder of an option for purposes of the 50% requirement can only be an individual or entity. A public group is not treated as a holder that is subject to the 50% requirement. Treas. Reg. § 1.382-4(d)(4)(ii)(A)(1).

For purposes of the 50% requirement, an indirect ownership interest is determined under rules that differ from the normal rules that apply for ownership change purposes. The constructive ownership rules generally apply. However, stock that is subject to the entity attribution rule is considered owned by the holder of the stock as well as the person that is treated as constructively owning the stock. This modification to the constructive ownership rules is not to be applied if results in double counting of the stock. Treas. Reg. § 1.382-4(d)(4)(ii)(B).

For purposes of the 50% requirement, a direct or indirect ownership interest of a related person (or persons) is taken into account. Treas. Reg. § 1.382-4(d)(4)(i)(B). A person is related to a holder if they have a relationship specified in either section 267(b) or 707(b). Treas. Reg. § 1.382-4(d)(4)(ii)(A)(2). Under sections 267(b) and 707(b) a person is generally related to another if they are members of a family or there is some element of more than 50% common control. In addition, a person is treated as related to the holder if they have “a formal or informal understanding among themselves to make a coordinated acquisition of stock.” Treas. Reg. § 1.382-4(d)(4)(ii)(A)(2). See the above discussion of the meaning of the term “coordinated acquisition of stock” with respect to the definition of “entity” for ownership change purposes.

The applicable regulations list factors (in addition to the general factors described below) in determining whether the control test is met. They are:

- the economic interests of the holder (or related persons) in the loss corporation, and
- the influence of the holder (or related persons) over management of the loss corporation.

Treas. Reg. § 1.382-4(d)(6)(iii). The above factors are to take into account rights acquired through the option, as well as related arrangements and rights in stock. *Id.*

Income Test. An option satisfies the income test if the principal purpose requirement is met and the arrangement facilitates “the creation of income (including accelerating income or deferred deductions) or value (including unrealized built-in gains)” before the option is exercised (or transferred). Treas. Reg. § 1.382-4(d)(5).

The applicable regulations list factors (in addition to the general factors described below) in determining whether the income test is met. They are:

- whether the loss corporation engages in “income acceleration transactions” in connection with the issuance or transfer of the option, and
- whether the holder (or related persons) purchases stock (including pure preferred stock) from the loss corporation (or makes a capital contribution or loan), in connection with the issuance or transfer of the option, that can “reasonably be expected to avoid or ameliorate the impact of an ownership change.”

Treas. Reg. § 1.382-4(d)(6)(iv).

An income acceleration transaction includes a transaction that accelerates income or gain into the period before exercise (or defers deductions into the period after exercise) if the transaction is outside the normal course of business. *Id.*

For purposes of the income test, the weight given to any stock purchase, capital contribution, or loan as a factor depends upon the size of the amount received by the loss corporation. Larger amounts are more likely indicators that the income test is met. However, an infusion of cash (or other resources) is ignored if it made to enable the loss corporation to continue basic operations. Examples include cash transferred to the loss corporation to fund monthly payroll or other operating expenses. *Id.*

Factors. A determination as to whether the ownership, control, or income tests are met is based upon all of the relevant facts and circumstances. The applicable regulations list factors that are relevant under all three tests. Additional factors that are relevant to only a single test are described above. The weight given to any factor depends on the facts and circumstances. There are no presumptions created by the presence or absence of any factor. Treas. Reg. § 1.382-4(d)(6)(i).

The factors that are relevant under all three tests are:

- the business purpose for the issuance, transfer, or structure of the option,
- the likelihood that the option will be exercised (taking into account contingencies, as well as other relevant considerations),
- the existence of other related transactions, and
- the consequences of treating the option as exercised.

Id.

Exempt Transactions

The applicable regulations list several options that are exempt from the option attribution rules (or one or more of the tests). No presumption applies for options that are not eligible for exemption. Treas. Reg. § 1.382-4(d)(7). The options that are eligible for exemption are described below.

Certain contracts to acquire stock are exempt from the ownership and control tests (but not the income test). A stock purchase agreement (or similar arrangement) is exempt if (i) the terms are commercially reasonable, (ii) the obligations to complete the transaction are only subject to reasonable closing conditions, and (iii) the transaction closes on a change date within one year of the date the agreement was entered into. Treas. Reg. § 1.382-4(d)(7)(i). As a result of the reference in the third requirement to a “change date,” it appears that this exception only applies if the closing of the agreement would otherwise cause (or contribute to) an ownership change.

Certain security arrangements are exempt from the option attribution rule. A security arrangement is exempt if it is pursuant to a typical lending transaction and subject to customary commercial conditions. A typical lending transaction includes a purchase money loan. A security arrangement includes (i) an escrow or pledge agreement, and (ii) an option to acquire stock contingent upon a loan default. Treas. Reg. § 1.382-4(d)(7)(ii).

Certain employee options are exempt from the option attribution rule. A compensatory option to acquire corporate stock is exempt if the option (i) is provided to an employee, director, or independent contractor in connection with the performance of services to the corporation (or related person), (ii) has customary terms and conditions, (iii) is not excessive by reference to the services performed, (iv) is “nontransferable”

(within the meaning of section 1.83-3(d) of the Treasury regulations), and (v) does not have a “readily ascertainable” fair market value (within the meaning of section 1.83-7(b) of the Treasury regulations) on the date issued. Treas. Reg. § 1.382-4(d)(7)(iii).

Certain stockholder buyout agreements are exempt from the option attribution rule. An agreement between two or more stockholders of a corporation (or between a corporation and a stockholder) to sell or buy stock of either stockholder is exempt if it is only exercisable upon the stockholder's (i) death, (ii) disability, (iii) mental incompetency, or (iv) retirement. However, exercise upon retirement is only permitted if the stock was acquired by the stockholder in connection with the performance of services for the corporation (or related person) and the stock is not excessive by reference to the services rendered. Treas. Reg. § 1.382-4(d)(7)(iv).

Certain rights of first refusal are exempt from the option attribution rule. A right of first refusal entered into between two or more stockholders of a corporation (or between a corporation and a stockholder) regarding the corporation's stock is exempt if (i) it is bona fide, and (ii) it has customary terms. Treas. Reg. § 1.382-4(d)(7)(v).

Certain rights to acquire stock pursuant to a bankruptcy or similar proceeding are exempt from the option attribution rule. A right to receive stock pursuant to a confirmed plan of reorganization under such a proceeding is exempt from the option attribution rule until the time the plan becomes effective. The exemption applies to (i) an option created by solicitations or receipts of acceptance of the plan, (ii) an option created by the confirmation of the plan by a court, and (iii) any option created under the plan. Treas. Reg. § 1.382-9(o)(1). The intent of this rule was to help ensure that any ownership change resulting from a bankruptcy plan of reorganization occurred on the effective date of the plan.

C. Family Attribution

Under the family attribution rule, an individual and all of the members of his “family” are treated as a single individual for ownership change purposes. IRC § 382(l)(3)(A)(i); Temp. Reg. § 1.382-2T(h)(6)(ii). The members of an individual's family include (i) a spouse (other than one that is legally separated under a decree of divorce or separate maintenance), (ii) children, (iii) grandchildren, and (iv) parents. IRC § 318(a)(1)(A). For this purpose a legally adopted child is treated as a child by blood. IRC § 318(a)(1)(B).

It is possible that an individual could be a member of more than one family (if there were no coordination rule). In such case, the individual is treated as a member of the family that results in the lowest cumulative owner shift on the testing date. The individual is not treated as a member of any other family. Temp. Reg. § 1.382-2T(h)(6)(iv).

Generally, the family attribution rule does not apply to members of a family who did not own at least 5% of the loss corporation (directly, or indirectly by attribution) at any time during the testing period. Temp. Reg. § 1.382-2T(h)(6)(iii). However, the family attribution rule applies if the loss corporation has actual knowledge of the facts. Temp. Reg. § 1.382-2T(k)(2). This is how the temporary Treasury regulations state the rules. A more practical way of describing the rule is an individual and all family members are treated as a single 5% shareholder if they own 5% or more (on a combined basis) unless the loss corporation does not have actual knowledge of the facts relating to the ownership by the family members.

It is possible under the current rules, that an ownership change could occur if the composition of a family changes. The Treasury Department and the IRS stated in 2003 that they intend to promulgate regulations to prevent a change in the composition of family from causing an ownership change where the ultimate beneficial ownership is unaffected. As an example, it was thought that a marriage of two individuals should

not contribute to an ownership change. The forthcoming regulations will address “marriage, birth, divorce, death, or other events” that cause an individual to join or leave a family. TD 9063, 2003-2 CB 510. It was also announced that the forthcoming regulations would allow taxpayers to elect to apply them retroactively. *Id.* These regulations have not yet been proposed or promulgated. The Treasury Department and the IRS announced in 2006 that they were still studying the issue. TD 9269, 2006-2 CB 92.

For purposes of determining the amount of stock owned by a family, stock constructively owned by a person by reason of the attribution rules is considered actually owned by such person (that is, reattribution is permitted). IRC § 318(a)(5)(A). Normally under the section 318 attribution rules, reattribution is not permitted from one family member to another. IRC § 318(a)(5)(B). For section 382 purposes, the rule preventing reattribution among family members does not apply. IRC § 382(l)(3)(A)(i); Temp. Reg. § 1.382-2T(h)(6)(i). This allowance of family reattribution creates the potential for broadly expanding the number of family members (in the right circumstances) to siblings, cousins, nieces, and nephews. There is currently a great deal of uncertainty as to the scope of the rules permitting family reattribution.

The Tax Court in *Garber Industries Holding Co. v. Commissioner*, 124 TC 1 (2005), *aff’d*, 435 F.3d 555 (5th Cir. 2006), held that the sale of shares by one brother to another was an owner shift that resulted in an ownership change. The taxpayer tried to argue that siblings are members of the same family for section 382 purposes, since shares held by one sibling are attributed to the parents and then back to the other sibling. In the instant case, neither parent was alive at the time of the transfer or had never been a shareholder.

The Tax Court in *Garber* could have narrowly interpreted the statute as allowing attribution only from living individuals. However, they interpreted the statute as only allowing attribution from shareholders. Under this interpretation, it appears that one starts the analysis by finding a 5% shareholder and aggregating the shares owned by other shareholders who fit within the definition of family with respect to that person. *Garber*, 124 TC 1.

The IRS argued in *Garber* that attribution is only available with respect to living individuals. It is possible that the IRS would have treated the two brothers as members of the same family, if a parent had been living during the testing period. *See* FSA 200245006 (July 25, 2002). It is unclear today as to whether this still represents the IRS’ view or the IRS will follow *Garber*.

D. Step-into-the-Shoes Rule

Under the step-into-the-shoes rule, one shareholder is treated as owning stock during the period the stock was owned by another person. The step-into-the-shoes rule applies in the following circumstances:

- the basis of the shareholder’s stock is determined under section 1014 (i.e., property acquired from a decedent),
- the basis of the shareholder’s stock is determined under section 1015 (i.e., property acquired by gift),
- the basis of the shareholder’s stock is determined under section 1041(b)(2) (i.e., property acquired from a spouse),
- the stock is acquired in satisfaction of a right to receive a pecuniary bequest,
- the stock is acquired pursuant to a divorce or separation instrument, and
- the stock is distributed by a qualified trust within the meaning of section 401(a) (a trust under a US pension, profit-sharing, or stock bonus plan).

IRC § 382(l)(3)(B); Treas. Reg. § 1.382-10(a)(1).

The IRS has issued guidance with respect to distributions by a qualified trust but not the other transactions. Where a qualified trust distributes stock, the distributed ownership interest is treated as having been acquired by the new shareholder on the date (and in the manner) acquired by the trust. For testing dates on or after the distribution, the trust is not treated as having owned the distributed shares. In addition, the day of distribution is not a testing date unless another transaction occurred that day. Treas. Reg. § 1.382-10(a)(1).

Special rules apply to help qualified trusts determine which shares were distributed. For example, if a qualified trust acquired and disposed of shares on multiple dates during the testing period, the shares that are distributed and the shares that are retained are relevant to the ownership change analysis. The loss corporation can either specifically identify all shares distributed and disposed of by the trust or can apply the first-in, first-out (FIFO) approach to distributions and dispositions. A single approach must be applied to all distributions by a qualified trust. Treas. Reg. § 1.382-10(a)(2)(i), (ii)(B). If the FIFO approach is applied, it must be applied on a class-by-class basis. Treas. Reg. § 1.382-10(a)(2)(ii)(A).

An example of how the step-into-the-shoes rule applies to a qualified trust can be found in section 1.382-10(a)(3) of the Treasury regulations.

V. Section 382 Limitation

Sections 382 and 383 limit the ability of a corporation to take into account specified tax attributes after an ownership change. The limit on losses and deductions is referred to as the section 382 limitation. The limit on tax credits is referred to as the section 383 credit limitation.

The starting point for determining the section 382 limitation is to determine the base annual section 382 limitation. The base annual section 382 limitation represents the amount of losses and deductions that can generally be applied to offset taxable income in a given post-change year. To the extent the base annual section 382 limitation is not used in a taxable year to allow the use of tax attributes, it builds up and can be used in a later tax year. IRC § 382(b)(2).

The section 382 limitation generally represents the cumulative amounts of unused base annual section 382 limitations. However, the section 382 limitation can be increased to the extent of any recognized built-in gains (RBIGs). The base annual section 382 limitation can drop to zero if the loss corporation does not satisfy the continuity of business enterprise (COBE) requirement (described below). IRC § 382(c)(1).

Sections 382 and 383 only apply to limit the use of tax attributes in a “post-change year.” IRC §§ 382(a), 383; Treas. Reg. §§ 1.382-5(a), 1.383-1(b). A post-change year is any taxable year ending after the change date. IRC § 382(d)(2). If an ownership change occurs in the middle of a taxable year, that year is a post-change year.

The base annual section 382 limitation equals the fair market value of the stock of the loss corporation (immediately before the ownership change and as adjusted) multiplied by the “long-term tax-exempt rate.” IRC § 382(b)(1), (e)(1), (k)(5); Treas. Reg. § 1.382-5(a).

Section 382 Limit Example. Lossco has an ownership change on December 31, 2007. The fair market value of the Lossco stock before the ownership change is \$1 million. Assume the long-term tax-exempt rate for December 2007 equals 5%. The base annual section 382 limitation equals \$50 thousand. If Lossco has NOLs in 2008 through 2010 and does not use any of the pre-change losses until 2011, the section 382 limitation in the 2011 taxable year equals \$200 thousand (4 taxable years of built-up base annual section 382 limitations).

Long-Term Tax-Exempt Rate

The long-term tax-exempt rate is a rate published monthly by the IRS (generally in the middle of the prior month). As discussed in more detail below, the rate is designed to mimic the rate of long-term municipal bonds. *See* IRC § 382(f).

The long-term tax-exempt rate has generally been in the 2-6% range during the 21st Century. However, the rate has dropped to lower levels near the end of 2019 (and has stayed at a low level ever since). The rate is 2.36% for ownership changes that occur in June 2022. Rev. Rul. 2022-10, 2022 IRB Lexis 181. The record low was 0.85% for ownership changes in October 2020. Rev. Rul. 2020-20, 2020-41 IRB 880.

The long-term tax-exempt rate for a particular calendar month equals the highest of the “adjusted federal long-term rates” for the three-calendar month period ending with the month of the ownership change. IRC § 382(f)(1); Treas. Reg. § 1.382-12(a). The IRS publishes each month both the long-term tax-exempt rate and the adjusted federal long-term rate. Treas. Reg. § 1.382-12(a).

The adjusted federal long-term rate equals the “federal long-term rate” (compounded annually), adjusted for differences in long-term rates between taxable and tax-exempt debt obligations. IRC § 382(f)(2); Treas. Reg. § 1.382-12(a). The federal long-term rate is also published monthly by the IRS and is generally used for purposes of determining the applicable federal rate under section 1274 for a long-term (over nine years) debt obligation. IRC § 1274(d)(1)(A).

In 2013, the Treasury Department changed the methodology for determining the adjusted federal long-term rate. Before this change (and going back to 1986), the rate was determined by multiplying the federal long-term rate by a fraction. The numerator of the fraction equaled the composite yield of prime general-obligation tax-exempt bonds (i.e., the highest grade tax-exempt bonds available). The denominator of the fraction equaled the composite yield of Treasury bonds with maturities that are similar to the tax-exempt bonds used to determine the numerator. Notice 2013-4, 2013-1 CB 527.

In recent years (since 2008), there has been a perceived difference in credit risk between bonds issued by state and local governments and the Treasury Department. As a result, the market yields of prime general-obligation tax-exempt bonds have exceeded the yields of comparable Treasury bonds. Accordingly, the fraction used to determine the adjusted federal long-term rate has exceeded 100% and the rate had exceeded the federal long-term rate (before the change described below).

In Notice 2013-4, the IRS and the Treasury Department announced that, pending further guidance, the adjustment fraction used to determine the adjusted federal long-term rate will never exceed 100%. In addition, the denominator of the fraction will never be less than zero (i.e., negative interest rates on Treasury bonds will be treated as a rate of zero). These changes affected adjusted federal long-term rates for March 2013 (and later months). Notice 2013-4, § IV. Since the long-term tax exempt rate is the greater of three most recent adjusted federal long-term rates, this change did not generally affect the section 382 limit for ownership changes until May 2013.

In April 2016, the IRS and the Treasury Department issued regulations that made more drastic changes to the computation of the adjusted federal long-term rate. Under the new rules, the adjusted federal long-term rate equals the product of the federal long-term rate (based on annual compounding) multiplied by an adjustment factor. The adjustment factor equals 100%, minus 59% multiplied by the sum of the maximum tax rate in effect for individuals. The maximum tax rate for individuals equals the sum of the top rates under sections 1 (ordinary income rate) and 1411 (rate on net investment income). Treas. Reg. § 1.382-12(b), (c).

Under current law, the maximum tax rate for individuals equals 40.8% (37% plus the 3.8% tax on net investment income).

The 59% adjustment rate in the above-described formula is based on the ratio of yields on prime, general obligation tax-exempt obligations to the yields on US Treasury obligations of similar maturity from 1986 to 2007. The authors of the preamble to the regulations when they were first proposed stated that the relationship was relatively stable over the period and did not vary by more than a few percentage points. REG-136018-13, 2015-11 IRB 759, 761.

The regulations first became effective for the rates determined during August 2016 (that apply during September 2016). Treas. Reg. § 1.382-12(d).

As an example of how the new rules affect the computations, the adjusted federal long-term rate for June 2015 was 2.50% (computed under then existing rules and limited to the federal long-term rate). If the proposed regulation has been in effect, the rate would have been 1.86% (federal long-term rate of 2.50% multiplied by adjustment rate of 74.39% (100% minus (59% multiplied by 43.4% (39.6% plus 3.9%))).

Special Rules

If a post-change year has fewer than 365 days in it, the base annual section 382 limitation is reduced. The amount is reduced by the ratio of (i) the number of days in the taxable year, over (ii) 365. No reduction is required if the taxable year is less than 365 days due to the use of a 52-53 week taxable year (unless a return is required under section 443). Treas. Reg. § 1.382-5(c). The regulations do not appear to take into account the extra day in a leap year.

Special rules apply where a change date occurs other than on the last day of the taxable year. In such case, the base annual section 382 limitation for the taxable year that includes the change date is reduced. The reduced amount equals the ratio of (i) the number of days in the post-change period, over (ii) the number of days in the taxable year. IRC § 382(b)(3)(B), (h)(5)(B).

If a loss corporation has two (or more) ownership changes, special rules apply. The pre-change losses that arose before the first change date are subject to both section 382 limitations. The amount allowable in a post-change year will generally equal the lower of the two section 382 limitations. Treas. Reg. § 1.382-5(d).

Special rules apply where a loss corporation has had two or more ownership changes and pre-change losses that are not subject, in whole or in part, to all of the section 382 limitations. In such case, the earliest pre-change losses are allowed to the extent of the lowest of the relevant section 382 limitations. Pre-change losses that are not subject to the earlier section 382 limitation are allowed up to the amount of the excess of the later section 382 limitation over the pre-changes losses allowed with respect to the earlier section 382 limitation. Treas. Reg. § 1.382-5(d). For example, assume that a loss corporation has two ownership changes. If the first ownership change has a section 382 limitation of \$75 million and the second ownership change has a section 382 limitation of \$100 million, then the pre-change losses that are subject to both section 382 limitations (i.e., pre-change losses that pre-date the first ownership change) are allowed up to \$75 million. Pre-change losses that are only subject to the second section 382 limitation (i.e., pre-change losses that occurred after the first ownership change and before the second ownership change) are allowed up to \$25 million (assuming that pre-change losses that pre-date the first ownership change equal at least \$75 million). If the loss corporation only has \$30 million of pre-change losses that pre-date the first ownership change, then the second section 382 limitation would allow up to \$70 million of later pre-change losses.

A. Computation of Value

The base annual section 382 limitation is computed with reference to the fair market value of the stock of the loss corporation. Generally, the value is determined immediately before the ownership change (i.e., generally, before the events that caused the ownership change). IRC § 382(e)(1). As a result, any increase in value from the transaction is not taken into account. For example, if the issuance of new shares by the loss corporation causes an ownership change, the value of the new shares is not taken into account.

In determining stock value, pure preferred stock is taken into account even though it is ignored for ownership change purposes. IRC § 382(e)(1); Treas. Reg. § 1.382-2(a)(3)(i). Similarly, stock that is ignored for ownership change purposes under the stock recharacterization rule is taken into account for the purposes of determining value. Temp. Reg. § 1.382-2T(f)(18)(ii). Non-stock ownership interests that are treated as stock for ownership change purposes under the non-stock recharacterization rule are also treated as stock for value purposes. Temp. Reg. § 1.382-2T(f)(18)(iii).

The Treasury Department has the regulatory authority to treat options and similar interests as stock for purposes of section 382. IRC § 382(k)(6)(B)(i). The Blue Book indicates that the Treasury Department is “required” to promulgate such regulations “as are necessary to treat” options and similar interest as stock for purposes of determining the value of the loss corporation. Blue Book, p. 316. No such regulations have been promulgated or proposed. The IRS has ruled that the value of options to issue shares is taken into account, notwithstanding the lack of regulations. TAM 9332004 (Apr. 30, 1993). *But see* 1992 FSA Lexis 286 (value not taken into account, but significant hazards to position acknowledged).

The Blue Book indicates that in determining value, the price at which stock changes hands in arm’s-length transactions is evidence as to the value of the stock. However, such information is not conclusive evidence. For example, if a shareholder purchases 20% of its stock and pays a control premium to increase its stock ownership from 35% to 55%, the amount paid for the new shares would not dictate the value of the remaining 45%. Blue Book, p. 316.

Where an ownership change is caused by a 100% purchase of stock, cases and rulings have generally required taxpayers to use the price paid as the value of the loss corporation. *See Berry Petroleum Co. v. Comm’r*, 104 TC 584, 637-40 (1995), *aff’d*, 98-1 USTC P50398 (9th Cir. 1998); PLR 9630038 (May 1, 1996). It appears that a taxpayer would be able to use a higher value only in exceptional circumstances.

If the purchase price for the stock includes contingent consideration, it appears that the fair market value of the contingent consideration is determined as of the change date. Presumably, the section 382 limitation does not increase or decrease to the extent the actual amount received differs from the estimated value. 1994 FSA Lexis 212; *see also* Notice 2003-65, § IV.A, 2003-2 CB 747 (calculation of NUBIG and NUBIL under the section 338 approach).

Where an ownership change occurs as a result of trading of publicly-traded loss corporation stock, it appears that the value of the loss corporation is generally determined based on the traded price on the change date (or the mean of the highest and lowest, that day). 1992 FSA Lexis 286; *see also* Treas. Reg. § 20.2031-2 (value of stock). A good argument can be made that the price can be increased by a control premium. *See* TAM 9332004 (Apr. 30, 1993).

The value of the stock is determined immediately before the ownership change. IRC § 382(e)(1). When a corporate subsidiary is sold to a third party, it is the usual practice for any intercompany debt to be cancelled before the stock sale takes place. This is frequently pursuant to contract terms. There is currently uncertainty as to whether the value is determined before the debt is cancelled. (Of course, if the intercompany debt is

not treated as debt under general tax principles the issue goes away.) It is possible that the likelihood of success will depend upon when the debt cancellation occurs. It would seem that the strongest argument would exist if the debt is cancelled before the sales process begins. It appears that a reasonable position is available if the debt is cancelled at least the day before the change date. Canceling the debt on the closing date would represent a significantly weaker argument. It should be noted that this issue of cancelling intercompany debt did not exist before the IRS eliminated the statutory presumption that a negative adjustment to value was required for capital contributions made within two years of the change date. *See* Notice 2008-78, 2008-2 CB 851.

There are numerous negative adjustments to the amount of the stock value. There are adjustments for (i) redemptions and other corporate contractions, (ii) capital contributions, (iii) substantial nonbusiness assets, (iv) foreign loss corporations, and (v) members of controlled groups.

It is technically possible that more than one of the negative adjustments can apply to the value resulting in a possible double (or more) reversal of the economic benefit to the loss corporation. For example, if a loss corporation receives a significant infusion of cash before the change date as a capital contribution and uses that cash to redeem shareholders in connection with the ownership change, the cash could result in a reduction as (i) a capital contribution, (ii) a nonbusiness asset, and (iii) a redemption. Although technically possible, there is no policy justification for reducing value more than once with respect to the same amount.

The Blue Book indicates that such double (or triple) counting “may” be dealt with by regulations “under appropriate circumstances.” Blue Book, p. 319. Regulations have only been promulgated with respect to duplication between the controlled group rules and other adjustments. *See* Treas. Reg. § 1.382-8(d). However, the IRS in one ruling did not require double counting of the adjustments. *See* PLR 9137041 (June 18, 1991).

The IRS has clarified that if the value of a loss corporation is subject to reduction under both the capital contribution rule and the substantial nonbusiness asset rule, appropriate adjustments are necessary to prevent a duplication in the adjustments to value. Notice 2008-78, 2008-2 CB 851, § III.C; *see also* PLR 201314035 (Dec. 17, 2012).

There is a possibility of a potential double adjustment for a capital contribution (before the ownership change) and a corporate contraction (after the ownership change). For example, if shareholders contribute \$10 million dollars to the loss corporation (for the principal purpose of increasing the section 382 limit) and a similar amount is distributed to shareholders in redemption, is the adjustment \$10 million, \$20 million, or some amount in between? An adjustment of \$20 million may not be appropriate from a policy standpoint since it could result in an adjusted value that is below the post-ownership change fair market value. Since there is no guidance, factors that may be relevant could include (i) whether the contribution and corporate contraction were part of the same plan, (ii) whether some or all of the shareholders that made the contribution received the redemption, (iii) the timing of the contribution and corporate contraction relative to the ownership change, and (iv) whether the asset contributed can be traced to the later corporate contraction (e.g., cash is fungible and the cash contributed may have been spent before the change date).

Redemptions and other corporate contractions

The value of the loss corporation is reduced for purposes of computing the base annual section 382 limitation if a “redemption or other corporate contraction” occurs in connection with an ownership change. IRC § 382(e)(2). In such case, the Blue Book indicates that the value of the loss corporation is determined after taking the redemption into account. Blue Book, p. 316.

The Blue Book indicates that a redemption that results in a negative adjustment to value can take place either before or after the ownership change. An example of such a transaction is a redemption that takes place 6 ½ months after an ownership change that was part of the same plan. Blue Book, p. 316-17.

The term “redemption” is not defined. Presumably, it means an acquisition of loss corporation stock from a shareholder in exchange for property. *See* IRC § 317(b) (definition for purposes of sections 301 to 318); Treas. Reg. § 1.382-2T(j)(2)(iii)(C) (definition for ownership change purposes); *see also* PLR 9216020 (Jan. 17, 1992), *mod. by*, PLR 9234030 (May 27, 1992) (split-off); PLR 9137041 (June 18, 1991) (distribution of debt or cash in retirement of stock).

The term “corporate contraction” is not defined. The Blue Book describes a “bootstrap acquisition” as an example of a corporate contraction. In a bootstrap acquisition, the acquisition is financed by indebtedness incurred by the target corporation. Acquisition financing can potentially be a corporate contraction even if the loss corporation is only indirectly liable for the debt (as guarantor or otherwise). A transaction can potentially be a corporate contraction even if the loss corporation has no liability for the acquisition debt but it is anticipated that the source of repayment funds will come from the loss corporation (through dividends or otherwise). Blue Book, p. 316, n. 35; *see also* *Berry Petroleum Co. v. Comm’r*, 104 TC 584, 640-44 (1995), *aff’d*, 98-1 USTC ¶50398 (9th Cir. 1998) (cash transferred to shareholder after acquisition); FSA 200140049 (July 6, 2001).

In Private Letter Ruling 200406027 (Oct. 10, 2003), an acquiring corporation purchased 100% of the stock of a loss corporation through a tender offer and squeeze-out merger. The IRS ruled that none of the below activities constituted a corporate contraction.

- The acquiring corporation borrowed the funds necessary to make the acquisition by drawing down on its existing line of credit. The loss corporation became a guarantor of the debt upon acquisition. All of the previously-owned subsidiaries were also guarantors. The acquiring corporation represented that it had sufficient funds to pay back the line of credit without resort to the loss corporation’s cash flow.
- Excess cash of the loss corporation (and all other subsidiaries of the acquiring corporation) was routinely swept to the acquiring corporation. An intercompany account system was maintained to keep track of the cash transferred.
- The loss corporation discontinued certain operations that overlapped with the acquiring corporation. The operations of the acquiring corporation that overlapped with the discontinued operations were contributed to the capital of the loss corporation.
- The loss corporation was paying royalties to a related party for the use of intellectual property at the same rate as other subsidiaries.

PLR 200406027.

Capital Contributions

For purposes of section 382, any “capital contribution” is not taken into account if it was received as “part of a plan a principal purpose of which is to avoid or increase any limitation” under section 382. IRC § 382(l)(1)(A). In such case, the value of the loss corporation is reduced. Blue Book, p. 318. The IRS has issued Notice 2008-78, 2008-2 CB 851 as guidance on the when a capital contribution adjustment is required. Notice 2008-78 is discussed after the general discussion of the capital contribution adjustment rules.

The term “capital contribution” is not defined within section 382. However, the term has a well-defined meaning under general tax principles. Such term generally includes any transfer of property (or other consideration) by a shareholder or shareholders to a corporation (whether or not pro rata) intended “to protect or increase the value of their investment in the corporation.” *Comm’r v. Fink*, 483 US 89, 97 (1987).

The Blue Book indicates the term “capital contribution” was intended to have a broader meaning than under general tax principles. Specifically the term was intended to include a section 351 transfer and “any direct or indirect infusion of capital into a loss corporation (e.g., the merger of one corporation into a commonly owned loss corporation).” Blue Book, p. 318. The IRS, in rulings, has applied this broadened definition of capital contribution. *See* PLR 201251002 (Sept. 24, 2012); TAM 9332004 (Apr. 30, 1993); 1992 FSA Lexis 286; PLR 8927079 (Apr. 14, 1989). There is uncertainty as to whether a court would apply this broader meaning as there has been a reluctance to apply legislative history in recent years. *See, e.g., Gitlitz v. Comm’r*, 531 US 206 (2001) (contradictory legislative history not referred to in majority opinion).

Any capital contribution made within the two-year period ending on the change date is treated by the statute as part of a plan with a principal purpose of avoidance. IRC § 382(l)(1)(B). The Blue Book indicates that this presumption was intended to be “irrebuttable.” Blue Book, p. 318.

Capital contributions made within the two-year period are not treated as part of a section 382 avoidance plan to the extent provided in regulations. IRC § 382(l)(1)(B). Regulations have only been issued with respect to an increase in the value of the stock of a loss corporation that takes place pursuant to an ownership change to which section 382(l)(6) (bankruptcy and similar proceedings) applies. If a second ownership change takes place within two years of the first, no reduction in value is required with respect to the second ownership change as a result of capital contributions that took place in conjunction with the first ownership change. Treas. Reg. § 1.382-9(n)(2). The IRS applied a similar result to an emergence from bankruptcy that did not result in an ownership change. *See* PLR 200814004 (Jan. 2, 2008).

The Blue Book indicated that the regulations would provide for exceptions from the two-year presumption. It indicated that these regulations generally would exempt:

- capital received upon formation of a loss corporation (not accompanied by the incorporation of assets with a NUBIL),
- capital received before the first year that the loss corporation had a pre-change loss, and
- capital received to continue basic operations of the loss corporation’s business (e.g., to fund monthly payroll or other operating expenses).

Blue Book, p. 318-19.

Notwithstanding the lack of regulations, the IRS in private rulings has applied the exceptions described in the Blue Book. *See, e.g.,* PLR 201314035 (Dec. 17, 2012); PLR 200952012 (Sept. 24, 2009); PLR 200730003 (Apr. 27, 2007). *But see* 1992 FSA Lexis 286. Most of the IRS rulings involve the exception for capital received to continue basic operations. The below use of funds have been treated by the IRS as eligible for the basic operations exceptions:

- ongoing operating expenses (including, employee salaries and benefits, rent, utilities, professional fees, and general and administrative costs) and working capital, PLR 201314035; PLR 201251002; PLR 200952012; PLR 9706014 (Nov. 13, 1996); PLR 9630038 (May 1, 1996),
- research and development expenses, PLR 9706014 (Nov. 13, 1996); PLR 9630038 (May 1, 1996),
- funds to pay-off short-term advances or collateralize a letter of credit, PLR 9508035 (Nov. 30, 1994); TAM 9332004 (Apr. 30, 1993),

- settlement of a lawsuit, TAM 9332004 (Apr. 30, 1993), and
- reserve requirements of a bank or insurance company, PLR 200730003; PLR 9835027 (May 29, 1998); PLR 9541019 (July 10, 1995); PLR 9508035 (Nov. 30, 1994).

In Technical Advice Memorandum 9332004, the IRS treated a repayment of two loans as not eligible for the basic operations exception. The loans had been incurred more than 21 months before the capital contribution that paid them off. The IRS believed that there was not sufficient proximity in time between the two transactions. They also did not believe that the use of the loan proceeds was relevant to determine whether the basic operations exception was met. *Id.*

Notice 2008-78. The IRS issued general guidance on the capital contribution rules in 2008. Notice 2008-78, 2008-2 CB 851, among other things, overrides the two-year presumption. As a result, where the notice applies, a capital contribution results in an adjustment to value only if it is part of a plan with a tax avoidance purpose. Notice 2008-78, § III.A. The notice applies until there is additional guidance. Notice 2008-78, § IV.

The notice defines the term “capital contribution” to include a series of related capital contributions. Notice 2008-78, § III. The notice does not provide other guidance as to the meaning of the term.

Under Notice 2008-78, a capital contribution received by an old loss corporation before an ownership change is generally taken into account in determining the value of the stock. In other words, the value of the stock is generally not reduced by a prior capital contribution (even if the capital contribution was within two years of the ownership change). Notice 2008-78, § III.A, B(1).

A capital contribution received by an old loss corporation before an ownership change does result in a reduction in value if the contribution is “part of a plan a principal purpose of which is to avoid or increase a section 382 limitation” (a “section 382 avoidance plan”). Notice 2008-78, § III.B(1). Whether a capital contribution is part of a section 382 avoidance plan is determined based upon all of the facts and circumstances.

The notice does not give any guidance as to what facts and circumstances are taken into account in determining whether a section 382 avoidance plan exists. However, the notice does offer safe harbors. A contribution that fits within a safe harbor will not be considered a section 382 avoidance plan. The fact that a contribution does not meet a safe harbor is not considered evidence that a section 382 avoidance plan exists. Notice 2008-78, § III.B(1).

If the transaction does not meet the requirements of a safe harbor, then the taxpayer will need to analyze the facts and circumstances. In one ruling, capital contributions made to facilitate a section 355 spin-off were not treated as pursuant to a section 382 avoidance plan. PLR 201350006 (Sept. 13, 2013).

Which safe harbor applies generally depends upon (i) the proximity between the capital contribution and the ownership change, (ii) the relationship between the shareholder and the loss corporation, and (iii) the relative size of the contribution. The notice provides for six safe harbors. They are:

- certain capital contributions that occur more than six months before the ownership change (the “six-month safe harbor”),
- certain capital contributions that occur more than twelve months before the ownership change (the “twelve-month safe harbor”),
- capital contributions in connection with the performance of services (the “compensation safe harbor”),

- shares of stock acquired by a retirement plan (the “retirement plan safe harbor”),
- contributions received upon formation of a loss corporation (the “formation safe harbor”), and
- contributions received before the first year that the loss corporation had a pre-change loss (the “pre-attribute safe harbor”).

Many of the safe harbors refer to terms that are defined in section 1.355-7 of the Treasury regulations. Section 1.355-7 provides rules relating to tax-free spin-offs in connection with an acquisition. The cross-references to a complicated provision that is unrelated to section 382 may potentially make interpreting the safe harbors difficult.

In applying the terms and definitions of section 1.355-7, certain terms are substituted. In each instance, (i) “contribution” is substituted for “distribution,” (ii) “loss corporation” for “Distributing” and/or “Controlled,” and (iii) “ownership change” for “acquisition.” For purposes of substituting the term ownership change, “any ownership change” is substituted for “the acquisition.” Notice 2008-78, § III. The New York State Bar Report on Notice 2008-78, contains an exhibit with the relevant language of section 1.355-7, as modified for Notice 2008-78 purposes. *See* NYSBA, Tax Section, *Report on the Treatment of Capital Contributions under Code section 382(l)(1)*, 2009 TNT 14-53.

Generally, capital contributions that occur more than six months before the ownership change meet the six-month safe harbor if (i) the contribution is made by a person who is not a “controlling shareholder” or a “related party,” (ii) the stock issued in connection with the contribution constitutes 20% or less of the loss corporation’s outstanding stock (by value), and (iii) there was no “agreement, understanding, arrangement, or substantial negotiations” at the time of the contribution regarding a transaction that would result in an ownership change. Notice 2008-78, § III.B(2)(a).

The definition of “controlling shareholder,” for purposes of the six-month safe harbor, is dependent upon whether the stock of the loss corporation is listed on an “established market.” An established market is defined as (i) a national securities exchange registered under section 6 of the Securities Exchange Act of 1934 (e.g., the New York Stock Exchange), and (ii) an interdealer quotation system sponsored by a national securities association registered under section 15A of the Securities Exchange Act of 1934 (e.g., NASDAQ). In addition, the IRS can designate additional established markets by published guidance. Treas. Reg. § 1.355-7(h)(7). The IRS has not designated any additional established markets.

If a loss corporation’s stock is listed on an established market, a controlling shareholder is defined as a “5% shareholder” who actively participates in the management or operations of the loss corporation. For this purpose, a member of the board of directors is treated as actively participating in management. Treas. Reg. § 1.355-7(h)(3)(i).

Section 1.355-7 has its own definition of the term “5% shareholder” that differs from the general definition of the term under section 382. For purposes of section 1.355-7, a 5% shareholder is generally a person (or “coordinating group”) that owns 5% or more (directly, or indirectly by attribution) of any class of stock of the loss corporation. Similar to the general section 382 rules, a loss corporation can rely on Schedules 13D and 13G (or similar schedules) to determine if a person is a 5% shareholder (except if there is actual knowledge to the contrary). Treas. Reg. § 1.355-7(h)(8).

If a loss corporation’s stock is not listed on an established market, a controlling shareholder is defined as a person (or “coordinating group”) that owns stock (directly, or indirectly by attribution) possessing voting power with a meaningful voice in corporate governance. Treas. Reg. § 1.355-7(h)(3)(ii).

If a capital contribution precedes an ownership change, the controlling shareholders of the loss corporation (determined immediately after the contribution) are treated as controlling shareholders at the time of the contribution. Treas. Reg. § 1.355-7(h)(3)(iii). As a result, it appears that the relationship is determined either at the time of or immediately after the capital contribution.

A “coordinating group” exists if two more persons join in one or more coordinated acquisitions (or dispositions) of the stock of a loss corporation (as described in the next paragraph). The members of such a coordinating group are treated as a single shareholder for purposes of determining whether the group is treated as a controlling shareholder or a 5% shareholder. Treas. Reg. § 1.355-7(h)(4).

A coordinated acquisition (or disposition) exists if there is a “formal or informal understanding” among the parties. For this purpose, the principal factor in determining whether the requisite “understanding” exists is “whether the investment decision of each person is based on the investment decision of one or more existing or prospective shareholders.” Treas. Reg. § 1.355-7(h)(4). In other words, is the person acquiring stock independently or based on the knowledge that others are also buying stock.

In determining whether a person owns sufficient stock to be considered a controlling shareholder or 5% shareholder, the person will be treated as owning any loss corporation stock that it actually owns. In addition, the attribution rules of section 318(a) apply, instead of the attribution rules that normally apply under section 382 (i.e., section 382(l)(3)(A) and section 1.382-2T(h) of the temporary Treasury regulations). For this purpose, the option attribution rule of section 318(a)(4) is not applied. Instead, an option is treated as exercised if it would cause (whether alone or in conjunction with other options) the person to be treated as a controlling shareholder or 5% shareholder. Treas. Reg. § 1.355-7(h)(3)(ii), (8).

The attribution rules of section 318(a) apply very differently from the attribution rules that normally apply for section 382 purposes. Under the section 318(a) rules it is possible to attribute ownership due to ownership of pure preferred stock. The section 318(a) rules also provide for attribution from owners to entities (i.e., downward attribution). IRC § 318(a)(3). In addition, attribution from or to a corporation only applies under the section 318(a) rules if the owner owns 50% or more of the stock of the corporation. IRC § 318(a)(2)(C), (3)(C).

Generally, capital contributions that occur more than one year before the ownership change meet the twelve-month safe harbor if (i) the contribution is made by a person who is not a “related party” (or, by a person that is a related party, if the stock issued in connection with the contribution constitutes 10% or less of the loss corporation’s outstanding stock (by value)), and (ii) there was no “agreement, understanding, arrangement, or substantial negotiations” at the time of the contribution regarding a transaction that would result in an ownership change. Notice 2008-78, § III.B(2)(b). The term “related party,” for purposes of the six-month and twelve-month safe harbors, is defined as a person that has a relationship with the loss corporation specified in section 267(b). The relationship is determined immediately after the capital contribution. Notice 2008-78, § III. Under section 267(b), a person is generally related to a loss corporation if there is some element of more than 50% common control. The term “related party” also includes “one or more persons that, pursuant to a formal or informal understanding, would be treated as becoming a related party under the principles of” the definition of “coordinating group” (as described above). Notice 2008-78, § III; Treas. Reg. § 1.355-7(h)(4).

The term “agreement, understanding, arrangement, or substantial negotiations,” for purposes of the six-month and twelve-month safe harbors, is defined in section 1.355-7(h)(1) of the Treasury regulations, as modified by Notice 2008-78. Notice 2008-78, § III. The reader is commended to read section 1.355-7(h)(1) (or the NYSBA report with the substituted language) for a full command of the definition of the terms “agreement, understanding, arrangement, or substantial negotiations.”

Generally, all facts and circumstances are taken into account in determining whether an agreement, understanding, or arrangement exists. A binding contract or term sheet is not necessary to meet the standard. However, an agreement clearly exists if a binding contract exists. Treas. Reg. § 1.355-7(h)(1)(iii). Substantial negotiations will generally be treated as having existed if discussions of significant economic terms have taken place. Treas. Reg. § 1.355-7(h)(1)(iv), (v).

Certain capital contributions related to the performance of services meet the compensation safe harbor. Notice 2008-78, § III.B(2)(c). A capital contribution meets the compensation safe harbor (i) if stock of a loss corporation is acquired by a person in connection with the person's performance of services in a transaction to which section 83 or subsection (a) or (b) of section 421 applies, and (ii) the stock acquired is not excessive by reference to the services performed. Section 83 applies to property (including stock) transferred in connection with performance of services. Subsection (a) and (b) of section 421 apply to transfers of stock upon exercise of an incentive stock option or an option pursuant to an employee stock purchase plan.

The performance of services by the recipient of the stock under the compensation safe harbor can be for services as an employee, director, or independent contractor. The services for which stock is received can be performed for (i) the loss corporation, (ii) a "related person" to the loss corporation, (iii) a corporation the assets of which the loss corporation (or a "related person") acquires in a corporate reorganization, or (iv) a corporation that acquires the assets of the loss corporation in such a reorganization. *See* Treas. Reg. § 1.355-7(d)(8)(i).

For purposes of the compensation safe harbor, a related person is a person that is related to a corporation based upon a relationship specified in either section 267(b) or 707(b)(1). IRC § 355(d)(7)(A); Treas. Reg. § 1.355-7(d)(8)(i). Under sections 267(b) and 707(b)(1), a person is generally related to another if they are members of a family or there is some element of more than 50% common control. It should be noted that the definition of "related person" (for purposes of the compensation safe harbor) is different than the definition of "related party" (described above for purposes of the six-month and twelve-month safe harbors).

The compensation safe harbor does not apply if the acquirer (or a coordinating group of which the acquirer is a member) is a controlling shareholder or 10% shareholder of the loss corporation, immediately after any ownership change. *See* Treas. Reg. § 1.355-7(d)(8)(ii). The definitions of "controlling shareholder" and "coordinating group" are described above with respect to the six-month safe harbor. The members of a coordinating group are treated as a single shareholder for purposes of determining whether the group is treated as a controlling shareholder or a 10% shareholder. Treas. Reg. § 1.355-7(h)(4).

For a loss corporation whose stock is listed on an established market, the definition of "10% shareholder" is similar to the definition of "5% shareholder" described above (but substituting "10% or more" for "5% or more"). For loss corporations that do not have stock listed on an established market, a 10% shareholder is generally a person (or coordinating group) that owns 10% or more (directly, or indirectly by attribution) of the stock of the loss corporation (by vote or value). The attribution rules for purposes of determining whether a person is a 10% shareholder are the same as the rules for purposes of determining status as a "controlling shareholder" or "5% shareholder." Treas. Reg. § 1.355-7(h)(14).

Generally, shares of stock acquired by a retirement plan meet the retirement plan safe harbor. Notice 2008-78, § III.B(2)(c). To meet the retirement plan safe harbor, the plan must be a retirement plan of the loss corporation (or any other person that is treated as the same employer as the loss corporation under subsection (b), (c), (m), or (o) of section 414). For purposes of the retirement plan safe harbor, a retirement plan is a plan that qualifies under either section 401(a) or 403(a). Treas. Reg. § 1.355-7(d)(9)(i). Section

401(a) applies to an employee US stock bonus, pension or profit-sharing plan. Section 403(a) applies to employee annuity contracts.

The retirement plan safe harbor does not apply to the extent that the stock acquired represents more than 10% of the stock of the loss corporation (by vote or value). For this purpose, stock acquired by all of the qualified plans of the loss corporation (and any other person that is treated as the same employer as the loss corporation under subsection (b), (c), (m), or (o) of section 414) during the four-year period beginning two years before the capital contribution are aggregated. Treas. Reg. § 1.355-7(d)(9)(ii). There is some uncertainty as to how to apply this exception to the safe harbor where the stock represents more than 10%. The use of the term “to the extent” suggests that only the excess over 10% does not meet the safe harbor. If this reading is correct, the part that meets the safe harbor may be difficult to determine as all of the transactions over a four-year period (including multiple retirement plans and employers) are taken into account in determining the 10%. Based on these implementation difficulties, the provision may possibly be read as not allowing the safe harbor to any of the contributions made in the four year period if the 10% limit is exceeded.

The formation safe harbor applies to contributions received on the formation of a loss corporation (not accompanied by the incorporation of assets with a NUBIL). Notice 2008-78, § III.B(2)(d). The formation safe harbor appears to be similar to the exemption described in the Blue Book.

The pre-attribute safe harbor applies to contributions received before the first year that the loss corporation has a tax attribute that is potentially subject to section 382. For this purpose, a tax attribute that is potentially subject to section 382 includes carryforwards of NOLs, capital losses, excess credits, and excess foreign taxes. In addition, the exception only applies if the contribution is made before the first year in which there is a NUBIL. Notice 2008-78, § III.B(2)(d). The pre-attribute safe harbor appears to be similar to the exemption described in the Blue Book. There does not appear to be any relief for de minimis tax attributes. For example, an NOL carryforward of as little as one dollar might prevent a capital contribution from meeting the pre-attribute safe harbor.

The most notable absence from the list of safe harbors is an exemption for capital received to continue basic operations of the loss corporation’s business. This is the third exemption described in the Blue Book and the only one that did not receive safe harbor status. We understand from speaking to the IRS that there is still an available exemption for basic operations. They just did not provide for a safe harbor. A safe harbor would have required them to enunciate specific rules.

In 2008, the IRS and the Treasury Department announced that they intend to issue regulations with respect to the capital contribution rules based upon the rules described in Notice 2008-78. They have also asked for comments with respect to (i) the appropriate scope and application of the capital contribution rules, (ii) the appropriate factors for determining whether a capital contribution is part of a section 382 avoidance plan (including standards for related party contributions), (iii) the desirability of applying the standards of section 1.355-7 as safe harbors, (iv) whether additional safe harbors are needed, and (v) the appropriate treatment of options and conversion rights and whether rules coordinating with the option attribution rules are necessary. Notice 2008-78, §§ IV, V. It appears that this guidance project is not actively being worked on.

Substantial Nonbusiness Assets

A loss corporation is required to reduce the value of its stock if it has “substantial” nonbusiness assets immediately after an ownership change. IRC § 382(l)(4)(A). No reduction is generally required for RICs, REITs, or real estate mortgage investment conduits (REMICs). IRC § 382(l)(4)(B)(ii).

The term “nonbusiness assets” is defined as assets that are held for investment. IRC § 382(l)(4)(C). The Blue Book lists cash and marketable stock or securities as examples of nonbusiness assets. The Tax Court has treated a business line that was required to be sold by the loss corporation as a nonbusiness asset. *Berry Petroleum Co. v. Comm’r*, 104 TC 584, 644-51 (1995), *aff’d*, 98-1 USTC P50398 (9th Cir. 1998).

Assets that are held as an “integral part of the conduct of a trade or business” are not treated as nonbusiness assets. Blue Book, p. 319. An example of investment assets that meet the “integral part” exception are assets funding the reserve requirements of a bank or insurance company. *Id.* The IRS has treated cash and cash equivalents held to satisfy working capital needs for 18 months as not meeting the “integral part” exception. PLR 9835027 (May 29, 1998).

For purposes of determining the amount of nonbusiness assets, stock and securities held by the loss corporation in any subsidiary corporation are disregarded. Instead, the loss corporation is treated as owning its ratable share of the subsidiary’s assets. For this purpose, a corporation is a subsidiary corporation if the loss corporation owns 50% or more of the stock (by vote or value). IRC § 382(l)(4)(E). Presumably, lower-tier subsidiaries and partnerships receive similar look-through treatment.

If a loss corporation has substantial nonbusiness assets, then the value of the loss corporation’s stock is reduced. The amount of the reduction equals the excess of (i) the fair market value of the nonbusiness assets, over (ii) the amount of liabilities allocable to the nonbusiness assets. IRC § 382(l)(4)(A). The amount of liabilities of the loss corporation that are allocable to the nonbusiness assets is based on the ratio of (i) the fair market value of the nonbusiness assets, to (ii) the fair market value of all of the assets of the loss corporation. IRC § 382(l)(4)(D). The amount of the reduction is determined immediately before the ownership change. IRC § 382(l)(4)(A).

Although the determination of whether the nonbusiness assets are substantial is generally made based on assets held immediately *after* the ownership change, the reduction is made based on the nonbusiness assets held immediately *before* the ownership change. An asset that is a nonbusiness asset after the change but not before, counts towards meeting the definition of substantial but is not taken into account for determining the amount of reduction. *See Berry Petroleum Co.*, 104 TC at 644-51.

The determination as to whether a loss corporation’s nonbusiness assets are substantial is generally made immediately after the ownership change. IRC § 382(l)(4)(A). The nonbusiness assets of a loss corporation are treated as substantial if at least one-third of the value of the total assets of the “old” loss corporation consists of nonbusiness assets. IRC § 382(l)(4)(B)(i). There is uncertainty as to whether this one-third test is the definition of substantial or is merely a presumption. In addition, due to the reference in the statute to the “old loss corporation,” there is uncertainty as to whether this one-third determination is made before or after the ownership change.

The Blue Book indicates that the one-third test is the definition of substantial and not a presumption. Blue Book, p. 319. It appears that the one-third test was believed by the authors of the Blue Book to be determined immediately after the ownership change.

The Ninth Circuit in *Berry Petroleum Co. v. Commissioner*, 98-1 USTC P50398 (9th Cir. 1998), has interpreted the determination of “substantial” differently than how it is described in the Blue Book. In the view of the Ninth Circuit there are two independent tests for determining whether the nonbusiness assets are substantial, a pre-change objective test (i.e., the one-third test) and a post-change subjective test. The one-third test is performed immediately before the ownership change. If the one-third test is met, then the loss corporation is deemed to have substantial nonbusiness assets. If the one-third test is not met, then the nonbusiness assets immediately after the ownership change are tested to see if they are substantial.

The Ninth Circuit did not give any guidance as to the meaning of the term “substantial” with respect to the post-change test. The nonbusiness assets in question were treated by the court as substantial since they amounted to more than 70% of the value of the assets immediately after the ownership change. *Id.* There is a great deal of uncertainty as to the correct standard under the court’s post-change subjective test as different standards have been in use throughout the Code and Treasury regulations. *See, e.g.*, IRC §§ 168(d)(3) (more than 40%), 751(b)(3) (more than 20%); Treas. Reg. §§ 1.148-1(b) (10% or more), 1.279-3(c)(2) (5% or more).

The Ninth Circuit’s analysis is based on the reference to the “old loss corporation” in the statutory language for the one-third test. The substantial nonbusiness asset rules refer to both the “new loss corporation” (with respect to determining whether the loss corporation has substantial nonbusiness assets immediately after the ownership change) and the “old loss corporation” (with respect to the adjustment to value). It is possible to read the reference to the old loss corporation in the one-third test as a reference to whether an adjustment to value is necessary.

Substantial Nonbusiness Asset Example. Lossco has nonbusiness assets with a fair market value of \$100 thousand and no liabilities. On January 1, 2008, Corporation A acquires 100% of the stock of Lossco for \$1 million. In conjunction with the acquisition, Corporation A requires Lossco to exchange one of its business assets for marketable securities with a fair market value of \$600 thousand. Before the ownership change, the nonbusiness assets amounted to 10% of the fair market value of the gross assets. After the ownership change, the nonbusiness assets amounted to 70% of the fair market value of the gross assets. It appears that Lossco has substantial nonbusiness assets. As a result, Lossco reduces the value, for purposes of computing the base annual section 382 limitation, by \$100 thousand (the fair market value of the pre-change nonbusiness assets) to \$900 thousand. *See Berry Petroleum Co. v. Comm’r*, 104 TC at 644-51.

Foreign corporations

Special rules apply in determining the value of a loss corporation that is a foreign corporation. In such case, only assets and liabilities that are treated as connected with the conduct of a US trade or business (e.g., a US branch) are taken into account. IRC § 382(e)(3). As a result, it appears that the value of a foreign loss corporation that does not have a US trade or business is zero. *See* 1999 FSA Lexis 401.

Regulations could provide for a different rule for foreign corporations. However, no such regulations have been promulgated or proposed.

There is a great deal of uncertainty as to the determination of the assets and liabilities that are connected with a US trade or business. It appears that stock in a subsidiary will generally not be treated as connected with a US trade or business. *See* 1997 FSA Lexis 17. However, if a subsidiary is a US real property holding company, within the meaning of section 897(c)(2), it is possible that the stock would be taken into account for section 382 value purposes. *See* IRC § 897(a)(1).

Section 1.882-5 of the Treasury regulations generally requires foreign corporations with a US trade or business to determine its US-connected liabilities based on a formula and to determine its US booked liabilities. Treas. Reg. § 1.882-5(c), (d)(2). This calculation of US-connected and US booked liabilities is performed to determine the amount of interest expense that is allocable to the US trade or business. Treas. Reg. § 1.882-5(a)(1)(i). There is uncertainty as to whether US-connected or US booked liabilities should be used for purposes of determining stock value.

Many foreign corporations with both a US branch and one or more foreign branches have had difficulty assigning a fair market value to the net assets of the US branch. In many cases, the business conducted by the US branch cannot be sold independently of the other businesses of the corporation. We understand that some taxpayers have taken the position that the total value of the foreign loss corporation can be allocated to the US branch based on relative sales or adjusted basis of assets (or some other objective measure).

As a result of the enactment of the GILTI regime by the TCJA, CFCs are now generally required to determine their taxable income as if they were a domestic corporation. IRC § 951A(c)(2)(A); Treas. Reg. §§ 1.951A-2(b), (c)(2), 1.952-2(b)(1). Section 382 could apply for GILTI purposes if the CFC has a NUBIL or a disallowed business interest expense carryforward (pursuant to section 163(j) at the time of an ownership change). (Applicable regulations do not permit CFCs to carryforward NOLs or capital losses for GILTI purposes. Treas. Reg. §§ 1.951A-2(c)(2), 1.952-2(c)(5).) Marie Milnes-Vasquez, special counsel to the IRS associate chief counsel (corporate), was quoted as saying that “it appears that the GILTI rules do actually implicate [section] 382” and until regulations are issued the rules apply broadly. Ms. Milnes-Vasquez mentioned that it is possible that regulations might exempt CFCs from section 382 if they are only CFCs as a result of downward attribution. Emily L. Foster, “It’s a Complex World for Troubled CFCs’ Tax Attributes,” 2021 TNTF 12-1.

There is uncertainty as to how to determine the value of a CFC under GILTI for section 382 limitation purposes. It is possible that the fair market value of the CFC’s stock is taken into account (regardless of whether it is related to a US trade or business) since taxable income for GILTI purposes is determined as if the CFC was a domestic corporation. (In such case, the controlled group rules described below would apply.) Alternatively, the value for section 382 limitation purposes might be zero based on the language of section 382(e)(3) (assuming that the CFC does not have a US trade or business).

The Treasury Department and the IRS stated in TD 9905, 85 Fed. Reg. 56686 (2020) (the preamble to the section 163(j) regulations) that they are aware of the issues described herein relating to the application of section 382 to foreign corporations (including CFCs). They stated that they are continuing to study the issue and may address it in further guidance. TD 9905, p. 56744.

The Treasury Department and the IRS are currently working on a new set of proposed regulations to supersede the proposed section 382(h) regulations. We understand that the forthcoming guidance will provide rules for the section 382 treatment of CFCs.

B. Controlled Groups

The Treasury Department has the regulatory authority to provide rules with respect to the application of sections 382 and 383 to controlled groups of corporations. Such rules are to provide “appropriate adjustments to value, built-in gain or loss, and other items so that items are not omitted or taken into account more than once.” IRC § 382(m)(5). Regulations have been issued with respect to the determination of value of a loss corporation only. *See* Treas. Reg. § 1.382-8. Regulations with respect to the other issues described above have not been promulgated or proposed.

The controlled group rules apply if a loss corporation undergoes an ownership change and is a member of a controlled group. However, the rules generally do not apply if all of the members of the controlled group are also members of a consolidated group. Treas. Reg. § 1.382-8(f).

In applying the controlled group rules, a reference to a corporation (or component member of a controlled group) is also a reference to a predecessor or successor corporation. These rules are to apply as the context

may require. Treas. Reg. § 1.382-8(e)(5), *see also* Treas. Reg. § 1.382-2(a)(5), (6) (definitions of predecessor and successor corporations).

Where the controlled group rules apply, the fair market value of the stock of any member of a controlled group is generally not counted more than once in determining the value of multiple loss corporations for base annual section 382 limitation purposes.

Definition of Controlled Group

Two or more corporations are treated as members of a controlled group if they are either members of a “parent-subsidary controlled group,” a “brother-sister controlled group,” or a “combined group.” IRC §§ 382(m)(5), 1563(a); Treas. Reg. § 1.382-8(e)(2).

A “parent-subsidary controlled group” is defined as one or more chains of corporations connected through stock ownership with a common parent corporation if the common parent corporation owns (directly, or indirectly by attribution) 50% or more of the stock (by vote or value) of at least one other corporation. The members of the parent-subsidary controlled group include (i) the common parent corporation, and (ii) each corporation (other than the common parent) the stock of which is owned (directly, or indirectly by attribution) 50% or more (by vote or value) by a member of the group. IRC §§ 382(m)(5), 1563(a)(1); Treas. Reg. § 1.382-8(e)(2).

A “brother-sister controlled group” is defined as two or more corporations if five or fewer persons (who are individuals, estates, or trusts) own (directly, or indirectly by attribution) at least 50% of the stock (by vote or value) of each corporation. In addition, such persons must also own (directly, or indirectly by attribution) more than 50% of the stock (by vote or value) of each corporation only taking into account identical stock ownership with respect to both corporations. IRC §§ 382(m)(5), 1563(a)(2), (f)(5); Treas. Reg. § 1.382-8(e)(2). For example, if A owns 60% of Corp 1 and 30% of Corp 2 and B owns 10% of Corp 1 and 60% of Corp 2 and both A and B are individuals, the identical stock ownership would be 30% for A and 10% for B. Corps 1 and 2 would not be a brother-sister controlled group since the total identical ownership would only be 40% (less than 50%). The fact that A and B own (on a combined basis) 90% of Corp 1 and 70% of Corp 2 would not affect the result.

A “combined group” is defined as three or more corporations each of which is a member of a controlled group and one of which is a common parent of a parent-subsidary controlled group and also a member of a brother-sister controlled group. IRC §§ 382(m)(5), 1563(a)(3); Treas. Reg. § 1.382-8(e)(2).

For purposes of determining whether two or more corporations are members of a controlled group, constructive ownership rules apply that differ from the section 382 constructive ownership rules. *See* IRC § 1563(d), (e), (f)(1-3). In addition, the rules regarding the determination of controlled group status apply a definition of “stock” that is different from the definition for section 382 purposes. *See* IRC § 1563(c). The controlled group rules apply only to the “component members” of a controlled group. Treas. Reg. § 1.382-8(b). The component members are determined separately for each taxable year. A member of a controlled group is generally treated as a component member with respect to a taxable year if it was a member on December 31 (or the change date, if earlier) of any taxable year. IRC § 1563(b)(1)(A); Treas. Reg. § 1.382-8(e)(3). A member of a controlled group is also a component member with respect to such taxable year if it was not a member on December 31 (or the change date, if earlier) but (i) was a member during the calendar year that includes such date, and (ii) was a member for one-half (or more) of the number of days in the prior taxable year. IRC § 1563(b)(1)(B), (3)(A), (B). Rules in section 1563(b) regarding excluded members and overlapping groups are ignored for section 382 purposes. Treas. Reg. § 1.382-8(e)(3). As a result, a corporation can be a component member of multiple controlled groups.

Application of Rule

A pre-change loss (including a NUBIL) is subject to the controlled group rules if the loss is a “controlled group loss.” Treas. Reg. § 1.382-8(c). A controlled group loss is defined as a pre-change loss (or a NUBIL) that is attributable to a taxable year of a loss corporation with respect to which the corporation is a component member of a controlled group. Treas. Reg. § 1.382-8(b)(1), (g) Ex. 1. Since controlled group status is determined on a taxable year-by-taxable year basis, some pre-change losses could be controlled group losses (and subject to the controlled group rules), while others are not pre-change losses.

If a pre-change loss is determined to be a controlled group loss, the next step is to determine the component members of the controlled group with respect to that controlled group loss. The controlled group for purposes of the controlled group loss includes the loss corporation itself and each corporation that was a component member of the controlled group that includes the loss corporation both (i) with respect to the taxable year to which the controlled group loss is attributable, and (ii) on the change date. Treas. Reg. § 1.382-8(b)(1), (g) Ex. 1. Since component member status is determined on a taxable year-by-taxable year basis, the component members could differ for each taxable year for which there is a controlled group loss.

In applying these rules, loss corporations are required to determine the taxable year to which a pre-change loss (other than an RBIL) is attributable. It is relatively straightforward to determine the year in which an NOL or other pre-change loss is attributable. Thanks to detailed section 163(j) regulations, it is even straight forward to determine the year of attribution for a disallowed business interest expense. There is uncertainty as to how to attribute a minimum tax credit carryforward to a particular taxable year. The minimum tax credit does not have any ordering rules. IRC § 53.

Controlled Group Loss Example. Parent, Lossco 1, Lossco 2, Subsidiary, and Target are all domestic corporation that file separate returns on a calendar year basis. At the beginning of 2015, Lossco 1 owns 30% of the stock of Lossco 2 and Lossco 2 owns 100% of the stock of Subsidiary. Both Parent and Target are 100% owned by unrelated persons. Lossco 1 has an NOL in 2016 and 2017 and Lossco 2 has a NOL in 2015. All of the NOLs are carried forward to 2018.

On August 1, 2017, Lossco 1 acquires an additional 40% of the stock of Lossco 2 for cash. (The transaction does not cause an ownership change with respect to Lossco 2.) On December 1, 2017, Lossco 2 acquires all of the stock of Target for cash. On November 1, 2018, Parent acquires all of the stock of Lossco 1 for cash. The transaction causes both Lossco 1 and Lossco 2 to undergo an ownership change.

The 2015 NOL of Lossco 2 is a controlled group loss since Lossco 2 was a component member of a controlled group with respect to the 2015 taxable year. The members of the group on December 31, 2015 were Lossco 2 and Subsidiary. As a result, both corporations are component members of the group with respect to the 2015 taxable year. Both Lossco 2 and Subsidiary were also members of the controlled group on November 1, 2018 (the date of the ownership change). As a result, the controlled group with respect to the 2015 NOL of Lossco 2 includes only Lossco 2 and Subsidiary. Parent, Lossco 2, and Target are not taken into account since they were not members of the controlled group at any time during 2015.

The 2016 NOL of Lossco 1 is not a controlled group loss since Lossco 1 was not a component member of a controlled group with respect to 2016. Lossco 1 only owned 30% of the stock of Lossco 2 on December 31, 2016.

The 2017 NOL of Lossco 1 is a controlled group loss since Lossco 1 was a component member of a controlled group with respect to the 2017 taxable year. The members of the group on December 31, 2017 were Lossco 1, Lossco 2, Subsidiary, and Target. As a result, all of these corporations are component members of the group with respect to the 2017 taxable year. All four corporations were also members of the controlled group on November 1, 2018 (the date of the ownership change). As a result, the controlled group with respect to the 2017 NOL of Lossco 1 includes only Lossco 1, Lossco 2, Subsidiary, and Target. Parent, is not taken into account since it was not a member of the controlled group at any time during 2017.

See Treas. Reg. § 1.382-8(g) Ex. 1.

As an alternative, assume that all of the corporations in this example were fiscal year taxpayers. The results would be same since component member status is determined based on membership in the controlled group on the December 31 that is included in the taxable year.

As described above, loss corporations are generally required to determine the taxable year to which a pre-change loss is attributable to. Different rules apply with respect to a built-in loss. The loss corporation is required to determine the taxable year for which a NUBIL is attributable to (as opposed to the taxable year for which the RBIL is attributable). Treas. Reg. § 1.382-8(b)(1). It is possible that there might be a requirement to allocate the NUBIL to different years based on tracking the build-up of the NUBIL (or UBILs). (The preamble does state that loss corporations are required to determine the taxable year in which the NUBIL “accrues.” TD 8825, 1999-2 CB 19.) Nonetheless, it may be possible to just treat the NUBIL as attributable to the change year.

The regulations provide an irrebuttable presumption for purposes of determining the taxable year to which a NUBIL is attributable (the “determination year”). For this purpose, a UBIL with respect to a “prior change date asset” is deemed to be attributable to a period ending before the determination year. A prior change date asset is an asset held by the loss corporation at all times during the period beginning on the most recent change date and ending on the first day of the determination year. A similar presumption applies to built-in deductions. Treas. Reg. § 1.382-8(b)(2); TD 8825.

The rule described in the prior paragraph was intended to apply (and require the use of) a simplifying convention. TD 8825. The rule appears to apply to loss corporations with multiple ownership changes. It seems to require tracing UBILs and built-in deductions from the first ownership change and treats such items as attributable to the taxable year in which the first ownership change takes place. The preamble states that the presumption only applies if the loss corporation had a NUBIL with respect to the first ownership change. TD 8825.

Although the definition of controlled group and component member are complicated, the controlled group rules themselves are not that complicated. A loss corporation that is a component member of a controlled group is generally required to reduce the value of stock (for base annual section 382 limitation purposes) if the loss corporation *directly* owns stock in another component member immediately *after* the ownership change. Treas. Reg. § 1.382-8(c)(1). Reductions for indirect ownership interests are discussed below.

The amount of the reduction equals the value of the other component member stock immediately *before* the ownership change. The amount of the reduction is computed without regard to the other adjustments under the controlled group rules. Treas. Reg. § 1.382-8(c)(1), (g) Ex. 2. It appears that the actual value of the stock is used for this purpose. Adjusted value (e.g., adjusted for capital contributions, etc.) is not used for purposes of the reduction as the interaction with duplicated adjustments are dealt with by a different provision.

After the value of each component member is reduced under the rule described in the previous paragraph, a lower tier component member can elect to restore some or all of the reduced value to the higher tier member. The amount of restored value is limited to the lesser of (i) the value of the electing member's stock (taking into adjustments under the controlled group rules), or (ii) the value of the electing member's stock that is directly owned immediately after the ownership change (determined without regard to adjustments under the controlled group rules). Treas. Reg. § 1.382-8(c)(2), (g) Ex. 3. An election to reduce value can be made (and is generally advisable) for a corporation that is not a loss corporation (that is, has no pre-change losses). Treas. Reg. § 1.382-8(g) Ex. 2(d). If a lower tier component member makes a restoration election, the value of the higher tier member is increased by the amount elected and the value of the lower tier member is reduced by such amount. Treas. Reg. § 1.382-8(c)(2), (3).

An election to restore value is made by a lower tier entity (the "electing member"). The election must specify the amount restored. The election must be attached to the tax return that includes the change date of (i) the loss corporation, and (ii) the electing member (or United States shareholder, in the case of a CFC). From a practical standpoint, the deadline for filing the election is the extended due date of the return. To effect an election, both the loss corporation and the electing member must sign an agreement with respect to the election. Treas. Reg. § 1.382-8(h)(1). Failure to make this election on a timely basis is a frequent source of requests for section 9100 relief. *E.g.*, see PLR 202021010 (Feb. 24, 2020); PLR 201443009 (July 16, 2014); PLR 201421013 (Feb. 5, 2014); PLR 201421012 (Feb. 5, 2014); PLR 201421011 (Feb. 5, 2014).

An election to restore the full amount of value is deemed to be made for each foreign component member. Treas. Reg. § 1.382-8(h)(2)(i), (j)(4). For this purpose, a foreign component member is a component member that is a foreign corporation that does not have any items treated as connected with a US trade or business. Treas. Reg. § 1.382-8(e)(4). The foreign component member can elect to not restore some or all of the value to the loss corporation. The requirements for such an election are similar to the ones described to restore value. Treas. Reg. § 1.382-8(h)(2)(ii), (iii).

Before the enactment of the TCJA, it was rare for an election to be made to restore value to a foreign component member. However, as a result of the enactment of the GILTI regime, there will potentially be more circumstances in which an election will need to be considered. (This assumes that the value for section 382 limitation purposes is to be determined as if the CFC was a domestic corporation.) For example, if a US parent corporation undergoes an ownership change at a time that it has fifty foreign subsidiaries (all CFCs), consideration will need to be given as to whether an election to restore value should be made for some or all of the foreign subsidiaries.

An election to restore (or not to restore) value once made, can only be revoked with the consent of the Commissioner of Internal Revenue (i.e., a private letter ruling would be required). Treas. Reg. § 1.382-8(h)(3).

Adjustment to Value Example. Lossco 1, Lossco 2, and Holdco are all domestic corporation that file separate returns on a calendar year basis. Since 2011, Lossco 1 owned 80% of the stock of Holdco and Holdco owned 75% of the stock of Lossco 2. In addition, Lossco 2 owned 100% of the stock of Forco, a foreign corporation that does not have any ECI. Lossco 1 and Lossco 2 each has an NOL in 2018 that was carried forward to 2019. Forco had disallowed business interest expense in 2018 (for GILTI purposes) that was carried forward to 2019.

On December 1, 2019, an individual acquired 100% of the stock of Lossco 1. This caused Lossco 1, Lossco 2, and Forco to undergo an ownership change. (Holdco did not have an ownership change since it was not a loss corporation.) Immediately before the ownership change, the total value of

the stock (taking into account stock of subsidiaries) of each corporation was: (i) Lossco 1 - \$200 million, (ii) Holdco - \$100 million, (iii) Lossco 2 - \$40 million, and (iv) Forco - \$25 million.

The 2018 NOLs of Lossco 1 and Lossco 2 and the 2018 disallowed business interest expense of Forco are all controlled group losses since all of such corporations were component members of a controlled group with respect to the 2018 taxable year. All three corporations and Holdco were members of the group on December 31, 2018 and on December 1, 2019. As a result, all of these corporations are component members of the group with respect to the 2018 taxable year.

Assuming that no elections are made, the value of the stock of each corporation for base annual section 382 limitation purposes would be:

- Forco – zero
- Lossco 2 - \$40 million
- Holdco - \$70 million (\$100 million less 75% multiplied by \$40 million (the value allocated to Lossco 2))
- Lossco 1 - \$120 million (\$200 million less 80% multiplied by \$100 million (the value allocated to Holdco))

Lossco 2 can elect to restore up to \$25 million to Forco. As a result, Lossco 2 elects to forego the full \$25 million. Lossco 2's value is reduced to \$15 million (\$40 million less \$25 million) and Forco's value would increase to \$25 million. The election has no effect on the value of Lossco 1 or Holdco. (Whether this election provides a benefit will depend on whether the base annual section 382 limit for Forco is zero (per statute) or \$25 million (based upon a potential interpretation of the GILTI rules.)

Lossco 2 can elect to restore up to \$15 million to Holdco. As a result, Lossco 2 elects to forego the full \$15 million. Lossco 2's value is reduced to zero (\$15 million less \$15 million) and Holdco's value would increase to \$85 million (\$70 million plus \$15 million). The election has no effect on the value of Lossco 1.

Holdco can elect to restore up to \$80 million to Lossco 1 (the actual value of the stock of Holdco owned by Lossco 1). As a result, Holdco elects to forego the full \$80 million. Holdco's value is reduced to \$5 million (\$85 million less \$80 million) and Lossco 1's value would increase to \$200 million (\$120 million plus \$80 million).

As can be seen, Lossco 2 has made a "rookie mistake" by electing to restore the full \$15 million to Holdco. Holdco is not a loss corporation and cannot use the allocation directly. The amount that Holdco can restore to Lossco 1 is limited. So Lossco 2 should have only elected to restore \$10 million to Holdco. This would have resulted in a value to Lossco 2 of \$5 million (\$15 million less \$10 million). Lossco 1 would have received the same value of \$200 million.

Treas. Reg. §§ 1.382-8(g) Ex. 2, 3.

One complication that is not addressed in the regulations is the possibility that the base annual section 382 limitation can be different with respect to each taxable year for which a pre-change loss is attributable. For example, it is possible that an NOL from 2001 may not be a controlled group loss, an NOL from 2002 is a controlled group loss that is subject to a reduction with respect to a subsidiary, and an NOL from 2003 is a controlled group loss that is subject to a reduction with respect to a different subsidiary. The section 382 rules do not provide any guidance regarding the possibility of a different base annual section 382 limitations

with respect to the same ownership change. CO-077-90, 1991-1 CB 749 (requesting comments on this issue).

In addition to the above-described rules, additional “appropriate” adjustments are required to prevent duplication of value. These adjustments are to be made consistently with the principles of the above reduction and restoration rules. Examples of situations where additional adjustments are required are (i) indirect ownership interests in a component member (including through a partnership), (ii) cross ownership of stock by component members, and (iii) any duplication of value used to determine the base annual section 382 limitation with respect to pre-change losses from the same period. Treas. Reg. § 1.382-8(c)(4), (g) Ex. 5.

Partnership Example. Lossco 1 and Lossco 2 are both domestic corporations that file separate returns on a calendar year basis. Lossco 1 owns 80% of the capital and profits of LLC, an entity that is treated as a partnership for US income tax purposes, and LLC owns 75% of Lossco 2. Both Lossco 1 and Lossco 2 have an NOL in 2018 that is carried forward to 2019.

On December 1, 2019, an individual acquired 100% of the stock of Lossco 1. This caused Lossco 1 and Lossco 2 to undergo an ownership change. Immediately before the ownership change, the total value of the stock (taking into account stock of subsidiaries) of each corporation was: (i) Lossco 1 - \$150 million, and (ii) Lossco 2 - \$100 million.

Lossco 1 has an indirect ownership interest in Lossco 2 of 60% (80% multiplied by 75%). As a result, Lossco 1 must reduce the value for base annual section 382 limitation purposes by the value of indirect ownership interest of \$60 million (\$100 million multiplied by 60%). Assuming a restoration election is not made, then the value of the Lossco 1 stock would be reduced to \$90 million (\$150 million less \$60 million).

Treas. Reg. § 1.382-8(g) Ex. 5.

Additional reductions are required if a loss corporation disposes of a direct or indirect ownership interest in another corporation before an ownership change. The reductions are to be consistent with the principles of the above reduction and restoration rules. These additional adjustments apply if the loss corporation and the other corporation were component members of a controlled group (i) with respect to a taxable year to which the pre-change loss was attributable, (ii) at any time during the two-year period ending on the change date, and (iii) at any time during the two-year period beginning on the change date. Treas. Reg. § 1.382-8(c)(5).

As previously noted, it is possible that one or more of the adjustment rules can potentially apply to require multiple reductions for the same economic event. The controlled group rules do not require duplication of reductions. An example of such a situation where relief is appropriate is a contribution to the capital of a loss corporation of the stock of a component member of a controlled group. If the value of the loss corporation is reduced by the amount of the capital contribution it is not again reduced under the controlled group rules. Treas. Reg. § 1.382-8(d).

As stated above, the controlled group rules do not apply if all of the component members of a controlled group are also members of a consolidated group. However, the controlled group rules apply if there are one or more component members that are not members of the consolidated group. In such case, all of the members of the consolidated group are treated as a single corporation for purposes of applying the controlled group rules. Treas. Reg. § 1.382-8(f), (g) Ex. 4. This rule will generally apply if members of a consolidated group own a controlling interest in one or more foreign subsidiaries.

The election to restore value can also be relevant to a member of a consolidated group for state tax purposes. This is a result of the fact that most states do not apply the consolidated return rules but do apply many of the other federal rules that govern corporations. As a result, it is possible that section 1.382-8 would not apply to two or more corporations for federal purposes (since they are members of a consolidated group), but would apply for state purposes (since the corporations are also members of a controlled group).

In PLR 200949017 (Aug. 21, 2009) and related rulings, the IRS granted section 9100 relief to make a late restoration election under section 1.382-8 with respect to subsidiaries that were members of a consolidated group. What is extraordinary about these rulings is that election that was being made was ineffective for federal purposes. The apparent intent was for the election to provide section 382 relief solely for state tax purposes. *See also* PLR 200949016 (Aug. 21, 2009); PLR 200949015 (Aug. 21, 2009); PLR 200949014 (Aug. 21, 2009).

C. COBE Rule

Special rules apply if the new loss corporation does not continue the business enterprise of the old loss corporation “at all times” during the two-year period beginning on the change date (i.e., meet the COBE requirement). In such case, the section 382 limitation for all post-change years is zero. IRC § 382(c)(1). However, if the old loss corporation had a net unrealized built-in gain (NUBIG), the section 382 limitation can be increased for RBIGs. IRC § 382(c)(2)(A)(i), (B).

If a section 338 election is made with respect to the loss corporation it appears that the COBE requirement is not met and the section 382 limitation would generally be zero. This treatment should apply to elections under both section 338(g) and (h)(10). *See* IRC § 382(c)(2)(A)(ii). In such case, the section 382 limitation can be increased for RBIGs. However, if the NUBIG is zero (because the de minimis rule applies), then the section 382 limitation equals the lesser of (i) RBIGs recognized as a result of the section 338 election, or (ii) the NUBIG (computed without regard to the de minimis exception). IRC § 382(c)(2)(A)(ii), (B), (h)(1)(C).

The Blue Book indicates that the pre-change losses are subject to “complete disallowance” after an ownership change if the business enterprise is not continued for two years. Blue Book, p. 318. It appears that the disallowance was intended to be retroactive to the change date even though the triggering event did not occur until later.

Section 382 does not describe how a new loss corporation meets this COBE requirement. The Blue Book states that the COBE requirement for section 382 purposes is intended to be the same as the COBE requirement for corporate reorganizations. Blue Book, p. 318. This interpretation was accepted by the Tax Court. *Berry Petroleum Co. v. Comm’r*, 104 TC 584, 635, n. 30 (1995), *aff’d on other issues*, 98-1 USTC P50398 (9th Cir. 1998); *see also* PLR 201015024 (Jan. 4, 2010). The COBE rules for corporate reorganizations are found in section 1.368-1(d) of the Treasury regulations.

The Blue Book describes the section 382 COBE requirement as requiring that the new loss corporation (or a successor corporation) must either (i) continue the “historic” business (i.e., the business conducted most recently) of the old loss corporation (“business continuity”), or (ii) use significant portions of the assets of the old loss corporation in a business (“asset continuity”). A new loss corporation can discontinue a “minor” portion of the historic business without causing a COBE problem. Blue Book, p. 318.

By analogy to the reorganization COBE rules, the business continuity test is satisfied if the new loss corporation continues the old loss corporation’s historic business. *See* Treas. Reg. § 1.368-1(d)(2)(i). If the old loss corporation had more than one line of business, the test is met if the new loss corporation continues

a significant line of business. *See* Treas. Reg. §§ 1.368-1(d)(2)(ii), (5) Ex. 1 (continuation of one of three lines of business of equal value), 1.1502-93(d)(2) (same). In determining whether a line of business is significant, all facts and circumstances are taken into account. *See* Treas. Reg. § 1.368-1(d)(2)(iv). The old loss corporation's historic business is the business it has most recently conducted (but not including businesses entered into in conjunction with the ownership change). *See* Treas. Reg. § 1.368-1(d)(2)(iii). It is possible that lines of businesses acquired in a capital contribution that takes place in connection with the ownership change may not be taken into account. *See* IRC § 382(l)(1).

By analogy to the reorganization COBE rules, the asset continuity test is satisfied if the new loss corporation uses a significant portion of the old loss corporation's historic assets in a business. *See* Treas. Reg. § 1.368-1(d)(3)(i). The old loss corporation's historic business assets are the assets used in its historic business. These assets can include stock and securities and intangible operating assets. *See* Treas. Reg. § 1.368-1(d)(3)(ii). The determination as to whether the assets used are a "significant portion" is based on the relative importance of the assets used in the operation of the business. Other facts and circumstances are also taken into account, including the fair market value of those assets. *See* Treas. Reg. § 1.368-1(d)(3)(iii). Examples of the asset continuity test can be found in Examples 2 through 5 of section 1.368-1(d)(5) of the Treasury regulations.

In certain cases, the new loss corporation can transfer the historic business or the historic business assets to a partnership or related corporation without affecting the qualification under the COBE requirement. *See* Treas. Reg. § 1.368-1(d)(4), (5) Ex. 6-15.

There is an unresolved issue concerning the application of the COBE rules under section 382 to dispositions after the two-year period. Under section 382, the requirement must be met at all times over a two-year period. Under the corporate reorganization rules, the requirement must just be met at the time of the reorganization but later transactions may be taken into account for this purpose. In *Berry Petroleum Co.*, the Tax Court held that asset dispositions after the end of the two-year period are not taken into account for purposes of the section 382 COBE requirement even if the new loss corporation intended to dispose of the assets earlier. 104 TC at 636-37.

D. Change Year Allocation

Special rules apply where a change date occurs other than on the last day of the taxable year. In such case, the taxable income, or NOL, is allocated between the pre-change period (the period ending on the change date) and the post-change period (the period beginning on the day after the change date). These rules apply to a "change year," which is a taxable year in which an ownership change occurs. Treas. Reg. § 1.382-6(a)(1), (g)(2), (3).

If there is taxable income in the pre-change period, section 382 does not limit the ability to offset pre-change losses against that income. IRC § 382(b)(3)(A). If there is an NOL in the pre-change period, the pre-change NOL is treated as a pre-change loss that is subject to limit when carried forward to post-change years. IRC § 382(d)(1)(A).

Similar allocations between the pre-change period and the post-change period are required for (i) capital gains and losses, (ii) foreign taxes credits, (iii) general business credits, and (iv) minimum tax credits. Treas. Reg. § 1.382-6(a)(1), (e). (More complicated rules apply with respect to the allocation of disallowed business interest deductions and are described below.) To the extent these attributes are allocated to the pre-change period, the attribute is treated as a pre-change loss that is subject to limit when carried forward to post-change years. IRC § 383(d); Treas. Reg. § 1.383-1(c)(2)(ii), (3)(i)(B), (ii)(B), (iii).

There are two acceptable approaches to allocating the items. They are (i) the ratable allocation approach, and (ii) the closing-of-the-books approach. The ratable allocation approach is the default approach. IRC § 382(b)(3)(A), (d)(1); Treas. Reg. § 1.382-6(a)(1). The closing-of-the-books approach can only be applied by making an election. Treas. Reg. § 1.382-6(b)(1).

An election to apply the closing-of-the-books approach is made by attaching an election statement to a timely filed return for the change year. Treas. Reg. § 1.382-6(b)(2)(i). The election once made is irrevocable. Treas. Reg. § 1.382-6(b)(2)(ii). The regulations do not mention any possibility of revocation (with or without the permission of the IRS). The IRS has granted section 9100 relief to taxpayers that made late elections. PLR 202142008 (July 29, 2021); PLR 202142007 (July 29, 2021); PLR 202140007 (July 14, 2021); PLR 201942005 (July 23, 2019).

If one member of a consolidated group elects to apply the closing-of-the-books approach, all allocations for members of the group must be consistent with the election. Treas. Reg. § 1.382-6(b)(3)(i). As a result, it appears that an election by one member results in a deemed election for other members.

If one member of a controlled group elects to apply the closing-of-the-books election, the election will only be valid if all members of the controlled group make the election. This requirement only applies if two or more members of a controlled group (that are not members of the same consolidated group) (i) have ownership changes as part of the same plan or arrangement, and (ii) continue to be members of the controlled group after the ownership change (or become members of a different controlled group). Members of a consolidated group do not need to make a conforming election due to the rule described in the previous paragraph. Treas. Reg. § 1.382-6(b)(3)(ii). For the definition of controlled group, see the above discussion of the controlled group rules. There is uncertainty as to whether foreign subsidiaries that do not have a US trade or business need to make a closing-of-the-books election to make it valid for the domestic higher tier entities. It is possible that such entities need to make the election since their taxable income is now relevant as a result of the enactment of the GILTI regime.

Under the ratable allocation approach, items are allocated between the pre- and post-change periods based upon the number of days in each period. Treas. Reg. § 1.382-6(a)(1). Under the closing-of-the-books approach, items are allocated between the pre-change and the post-change periods as if the taxable year ended on the change date. However, the taxable year does not actually terminate and the two periods are treated as a single period for carryforward and other purposes. Treas. Reg. § 1.382-6(b)(1).

There is a great deal of uncertainty as to how to apply to apply the closing-of-the books approach. Does one treat the two periods as actual separate tax years as the regulation suggests? If that approach were applied then a full year of partnership, subpart F, and GILTI inclusions would be taken into account in the period that includes the end of the taxable year of the partnership or CFC (in many cases, the post-change period).

If a foreign subsidiary of a domestic loss corporation is a member of a controlled group with the loss corporation, the foreign subsidiary may be required to make a closing-of-the-books election in tandem with an election by the domestic loss corporation (see above discussion). If a CFC makes a closing-of-the books election, it is possible that any GILTI inclusion would reflect the closing-of-the books election made by the CFC. In that case, the taxable income and NOL of the domestic loss corporation for each period would reflect the GILTI inclusion with respect to the two short periods of the CFC. This approach is in contrast to reporting the full-year GILTI inclusion in the post-change period (as described in the previous paragraph).

A strict separate year approach might result in the two periods having a combined NOL or taxable income amount that was different than the full year amount. For example, the combined section 250 deduction (and

other items that require complicated calculations) for two short years might not equal the actual deduction for the full year. In such case, a methodology would need to be adopted to determine how to allocate the shortfall or excess between the two periods. It is possible that an approach that is similar to the one adopted for allocations of business interest expense (described below) might be warranted for formula driven taxable income items.

Although there do not appear to be any cases or rulings on point, a reasonable approach to the allocation of items between the two periods would be to follow the more robust rules that apply for estimated tax purposes. Treas. Reg. § 1.6655-2(f). Under this approach, partnership inclusions, as well as subpart F income and GILTI inclusions, would be allocated between the two periods regardless of which period the entities' taxable year ends in. IRC §§ 951A(f)(2)(A), 6655(e)(4); Treas. Reg. § 1.6654(d)(2).

Where the closing-of-the-books approach is applied, some loss corporations have difficulty allocating the income where the ownership change occurs in the middle of the month. This can happen where the books and records do not support daily allocations of income and expenses. Similar closing-of-the-books provisions of the consolidated return regulations generally permit taxpayers to elect to allocate items for the month that includes the closing on a pro-rata basis. *See* Treas. Reg. § 1.1502-76(b)(2)(iii). No such provision was included in the section 382 allocation regulations. The IRS did issue a private letter ruling to one taxpayer allowing use of a month of change proration in conjunction with the closing-of-the-books approach. PLR 9644004 (Aug. 6, 1996). There is uncertainty as to whether such position is available in the absence of a ruling from the IRS.

Where the closing-of-the-books approach is applied, the treatment of transactions that occur on the change date receive unusual treatment. Generally, items that occur on the change date are allocated to the pre-change period. PLR 200442011 (Oct. 23, 2003) (change date payments to a qualified settlement fund). However, to the extent the item is treated as an RBIG or RBIL, the item is allocated to the post-change period.

If a member of a consolidated group enters or departs the group in the middle of the taxable year, section 1.1502-76(b) of the Treasury regulations provides rules for allocating income, gain, deductions, losses, and credits between the consolidated return period and the separate return period. If a loss corporation has an ownership change in a taxable year for which section 1.1502-76(b) applies, the allocation between the two periods under section 1.1502-76(b) is applied first. The two periods are treated as separate taxable years for section 382 purposes. The section 382 allocation rules are then applied to the short taxable year (consolidated or separate) that includes the change date. The allocation under the section 382 rules only applies to the items that were allocated to the relevant period pursuant to section 1.1502-76(b). Treas. Reg. § 1.382-6(d).

The items that are allocated under either the ratable allocation approach or the closing-of-the-books approach are (i) NOLs, (ii) taxable income, (iii) net capital loss, (iv) modified capital gain net income, (v) excess foreign taxes (within the meaning of section 904(c)), (vi) current year business credits (within the meaning of section 38(b)), and (vii) minimum tax credits (within the meaning of section 53(b)). Treas. Reg. § 1.382-6(a)(1), (e).

The applicable regulations provide for detailed rules for the allocation of NOLs, taxable income, net capital losses, and modified capital gain net income. They are described below. Similar principals apply for purposes of the credits. Treas. Reg. § 1.382-6(e).

For purposes of the allocation provisions, the NOL for the change year is determined without regard to (i) capital gains and losses, (ii) the section 382 limitation, and (iii) RBIGs and RBILs. IRC § 382(h)(5)(A);

Treas. Reg. § 1.382-6(c)(1). For purposes of the allocation provisions, the taxable income for the change year is determined without regard to (i) NOL deductions, (ii) capital gains and losses, (iii) the section 382 limitation, and (iv) RBIGs and RBILs. IRC § 382(h)(5)(A), (k)(4); Treas. Reg. § 1.382-6(c)(1).

The term “net capital loss” generally means the excess of capital losses over capital gains. IRC § 1222(10). The term “modified capital gain net income” generally means the excess of capital gains over capital losses. Treas. Reg. § 1.382-6(g)(4). For purposes of the allocation provisions, the net capital loss or modified capital gain net income for the change year is determined without regard to (i) the section 382 limitation, and (ii) RBIGs and RBILs. IRC § 382(h)(5)(A); Treas. Reg. § 1.382-6(c)(1)(ii).

In applying the closing-of-the-books approach, there is a “ceiling” limitation. The amount allocated between two periods cannot exceed the total. For example, if a corporation had a pre-change period loss of \$250 thousand and post-change period income of \$100 thousand, the full year NOL of \$150 thousand would be allocated to the pre-change period. Treas. Reg. § 1.382-6(f) Ex. 1 (iii).

Special rules apply with respect to the application of the built-in gain or loss rules. Any RBIG or RBIL is allocated to the post-change period. IRC § 382(h)(5)(A); Treas. Reg. § 1.382-6(c)(1)(ii)(A). A similar result applies to any income or gain recognized with respect to assets that were transferred during the post-change period to the loss corporation for “a principal purpose of ameliorating the section 382 limitation.” Treas. Reg. § 1.382-6(c)(1)(ii)(B).

In determining the allocation between periods, capital gains and losses are allocated separately from ordinary income and deductions. If there is a net capital loss, the amount is carried forward to subsequent taxable years. The pre-change portion of the loss is subject to limitation and the post-change portion is not. The amount of net capital loss does not affect the allocation of NOL or taxable income.

If there is a modified capital gain net income, the amount is reduced by capital loss RBILs and capital loss carryforwards to the taxable year. To the extent either of such items reduces modified capital gain net income allocable to the post-change period, the reduction items are subject to the section 382 limitation. Treas. Reg. § 1.382-6(c)(2)(i).

If there is taxable income, the income in each period is increased by the modified capital gain net income allocable to each period. If there is an NOL, the amount of NOL allocated to each period is offset, by any modified capital gain net income allocable to the period (but not below zero). Any remaining modified capital gain net income reduces the NOL allocated to the other period (but not below zero). Both of these offsets are without regard to any section 382 limitation. Treas. Reg. § 1.382-6(c)(2)(ii).

Examples of how the above rules apply in the context of a change year in which there is an NOL and modified capital gain net income can be found in section 1.382-6(f) of the Treasury regulations.

Allocation Example. Lossco, a calendar year taxpayer, has an ownership change on July 1, 2008. Lossco has taxable income (before NOL deductions) for the year of \$100 million (\$70 million in the pre-change period and \$30 million in the post-change period). Lossco adopts the section 338 approach and has foregone amortization of \$80 million that is treated as an RBIG. Regardless of which approach is applied, the \$80 million RBIG is treated as post-change period income. For allocation purposes, Lossco has taxable income of \$20 million since RBIGs are not taken into account. If the ratable allocation approach is applied, \$10 million of the taxable income is allocated to each period; the pre-change period taxable income equals \$10 million and the post-change period income equals \$90 million (\$10 million plus \$80 million). If the closing-of-the-books approach is applied, the entire \$20 million of allocable taxable income is allocated to the pre-change period

under the ceiling rule and the pre-change period taxable income equals \$20 million and the post-change period income equals \$80 million.

Business Interest Expense

Rules that differ from the above-described rules apply with respect to the allocation of business interest expense (and the deductible and non-deductible portions) between periods. The allocation rules differ depending upon whether a taxpayer applies ratable allocation or the closing-of-the-books approach.

Where the ratable allocation approach is applied, a five step analysis is employed to determine the portion that belong in each period. The steps are:

- Step 1 – Compute the section 163(j) limitation for the change year.
- Step 2 – Compute the deductible business interest expense for the current year (i.e., the lesser of the business interest expense for the current year or the section 163(j) limitation for the current year). This amount is taken into account in determining taxable income or NOL for the change year (and will be part of the allocation of taxable income or NOL under the ratable approach).
- Step 3 – If Step 2 results in a portion of the current year business interest expense being disallowed, the disallowed business interest expense is allocated between the pre- and post-change periods based upon the number of days in each period. The portion that is allocated to the pre-change period is subject to section 382 and the portion that is allocated to the post-change period is not subject to limitation under section 382.
- Step 4 – If Step 2 results in an excess section 163(j) limitation (i.e., the limit exceeds the business interest expense for the current year), then the deductible disallowed business interest carryforward (i.e., the prior year carryforward to the extent of the excess section 163(j) limitation) is allocated between the pre- and post-change periods based upon the number of days in each period. The total deductible disallowed business interest carryforward that is allocable to the post-change period is subject to limitation under section 382. The total that is allocable to the pre-change period is only subject to limitation under section 382 to the extent it becomes part of a pre-change NOL.
- Step 5 – The disallowed business interest carryforward that is in excess of the section 163(j) limitation is carried forward to future taxable years and is subject to limitation under section 382.

Treas. Reg. § 1.382-6(a)(2).

Where the closing-of-the-books approach is applied, a six step analysis is employed to determine the portions that belong in each period. The steps are:

- Step 1 – Compute the adjusted taxable income limitation (i.e., adjusted taxable income multiplied by 30% or 50%, depending upon the year) for the change year. The adjusted taxable limitation is allocated between the pre- and post-change periods based upon the number of days in each period.
- Step 2 – The current-year business interest expense and business interest income are allocated to the pre-and post-change periods on a closing-of-the-books basis.
- Step 3 – The pre-change and post-change business interest expense is deducted to the extent of the pre- and post-change section 163(j) limitation. The pre-change section 163(j) limitation is the sum of the pre-change portion of (i) the adjusted taxable income limitation, and (ii) business interest income. The post-change section 163(j) limit is the sum of the post-change portion of such items.
- Step 4 – If any pre-change business interest expense was not deducted in Step 3, the amount can be deducted against the surplus post-change section 163(j) limitation (i.e., the amount by which the post change section 163(j) limitation exceeds the post-change deductible business interest expense).

Similarly, any post-change business interest expense that was not deducted in Step 3 can be deducted against the surplus pre-change section 163(j) limitation (i.e., the amount by which the pre-change section 163(j) limitation exceeds the pre-change deductible business interest expense).

- Step 5 – If, after Step 4, there is disallowed business interest expense (from a prior year) that can be carried forward to the change year, the expense is allocated between pre-change and post-change periods based upon the relative amounts of excess pre-change and post-change section 163(j) limitation. The excess pre-change section 163(j) limitation equals the excess, if any, of the surplus pre-change section 163(j) limitation (computed in Step 4) over the amount of post-change business interest expense that was deducted in Step 4. The excess post-change section 163(j) limitation equals the excess, if any, of the surplus post-change section 163(j) limitation (computed in Step 4) over the amount of pre-change business interest expense that was deducted in Step 4.
- Step 6 – The disallowed business interest expense that was allocated to the pre-change period (in Step 5) is deductible to the extent of the excess pre-change section 163(j) limitation (computed in Step 5). Similarly, the disallowed business interest expense that was allocated to the post-change period is deductible to the extent of the excess post-change section 163(j) limitation. The expense that was allocated to the post-change period is also subject to limitation under section 382. Any expense that is not deductible under Step 6 can be carried forward to a future year but will be subject to limitation under section 382 (irrespective of whether it is allocable to the pre- or post-change period).

Treas. Reg. § 1.382-6(b)(4).

Allocation Example. Lossco, a calendar year taxpayer, has an ownership change on October 19, 2021. Lossco has a disallowed business interest expense carryforward to 2021 of \$90 million. Lossco has business interest expense of \$250 million for 2021 (\$100 million of which accrued in the pre-change period and \$150 million of which accrued in the post-change period). Lossco's adjusted taxable income in 2021 equals \$500 million.

If Lossco applies the ratable allocation approach, then the above-described five step approach is used.

- Step 1 – Lossco's section 163(j) limitation for 2021 equals \$150 million (\$500 million multiplied by 30%).
- Step 2 – The deductible business interest expense for the current year equals \$150 million (lesser of \$150 million or the business interest expense for the current year (\$250 million)). This amount of \$150 million is deductible and is taken into account in determining taxable income or NOL for the change year.
- Step 3 – A portion of the current year business interest expense (\$250 million) is disallowed in Step 2. The disallowed portion (\$100 million) is allocated between the pre- and post-change period based on the number of days in each period. The pre-change disallowed portion is \$80 million (\$100 million multiplied by (292/365 days) and the post-change disallowed portion is \$20 million (\$100 million multiplied by 73/365 days). The pre-change portion of \$80 million is carried forward and will be subject to limitations under both sections 163(j) and 382 in future years. The post-change portion of \$20 is carried forward and will only be subject to limitation under section 163(j).
- Step 4 – Not relevant.
- Step 5 – The entire disallowed business interest expense carryforward of \$90 million is carried forward to 2022 and will be subject to limitations under both sections 163(j) and 382 in future years.

If Lossco applies the closing-of-the books approach, then the above-described six step approach is used.

- Step 1 - Lossco's adjusted taxable income limitation for 2021 equals \$150 million (\$500 million multiplied by 30%). The pre-change portion is \$120 million (\$150 million multiplied by (292/365 days) and the post-change disallowed portion is \$30 million (\$150 million multiplied by 73/365 days).
- Step 2 – The current-year business interest expense is \$250 million (\$100 million is pre-change and \$150 million is post-change).
- Step 3 – Since there is no business interest income, both the pre- and post-change section 163(j) limitation equals the equivalent pre- and post-change adjusted taxable income limitation. As a result, the deductible pre-change business interest expense for the current year equals \$100 million (lesser of the section 163(j) limitation (\$120 million) or the business interest expense for the current year of \$100 million). The deductible post-change business interest expense for the current year equals \$30 million (lesser of the section 163(j) limitation (\$30 million) or the business interest expense for the current year of \$150 million).
- Step 4 – The surplus pre-change section 163(j) limitation equals \$20 million (the excess of the section 163(j) limitation (\$120 million), over the deductible business interest expense for the current year of \$100 million). The surplus post-change section 163(j) limitation equals zero (since both the section 163(j) limitation and the deductible business interest expense both equal \$30 million). As a result, \$20 million of post-change business interest expense can be deducted (up to the amount of surplus pre-change section 163(j) limitation). The remaining \$100 million of post-change business interest expense is carried forward and will be subject to limitation under section 163(j) (but not section 382).
- Step 5 – The excess pre- and post-change section 163(j) limitation equals zero. The post-change amount equals zero since the surplus post-change section 163(j) limitation equaled zero. The pre-change amount equals zero since the surplus pre-change section 163(j) limitation of \$20 million was fully offset by post-change business interest expense.
- Step 6 – None of the business interest expense carry forward of \$90 million can be deducted in 2021. The entire amount is carried forward to 2022 and will be subject to limitations under both sections 163(j) and 382 in future years.

The above-described regulations for allocating business interest expense between periods, apply with respect to an ownership change that occurs during a taxable year beginning on or after November 13, 2020 (generally, 2021 and later taxable years). However, a taxpayer can choose (or can be required) to apply these rules to earlier ownership changes if the taxpayer (and all related parties) consistently applies the section 163(j) regulations to earlier periods in their entirety. Treas. Reg. § 1.382-6(h)(2).

The proposed section 163(j) regulations provided that disallowed business interest expense is allocated between the pre- and post-change periods based upon the number of days in each period. This rule would have applied regardless of whether a closing-of-the-books election was made. Prop. Reg. § 1.382-6(b)(4)(i). For example, assume that a corporation has \$100 million of business interest in 2019 with a section 163(j) limit of \$80 million. If the corporation has an ownership change on July 1, 2019, approximately half of the \$80 million of deductible interest would be allocated to the pre-change period and the other half would be allocated to the post-change period. Of the \$20 million of disallowed business interest carryforward, approximately half would be allocated to the pre-change period (and would be subject to section 382 in future years) and half would be allocated to the post-change period (and would not be subject to section 382). Prop. Reg. § 1.382-6(b)(4)(ii). Taxpayers and related parties can rely upon the proposed section 163(j)

regulations if the final regulations do not apply (generally in 2020 and earlier taxable years) if they are applied consistently in their entirety. REG-106089-18, 83 Fed. Reg. 67490, 67526 (2018); Prop. Reg. § 1.382-6(h)(2).

E. Limited Attributes and Ordering Rules

Sections 382 and 383 limit the amount of pre-change losses that a new loss corporation can apply in a post-change year. The amount of taxable income that may be offset by pre-change losses (other than pre-change credits) is limited to the section 382 limitation for the taxable year. The amount of “regular tax liability” that may be offset by “pre-change credits” is limited to the section 383 credit limitation for the taxable year. IRC §§ 382(a), 383; Treas. Reg. § 1.383-1(b), (d)(1).

The regular tax liability equals the income tax imposed for the taxable year other than BEAT and other special taxes described in section 26(b)(2). IRC § 26(b); Treas. Reg. § 1.383-1(c)(5). A pre-change credit is a tax credit that is potentially subject to limitation under section 383 (i.e., general business credit, foreign tax credit, and minimum tax credit). Treas. Reg. § 1.383-1(c)(3).

Limited Attributes

The list of tax attributes that are limited by sections 382 and 383 are as follows:

- NOLs under section 172,
- disallowed business interest under section 163(j),
- net capital losses under section 1212,
- excess foreign taxes under section 904(c) (i.e., taxes eligible for foreign tax credit),
- general business credits under section 39,
- minimum tax credit under section 53, and
- RBILs.

IRC § 382(d)(1), (3); Treas. Reg. § 1.382-2(a)(2), (7). Except with respect to RBILs, each of the above-limited tax attributes includes (i) amounts carried forward to a taxable year that includes the change date, and (ii) amounts carried forward from the taxable year that includes the change date to the extent attributable to the pre-change period. Treas. Reg. §§ 1.382-2(a)(2), 1.383-1(c)(2), (3).

It is possible that the list of tax attributes subject to section 382 and 383 includes tax credits that are taken into account during the recognition period that are attributable to the period before the change date (i.e., built-in credit items). *See* Treas. Reg. § 1.383-1(g).

Before the enactment of the TCJA, section 163(j) generally only applied if interest was paid or accrued to a related person who was not subject to US federal income tax on the interest (e.g., tax exempt organization and foreign persons). IRC § 163(j)(1)(A), (3)(A) (as in effect for taxable years beginning on or before December 31, 2017). Interest that was disallowed under old section 163(j) can be carried forward, but is generally subject to limitation under new section 163(j). The interest that was disallowed under old section 163(j) is referred to in the section 163(j) regulations as “disallowed disqualified interest.” Treas. Reg. §§ 1.163(j)-1(b)(12), -2(c)(1), -5(b)(2), -11(c)(1).

Disallowed disqualified interest (i.e., interest that has been carried forward under old section 163(j)) is generally not considered to be a pre-change loss (and is not generally subject to limitation under section 382) if the ownership change occurred before November 13, 2020. Disallowed disqualified interest with respect to later ownership changes (or for which the taxpayer or a related person choose to apply the section

163(j) regulations retroactively) is considered to be a pre-change loss that is subject to limitation under section 382. Treas. Reg. §§ 1.163(j)-11(c)(4); 1.382-2(a)(2)(vi), (7).

On September 27, 2018, the House of Representatives passed the American Innovation Bill of 2018, HR 6756, 115th Cong. (2018). This bill, if it had been enacted into law, would have exempted from sections 382 and 383, tax attributes that were incurred during a three-year period that begins on the date on which the corporation begins an active trade or business. HR 6756, § 3. The purpose was to allow corporations to retain the benefit of their start-up losses after an ownership change. The bill was not taken up by the Senate and died at the end of the 115th Congress. The bill was also introduced in the 116th Congress, American Innovation Bill of 2020, HR 7505 116th Cong. (2020), but did not receive a vote. It is possible that it could become law in the future.

Section 168(k)(4) (as in effect for property placed in service in taxable years beginning before January 1, 2018)) permits taxpayers to elect to increase the general limitations on the use of research tax credits and minimum tax credits. To the extent the increased limit exceeds the tax for the taxable year, the taxpayer is entitled to a refund. IRC § 168(k)(4)(F). The IRS has stated that these credits remain subject to section 383 if there has been an ownership change. Rev. Proc. 2009-16, 2009-1 CB 449, § 2.09, *mod. by*, Rev. Proc. 2009-33, 2009-2 CB 150. However, the IRS has ruled that section 383 only applies if the credits with the increased limit are being used to offset regular tax liability. In the situation where the taxpayer has no regular tax liability (e.g., due to an NOL), section 383 does not apply and the taxpayer is entitled to a refund under section 168(k)(4). CCA 201126029 (Mar. 17, 2011).

The corporate AMT was repealed for taxable years beginning after December 31, 2017. The TCJA increased the limitation on the credit in 2018 through 2021 taxable years so that the entire amount of the credit is creditable against tax due during those taxable years and the excess is refundable. There is uncertainty as to how section 383 will apply to the minimum tax credits that are eligible for the increased limitation. Presumably the treatment will be the same as with respect to the increase in limitation pursuant to section 168(k)(4).

Ordering Rules

Applicable provisions of the Code generally provide that each of the above attributes are applied in the order in which occurred (i.e., earliest year first) after applying the current year's amount. IRC §§ 39(b) (general business credit), 172(b)(2) (NOLs), 904(c) (foreign tax credit), 1212(a) (net capital loss); Treas. Reg. § 1.163(j)-5(b)(2) (disallowed business interest expense). (The minimum tax credit has no ordering rule. IRC § 53.) The rules of sections 382 and 383 generally do not effect these ordering rules. Treas. Reg. § 1.383-1(d)(3)(i).

Based on the above, a new loss corporation generally will apply the earliest allowable tax attributes up to the limitation and then apply the earliest allowable tax attributes not subject to limitation. For example, if loss corporation has a 2001 NOL carryforward of \$50 million (subject to a section 382 limitation of \$30 million) and a 2005 NOL carryforward of \$70 million, and 2008 taxable income (before NOLs) of \$100 million, the loss corporation would deduct \$100 million of NOL in 2008 (\$30 million 2001 NOL carryforward and \$70 million 2005 NOL carryforward). The remaining \$20 million of the 2001 NOL would carryforward to 2009 and would continue to be subject to section 382.

One modification made to the ordering rules applies where a loss corporation carries tax attributes from the same taxable year and some are subject to limit and other are not. In such a case, an NOL carryforward (or RBIL) that is subject to limitation is applied before an NOL from the same taxable year that is not subject to limitation. IRC § 382(l)(2)(B). Treas. Reg. § 1.383-1(d)(1)(ii). This rule was intended to minimize the

attributes that are subject to limitation. Blue Book, p. 319. For example, if a loss corporation has an NOL in a taxable year for which an ownership change occurs, the NOL attributable to the pre-change period (and RBILs) are used before NOLs attributable to the post-change period.

There had been uncertainty as to whether the ameliorative rule described in the prior paragraph applied to tax attributes other than NOLs. Regulations that were issued in 2020 expanded the rule to cover all attributes that are subject to section 382 and 383. As a result, if multiple attributes are carried forward from the same taxable year, losses that are subject to sections 382 and 383 are absorbed before other losses. Similarly, credits that are subject to section 383 are absorbed before other credits. The regulation gives as an example, a carryforward of a disallowed business interest expense (some of which is a pre-change loss). The taxpayer applies the portion that is subject to section 382 first (up to the limits under sections 163(j) and 382). If the section 163(j) limit is greater than the limit under section 382, the taxpayer can deduct some of the expense that is not subject to section 382. Treas. Reg. § 1.383-1(d)(1)(ii). This rule applies to ownership changes occurring during a taxable year beginning on or after November 13, 2020. However, a taxpayer can choose (or can be required) to apply these rules to earlier ownership changes if the taxpayer (and all related parties) consistently applies the section 163(j) regulations to earlier periods in their entirety. Treas. Reg. § 1.383-1(j)(2).

A second modification relates to the ability to carryforward disallowed pre-change losses. The provisions of section 382 modify the applicable carryforward rules to allow the amount that is in excess of the limitation to be carried forward. IRC § 382(l)(2)(A).

All rules that apply to limit use of a pre-change loss (other than sections 382 and 383) are applied before the section 382 limitation or section 383 credit limitation are absorbed. As a result, only currently allowable amounts are taken into account in applying the limitations of sections 382 and 383. Treas. Reg. § 1.383-1(d)(3)(i), (ii) (application of limitation on use of business credits).

The BEAT provides for an alternative corporate tax with a higher base (disallowance of base erosion deductions) and a lower rate (5%-13.5% depending upon the taxable year and the type of taxpayer). The application of BEAT is not a limitation on tax attributes that affects the application or absorption of sections 382 or 383. Treas. Reg. § 1.383-1(d)(3)(i). Thus, it is possible that a deduction that does not provide a tax benefit as a result of BEAT could be treated as absorbed before a deduction, loss, or credit that would provide a benefit.

The applicable regulations provide for the order in which the section 382 limitation and section 383 credit limitation are applied. The order is:

- current year RBILs that are capital losses,
- capital loss carryforwards (including, carryforwards of capital loss RBILs),
- current year RBILs that are ordinary deductions or losses,
- NOL carryforwards (including carryforwards of ordinary loss RBILs),
- foreign tax credits,
- general business credits, and
- minimum tax credits.

Treas. Reg. § 1.383-1(d)(2), (f)(1); TD 8264, 1989-2 CB 73.

The regulations issued in 2020 prescribe that the business interest expense carryforward under section 163(j) is available before NOL carryforwards (i.e., the fourth spot on the above list). This rule only applies to ownership changes that occur during or after the taxable year which includes November 13, 2020. Treas.

Reg. § 1.383-1(d)(2)(iv). However, a taxpayer can choose (or can be required) to apply these rules to earlier ownership changes if the taxpayer (and all related parties) consistently applies the section 163(j) regulations to earlier periods in their entirety. Treas. Reg. § 1.383-1(j)(2).

The section 382 limitation is absorbed by one dollar for each dollar of deductible pre-change losses that is used to offset taxable income. *Id.* After the section 382 limitation is reduced by allowable deductible pre-change losses, the section 383 credit limitation is computed.

The section 383 credit limitation generally equals the regular tax liability for the post-change year that could be reduced by additional deductible pre-change losses. The amount equals the excess of (i) the regular tax liability, over (ii) the recomputed regular tax liability. The recomputed regular tax liability equals the amount that would have been owed if the section 382 limitation (after absorption by deductible pre-change losses) were allowed as a deduction. Treas. Reg. § 1.383-1(c)(6)(i). For example, if a loss corporation has taxable income of \$100 million, a section 382 limitation of \$60 million, and no deductible pre-change losses, the section 383 credit limitation would equal \$12.6 million (regular tax liability of \$21 million (at 21% tax rate) less recomputed regular tax liability of \$8.4 million). *See* Treas. Reg. § 1.383-1(c)(6)(ii), (f)(2).

The section 383 credit limitation is absorbed by one dollar for each dollar of pre-change credits that are used to reduce regular tax liability. Treas. Reg. § 1.383-1(d)(2). After the absorption of pre-change credits is determined, the loss corporation computes the carryforward of the unused section 382 limitation.

The section 382 limitation that can be carried forward to a subsequent taxable year equals the excess of (i) the section 382 limitation for the post-change year reduced by absorption of deductible pre-change losses in that taxable year, over (ii) the section 383 credit reduction amount for the taxable year. Treas. Reg. § 1.383-1(e)(1).

The section 383 credit reduction amount equals the amount of taxable income that is equivalent to the amount of regular tax liability that was offset by pre-change credits. Each dollar of regular tax liability that was reduced by pre-change credits is divided by the effective marginal tax rate (generally 21%). Treas. Reg. § 1.383-1(e)(2), (f)(3). For purposes of determining the section 383 credit reduction amount, credits are treated as absorbed under the general ordering rules provided in the Code. IRC § 1.383-1(e)(4). For an example of the computation of the section 383 credit reduction see section 1.383-1(e)(3) of the Treasury regulations.

VI. Built-in Gains and Losses

Special rules apply if an old loss corporation has a NUBIG or NUBIL at the time of an ownership change. If the old loss corporation has a NUBIG, the section 382 limitation can generally be increased to the extent of any RBIGs. IRC § 382(h)(1)(A). If the old loss corporation has a NUBIL, any RBILs are treated as a pre-change loss that is subject to the section 382 limitation. IRC § 382(h)(1)(B).

RBIGs and RBILs are generally income, gains, deductions, and losses that are “built-in” at the change date and that are taken into account by the new loss corporation during the recognition period. The recognition period is the five-year period beginning on the change date. IRC § 382(h)(7)(A). For purposes of the built-in gain or loss rules, the change date is within the recognition period (and essentially a “post-change” day). For other section 382 purposes, the change date is a “pre-change” day.

The NUBIG and NUBIL rules generally apply to RBIGs and RBILs that are taken into account in a recognition period taxable year. A recognition period taxable year is a taxable year a portion of which is in the recognition period. IRC § 382(h)(7)(B).

The NUBIG rule applies if the old loss corporation has a NUBIG. In which case, the section 382 limitation for any recognition period taxable year is increased by any RBIGs taken into account in such taxable year. IRC § 382(h)(1)(A)(i).

The increase in the section 382 limitation in any recognition period taxable year is limited to the excess of (i) the NUBIG, over (ii) the total increases in the section 382 limitation in prior taxable years under the NUBIG rule (the “remaining NUBIG balance” limitation). IRC § 382(h)(1)(A)(ii). Thus, the amount of the NUBIG is a limitation on the total amount of RBIGs that can increase the section 382 limitation.

The NUBIL rule applies if the old loss corporation has a NUBIL. In which case, the RBILs for any recognition period taxable year are treated as a pre-change loss and are subject to the section 382 limitation. IRC § 382(h)(1)(B)(i).

The amount of RBILs that are treated as a pre-change loss in any recognition period taxable year is limited to the excess of (i) the NUBIL, over (ii) the total RBILs in prior taxable years (the “remaining NUBIL balance” limitation). IRC § 382(h)(1)(B)(ii). Thus, the amount of the NUBIL is a limitation on the total amount of RBILs that can be treated as pre-change losses.

Any deduction (or portion thereof) of an RBIL that is disallowed because it exceeds the section 382 limitation can be carried forward. IRC § 382(h)(4)(A). The carried forward deduction is treated as a pre-change loss that is subject to the section 382 limitation in subsequent years. IRC § 382(h)(4)(B). Pre-2018 ordinary deductions and losses can be carried forward generally for twenty taxable years under carryforward rules that are similar to the rules for NOLs. IRC §§ 172(b)(1)(A)(ii) (as in effect before amendment by the TCJA), 382(h)(4)(A). Post-2017 ordinary deductions and losses can be carried forward indefinitely. IRC §§ 172(b)(1)(A)(ii) (as in effect after amendment by the TCJA), 382(h)(4)(A). Capital losses can be carried forward generally for five taxable years under carryforward rules that are similar to the rules for net capital losses. IRC §§ 382(h)(4)(A), 1212(a)(1)(B).

The Blue Book indicates that a disallowed deduction of an RBIL can only be carried forward and cannot be carried back. Blue Book, p. 320. Some taxpayers have been taking the position that a disallowed RBIL can be carried back as an NOL. However, the IRS position appears to be that the RBILs can only be carried forward. CCA 201309013 (Nov. 21, 2012); CCA 201132022 (Apr. 28, 2011); CCA 200926027 (Mar. 9, 2009).

RBILs are carried forward under rules that are similar to the rules for carrying forward NOLs and capital losses, as the case may be. IRC § 382(h)(4)(A). The use of the term “similar” in the statute creates some ambiguity as to which rules for determining the amount of an NOL or capital loss deduction apply to RBIL carryforwards. For example, NOLs and capital loss carryforwards are subject to attribute reduction under section 108(b) if a corporation excludes cancellation of debt (COD) income under section 108(a). An attribute reduction provision does not appear to be a carryforward rule. As a result, it is possible that RBIL carryforwards are not subject to attribute reduction. However, we understand that some tax professionals are taking the position that RBILs are subject to attribute reduction. There is also uncertainty as to whether the 80% of taxable income limitation that applies to post-2017 NOLs also applies to the carryforward of post-2017 RBILs.

RBILs and built-in deduction items are not subject to limitation if the loss corporation has a NUBIG. TAM 200143001 (Dec. 15, 2000); 1993 FSA Lexis 210. Similarly, RBIGs and built-in income items do not increase the section 382 limitation if the loss corporation has a NUBIL. Notice 2003-65, § II.

There is uncertainty as to whether the NUBIL rules apply and how they apply, for regular tax purposes, to foreign corporations that do not have a US trade or business. It seems clear that if the NUBIL rules do apply to such a foreign corporation, the base annual section 382 limit is zero (and any RBILs would not be deductible). IRC § 382(e)(3); CCA 200238025 (June 14, 2002). In at least one ruling, the IRS has treated a foreign corporation without a US trade or business as potentially subject to the NUBIL rules. 1997 FSA Lexis 17.

There is also uncertainty as to how the NUBIL rules apply to a CFC for subpart F income and for purposes of sections 956 and 965. If a US shareholder of a CFC takes into account subpart F income of a CFC, properly allocated deductions are allowed to offset the income. IRC § 954(b)(5). It is possible that section 382 could apply in determining the deductions that offset subpart F income. Many of a US shareholder's consequences related to ownership of a CFC's stock relate to determinations of the E&P of a CFC. Positive E&P is necessary to have subpart F income or an inclusion under sections 956 and 965 (but not for purposes of GILTI inclusions). It appears that RBILs that are permanently disallowed by section 382 (due to a zero limitation) are taken into account as deductions for E&P purposes. RBILs that are deferred by section 382 may possibly be taken into account for E&P purposes when they would otherwise be taken into account for taxable income purposes. Treas. Reg. § 1.312-6(b). It is also possible that section 382 is not taken into account for E&P purposes, in which case the RBILs would reduce E&P when they are realized and recognized (and not when deductible). See Treas. Reg. § 1.163-4(c)(1) (effect of section 163(j), as amended by the TCJA, on E&P); *Weyerhaeuser v. Comm'r*, 33 BTA 594, 597 (1935) (excess charitable contributions); Rev. Rul. 2009-25, 2009-2 CB 365 (same); IT 3253, 1939-1 CB 178 (excess capital losses).

For GILTI purposes, it appears that the NUBIL rules apply since tested income is determined as if the CFC was a domestic corporation. IRC § 951A(c)(2); Treas. Reg. §§ 1.951A-2(b), (c)(2), 1.952-2(b)(1). However, as discussed above, there is uncertainty as to how to compute the section 382 limitation.

In 2003, the IRS issued interim guidance on the correct application of the NUBIG and NUBIL rules. Notice 2003-65, 2003-2 CB 747, generally allows loss corporations to adopt one of two approaches to applying the rules. The two approaches are (i) the section 338 approach, and (ii) the section 1374 approach.

In 2019, the IRS and the Treasury Department issued proposed regulations under section 382 on the correct application of the NUBIG and NUBIL rules (the "proposed section 382(h) regulations"). These proposed rules support a single approach (a variation on the section 1374 approach). Finalization of these proposed rules are included in the IRS' current priority guidance plan. Office of Tax Policy and the IRS, 2021-2022 Priority Guidance Plan, 2nd Quarter Update, p. 3 (Feb. 22, 2022).

Taxpayers are generally permitted to rely on the proposed section 382(h) regulations instead of Notice 2003-65. REG-125710-18, 84 Fed. Reg. 47455, 47462 (2019). In conjunction with the issuance of the proposed section 382(h) regulations, the IRS announced that Notice 2003-65 would be withdrawn and superseded effective on the day after the proposed section 382(h) regulations become final. However, taxpayers can continue to rely on Notice 2003-65 for ownership changes for which the final regulations do not apply. Prop. Reg. § 1.382-7(g)(1); REG-125710-18 (as amended), 85 Fed. Reg. 2061, 2062 (2020).

In this interim period before the proposed section 382(h) regulations are finalized, taxpayers can adopt (i) the section 338 approach under Notice 2003-65, (ii) the section 1374 approach under Notice 2003-65, or

(iii) the approach applied by the proposed section 382(h) regulations. In addition, taxpayers are also free to use any of the multitude of approaches that are available based upon the statute.

On May 14, 2022, Robert Liquerman, IRS Office of Associate Chief Counsel (Corporate), stated that the proposed section 382(h) regulations would be repropounded. We understand that the IRS is considering changes to rules for (i) foregone amortization, (ii) the treatment of change date items, (iii) and COD income. Chandra Wallace, “Section 382 Loss Limitation Regs to be Repropounded.” 2022 TNTF 95-1. It is anticipated that the new proposed regulations will be issued later in 2022.

A. Notice 2003-65

Notice 2003-65 generally allows loss corporations to adopt one of two approaches to applying the NUBIG and NUBIL rules. The two approaches are (i) the section 338 approach, and (ii) the section 1374 approach. Taxpayers can apply either (or neither) of the approaches described in Notice 2003-65.

If a taxpayer applies one of the approaches described in the notice, they are generally required to apply the approach in its entirety. The IRS does not permit using elements of each approach. The IRS has stated that it will not assert an alternative interpretation of the NUBIG or NUBIL rules with respect to a loss corporation that consistently applied either of the two approaches.

It appears that a taxpayer can use a different approach for each ownership change. Similarly, it appears that related taxpayers can apply different approaches for the same ownership change. For example, a parent corporation and a non-consolidated subsidiary (e.g., a CFC) appear to be allowed to use different approaches even if the same transaction causes an ownership change.

Taxpayers are permitted to apply approaches that differ from those described in Notice 2003-65. The IRS will examine such approaches on a case-by-case basis. Notice 2003-65, § V.

Both approaches compute the amount of NUBIG and NUBIL similarly. The amount of NUBIG and NUBIL generally equals the net gain or loss that would be recognized on a hypothetical sale of assets to an unrelated party immediately before the ownership change. The assets are presumed sold for fair market value consideration. The buyer is presumed to have assumed all of the loss corporation’s liabilities.

The section 338 approach generally compares the actual treatment of items of income, gain, deduction, and loss by the loss corporation with the treatment of such items under a hypothetical section 338 election. The hypothetical section 338 election treatment is determined by assuming a hypothetical purchase of 100% of the stock of the loss corporation on the change date for which a section 338 election was made. Notice 2003-65, § IV. As a result, the hypothetical treatment is determined as if (i) the new loss corporation was a newly-created corporation that is unrelated to the old loss corporation, and (ii) the new loss corporation acquired all of the assets of the old loss corporation in a taxable transaction. *See* Treas. Reg. § 1.338-1(a)(1), (b)(1)(i).

The section 1374 approach generally applies regulations that were issued under section 1374(d) (NUBIG rules for S corporation conversions). The basis for this approach can be found in sections 1.1374-3, -4, and -7 of the Treasury regulations. Notice 2003-65, § III.

Loss corporations that have a NUBIG generally choose to apply the section 338 approach. The section 338 approach allows for the treatment of “foregone amortization” as an RBIG. This generally allows for a greater section 382 limitation than would be available under other approaches. It should be noted that some

taxpayers are not applying the section 338 approach for section 382 purposes (even though beneficial) due to concerns that the section 338 approach would also be required to be applied for section 384 purposes.

Loss corporations that have a NUBIL generally choose to apply the section 1374 approach. The section 1374 approach allows for more favorable treatment of contingent liabilities under the built-in deduction item provisions. This generally allows for a smaller amount of RBILs than would be required under other approaches.

There is currently uncertainty as to when taxpayers can change the approach after applying it on a return. There is an arcane case law principal described as the doctrine of election that could be invoked by the IRS to force the taxpayer to stay on the first approach applied on a return.

The doctrine of election generally applies if (i) a taxpayer has a free choice between two or more alternative treatments, and (ii) the taxpayer clearly communicates the choice to the IRS on an original tax return. Generally, taxpayers have been treated as communicating the choice of treatments where the choice affected the amount of tax shown on a tax return. If the doctrine of elections applies, the taxpayer may not, without the consent of the IRS, retroactively change the treatment. *Pacific Nat'l Co. v. Welch*, 304 US 191 (1938); *J.E. Riley Inv. Co. v. Comm'r*, 311 US 55 (1940); *Grynberg v. Comm'r*, 83 TC 255, 261 (1984); *Hodel v. Comm'r*, TC Memo. 1996-348; CCA 201939003 (June 27, 2019); FAA 20105101F (Nov. 19, 2010). *But see Bayley v. Comm'r*, 35 TC 288, 298 (1960) (taxpayer permitted to change to installment method where gain originally reported on amended return). The doctrine of election does not apply where there is only one choice of treatment available under the tax rules. *Ag Processing, Inc. v. Comm'r*, 153 TC 34, 55 (2019).

Technical Advice Memorandum 200252059 (Sept. 10, 2002) is a good illustration of use of the doctrine invoked by the IRS. The regulations under section 263A(f) allow taxpayers to choose the measurement dates (within guidelines) to determine the amount of capitalized interest in a taxable year. The measurement dates can differ from one taxable year to another. The taxpayer chose to use monthly measurement dates for the 1997 taxable year and filed a return on that basis. During the IRS audit, the taxpayer attempted to change the measurement dates from monthly to quarterly. The IRS ruled that the taxpayer was bound by the choice and could not change it without the IRS' permission.

There is currently some uncertainty as to the IRS position on when a taxpayer can change from one approach to another. It appears that the IRS had been leaning towards requiring taxpayers to continue to use the same approach, once an approach is adopted. In November 2011, William Alexander, then IRS Associate Chief Counsel (Corporate), stated that “[w]hat the notice says is that we will accept one or the other as an interpretation of the statute. But presumably you're making an interpretation of the statute.” *Practitioners Criticize Proposed Regs on Use of Unduplicated Stock Loss in Consolidation*, 2012 TNT 34-12. The current view of the IRS is not known.

B. The Proposed Section 382(h) Regulations

The proposed section 382(h) regulations would require loss corporations to adopt a modified version of the section 1374 approach. These rules, if finalized, would supersede Notice 2003-65. However, taxpayers can continue to rely on Notice 2003-65 for ownership changes for which the final regulations do not apply. Prop. Reg. § 1.382-7(g)(1); REG-125710-18 (as amended), 85 Fed. Reg. 2061, 2062 (2020).

The proposed section 382(h) regulations are generally proposed to apply to ownership changes that occur 30 days after the rules are finalized (the “applicability date”). Prop. Reg. §§ 1.382-2(b)(4), -7(g)(1). The final rules will not apply to an ownership change that occurs after the applicability date if the ownership change occurs as a result of an owner shift or equity structure shift pursuant to:

- a transaction in which there was a binding agreement in effect on or before the applicability date (and at all times thereafter),
- a specific transaction that is described in a public announcement made on or before the applicability date,
- a specific transaction described in a filing with the SEC that was submitted on or before the applicability date, or
- pursuant to a transaction that is described in a private letter ruling request that was submitted to the IRS on or before the applicability date.

There is some uncertainty as to the requirements of the public announcement or SEC exceptions. They both apply only to a “specific transaction.” Practitioners have raised concerns with the IRS with regard to the possibility that a loss corporation might announce a potential transaction with a specific buyer, but the actual transaction may be with a different buyer (e.g., another buyer offers more money). Kristen A. Parillo, “IRS Aware of Sticky Transition Issues for Loss Limitation Regs,” 2021 TNTF 10-6 (Jan. 15, 2021).

There is also an exception from the applicability of the final regulations for ownership changes that occur as result of a title 11 (i.e., bankruptcy) or similar case (see discussion in Section VII.A below for the meaning of “title 11 or similar case”). The exception applies if the ownership change occurs as a result of an owner shift or equity structure shift pursuant to (i) an order of a court, (ii) a plan confirmed by a court, or (iii) a sale approved by order of a court. In order for the exception to apply, the taxpayer must be a debtor in a case before such court on or before the applicability date. Prop. Reg. § 1.382-7(g)(2).

Taxpayers will be permitted to apply the final rules for an ownership change that occurred before the applicability date (or qualified for one of the exemptions described above). Prop. Reg. § 1.382-7(g)(1); REG-125710-18 (as amended), 85 Fed. Reg. at 2062. Taxpayers are generally permitted to rely on the proposed section 382(h) regulations before finalization. REG-125710-18 (as amended), 85 Fed. Reg. at 2062. It is doubtful that many taxpayers will choose to adopt the proposed section 382 regulations for NUBIG purposes as they are generally less favorable to taxpayers than the section 338 approach.

The drafters of the proposed section 382(h) regulations have identified the neutrality principal as the focus of Congress in drafting section 382(h). That is, the treatment of an item should generally not be affected by whether it is recognized before or after an ownership change. For example, for a corporation with a NUBIL it will not matter whether a deduction is taken into account before the ownership change or afterwards since the deduction will either be subject to limitation as part of an NOL or as an RBIL. While there are certainly situations where this will be true, there are also many situations where the statute itself does not impose the neutrality principal (e.g., a post-change loss or deduction is not treated as an RBIL if the corporation does not have a NUBIL).

The proposed section 382(h) regulations and Notice 2003-65 compute the amount of NUBIG and NUBIL similarly. The amount of NUBIG and NUBIL generally equals the net gain or loss that would be recognized on a hypothetical sale of assets to an unrelated party immediately before the ownership change. The assets are presumed sold for fair market value consideration. The buyer is presumed to have assumed certain of the loss corporation’s liabilities.

One of the key difference between the two regimes with respect to the computation of NUBIG and NUBIL is the treatment of COD income. In Notice 2003-65 it is generally treated as unrealized income. The proposed regulations only treat COD income as unrealized income in very specific circumstances. The treatment of COD income is big reason as to why the proposed rules are more complicated than Notice 2003-65 for NUBIG and NUBIL purposes.

For purposes of computing RBIG and RBIL, the proposed section 382(h) regulations adopt the section 1374 approach (with modifications). The drafters of the proposed regulations view the section 1374 approach as simpler than the section 338 approach and more consistent with the statutory text and intent. As to the simplicity argument, it has been my experience that a section 1374 approach calculation generally costs clients at least twice as much as a similar section 338 approach. This is based on the need to make numerous method of accounting determinations. That being said, it does appear that the proposed regulations have eliminated some of the arcane determinations currently required of adopters of the section 1374 approach. So it may be correct to say that the proposed rules (with respect to computing RBIG and RBIL) are simpler to apply than the section 338 approach. However, most of the simplicity is at the cost of eliminating taxpayer-friendly provisions.

Some of the stated reasons for the Treasury Department and the IRS to reject the section 338 approach are: (i) it is more complex (discussed above), (ii) it treats certain items differently for NUBIG/NUBIL purposes compared to how they are treated for RBIG/RBIL purposes, (iii) it allows taxpayers the benefit of RBIG treatment without requiring taxpayers to dispose of the asset within the recognition period (as required by statute), and (iv) they are less workable after the enactment of the TCJA (e.g., as a result of the enactment of section 163(j)).

The drafters of the proposed section 382(h) regulations have specifically requested comments on the following issues:

- whether special rules should be provided for insolvent or bankrupt corporations,
- whether the recognition period should be redefined to begin on the day after the change date (instead of beginning on the change date),
- whether dividends paid on built-in gain stock (and similar items) should constitute an RBIG, and
- the appropriate treatment of COD income that is excluded under the farm and real estate business indebtedness exceptions, IRC § 108(a)(1)(C), (D).

REG-125710-18, 84 Fed. Reg. 47455, 47460-61 (2019).

On May 14, 2022, Robert Liquerman, IRS Office of Associate Chief Counsel (Corporate), stated that the proposed section 382(h) regulations would be repropounded. We understand that the IRS is considering changes to rules for (i) foregone amortization, (ii) the treatment of change date items, (iii) and COD income. Chandra Wallace, “Section 382 Loss Limitation Regs to be Repropounded.” 2022 TNTF 95-1. It is anticipated that the new proposed regulations will be issued later in 2022.

It is very possible that the revised proposed section 382(h) regulations, when they do come out, will allow for some form of foregone amortization. However, it is doubtful that the resulting rule will be as generous to taxpayers as the rule currently in effect under Notice 2003-65. *See* Chandra Wallace, “A Look Ahead: Loss Limits and Wasting Assets Waiting in the Wings,” 174 Tax Notes Federal 165 (2022).

C. NUBIG and NUBIL

The determination of NUBIG and NUBIL is relevant to determine which rule under section 382(h) applies (i.e., either the NUBIG or NUBIL rule) and the effect of the applicable rule. As a general rule, a loss corporation can have either a NUBIG or a NUBIL, but not both. Notice 2003-65, § II.

An old loss corporation generally has a NUBIG if the fair market value of the assets of the corporation exceeds the aggregate adjusted basis of those same assets. An old loss corporation generally has a NUBIL if the aggregate adjusted basis of the assets of the corporation exceeds the fair market value of those same

assets. The determination of the amount of NUBIG and NUBIL is made immediately before the ownership change. IRC § 382(h)(3)(A)(i). The amount of NUBIG or NUBIL is adjusted by built-in income and deductions items (as described in more detail below). IRC § 382(h)(6)(C).

Section 382(h)(8). A special rule under section 382(h)(8) applies for purposes of determining the fair market value of the assets for NUBIL purposes. This rule applies if 80% of more of the stock of the loss corporation (by value) is acquired in a single transaction (or a series of related transactions over any twelve-month period). In such case, the fair market value of the assets is limited to the “grossed up amount paid for such stock properly adjusted for indebtedness of the corporation and other relevant items.” IRC § 382(h)(8). The provisions of section 382(h)(8), where it applies, appears to create an irrefutable presumption of the fair market value of the assets (i.e., there is no distortion of value exception). *See* FSA 199914002 (Apr. 9, 1999).

The formula under section 382(h)(8) for determining the limitation on value is similar to the formula used to determine amount realized (i.e., aggregate deemed sales price (ADSP)) and basis (i.e., adjusted grossed-up basis (AGUB)) for section 338 purposes. *See* Treas. Reg. §§ 1.338-4(b)(1), -5(b)(1). As a result, it appears that the “grossed up amount paid” means the amount paid for the stock divided by the percentage of loss corporation stock acquired in the transaction. *See* Treas. Reg. § 1.338-4(c)(1).

The IRS held in FSA 199914002 that stock is “acquired” for purposes of the 80% test of section 382(h)(8) if a 5% shareholder obtains ownership of stock that it did not already own (directly, or indirectly by attribution). The ruling treated the issuance of stock to creditors, including the issuance to holders of convertible debentures, as an acquisition of stock. A stock-for-stock exchange can be ignored for this purpose if the stock exchanged has the same value. However, stock obtained in a section 1032 transaction is taken into account (i.e., shares issued for cash or property). Stock obtained with respect to the exercise of stock rights was treated as acquired to the extent of the cash paid for the additional shares. The IRS held that stock obtained before the beginning of the testing period can count as acquired for section 382(h)(8) purposes. FSA 199914002.

The IRS in FSA 199914002 also held that two transactions are treated as related for section 382(h)(8) purposes based upon general tax principles (e.g., the three part test used under the step transaction doctrine). FSA 199914002. In an earlier ruling, the IRS did not apply section 382(h)(8) to an ownership change resulting from separate transactions that cumulatively resulted in an 80% owner shift. PLR 9407025 (Nov. 22, 1993). It is not clear what standard was used to determine whether transactions were related in the earlier ruling.

Pre-ownership Change Transactions. The Treasury Department has the regulatory authority to provide that the determination of the amount of any NUBIG or NUBIL is made after taking into account any “redemption or other corporate contraction” that occurs in connection with an ownership change. IRC § 382(h)(3)(A)(ii). Presumably the terms “redemption” and “corporate contraction” have the same meaning as the similar provisions under the section 382 limitation value rules. No such regulations have been promulgated or proposed. The legislative history indicates that the provision was intended to prevent loss corporations from engaging in transactions to meet the de minimis threshold (in the case of a NUBIL) or avoid the de minimis threshold (in the case of a NUBIG). H. Rep. 100-795 (1988); S. Rep. 100-445, p. 48 (1988). The de minimis threshold for a NUBIG or NUBIL is described below.

As previously-described, capital contributions with a tainted principal purpose are not taken into account in determining stock value for section 382 limitation purposes. The statute says that such a capital contribution is not taken into account for purposes of section 382, without limiting the application to the determination of base annual section 382 limitation. IRC § 382(l)(1)(A). It is possible that this rule also

applies for purposes of computing the amount of any NUBIG and NUBIL. If the rule does apply, it would appear that any gain or loss attributable to capital contributions of property with a tainted principal purpose are not taken into account in determining NUBIG or NUBIL.

Threshold. The amount of any NUBIG or NUBIL is zero if the amount is below a certain threshold. Where the amount is below the threshold, generally neither the NUBIG rule nor the NUBIL rule applies. The threshold amount equals the lesser of (i) \$10 million, or (ii) 15% of the fair market value of the assets (determined immediately before the ownership change and with adjustments described in the next paragraph). IRC § 382(h)(3)(B)(i). For example, if a loss corporation has assets with a fair market value of \$40 million and basis of \$35 million, the threshold amount would be \$6 million (\$40 million multiplied by 15%). Since the NUBIG (before the threshold amount) is below the threshold amount (\$5 million), the NUBIG is zero.

In determining the amount of NUBIG or NUBIL under the threshold requirement, certain items are not taken into account. These items include any (i) cash, (ii) cash item, and (iii) marketable security where the value and adjusted basis do not substantially differ from each other. The Treasury Department has regulatory authority to allow or require taxpayers to take certain of these items into account. IRC § 382(h)(3)(B)(ii). The Blue Book indicates that the term “cash item” has the same meaning as it does under section 368(a)(2)(F)(iv) (investment company reorganizations). Blue Book, p. 320.

There is an exception from the threshold requirement for section 338 elections that are made in connection with an ownership change. In such case, the threshold requirement will not apply for purposes of determining the amount of a NUBIG (but not a NUBIL). If this rule applies, only RBIGs that occur by reason of the section 338 election are taken into account in determining the increase in the section 382 limitation. The amount of the increase in the section 382 limitation cannot exceed the amount of the NUBIG (computed without regard to the threshold requirement). IRC § 382(h)(1)(C). The discussion of the section 338 rule in this paragraph is a simplified version of a complicated rule. Due to changes in the option attribution rule and the reduction in the threshold amount, this rule rarely applies these days.

Loss corporations with a potential NUBIL may want to try to avoid it by reducing the amount below the threshold. This type of planning would make sense if the amount would otherwise be slightly above the threshold limit or the base annual section 382 limitation is zero or a de minimis amount. One obvious idea would be to dispose of (or write-off) built-in loss assets before the change date. Loss corporations potentially have the ability to take allowable write-off deductions (e.g., bad debts, worthlessness, obsolescence.) before the change date to reduce the amount of the NUBIL. IRC §§ 165, 166; Treas. Reg. §§ 1.165-2, 1.167(a)-9. (It should be noted that the disaster loss rules allow for a deduction in the taxable year before the occurrence of a federally declared disaster. IRC § 165(i).)

Practitioners might also want to investigate whether it is possible to disavow or waive the amount of basis of an asset or a potential built-in deduction. The provisions of the Code and regulations regarding adjusted basis are generally mechanical in nature. *See* IRC §§ 1011-23. While some provisions require interpretation or analysis of facts (such as the determination of fair market value), there does not appear to be language that suggests a taxpayer can choose to ignore basis. Writing adjusted basis down or off may be the extent of the non-transactional planning that is available to reduce basis for NUBIL purposes.

There appear to be better positions available with respect to deductions than there are with respect to adjusted basis. The Supreme Court has said that “an income tax deduction is a matter of legislative grace and . . . the burden of clearly showing the right to the claimed deduction is on the taxpayer.” *INDOPCO v. Comm’r*, 503 US 79, 84 (1992) (internal citations omitted)).

Taxpayers are only permitted “deductions that are allowed” by chapter 1 of subtitle A of the Code (normal taxes and surtaxes). IRC § 63(a). Items specified in sections 162 through 250 are allowed as deductions, but subject to limitations. IRC §§ 161, 211, 241. Most, but not all, of the provisions authorizing deduction use the language “shall be allowed as a deduction.” There is no similar “allowance” requirement for gross income. (It should be noted that the language used to specify that a deduction is available is not always uniform.)

The IRS dealt with taking an intentionally reduced deduction in Revenue Ruling 67-460, 1967-2 CB 123, in which a taxpayer reported a charitable contribution deduction of \$400, instead of the \$1 thousand the shareholder was entitled to. Taking the smaller amount would have allowed the taxpayer to avoid the 10% of taxable income limit (in effect at the time). The ruling concludes that a taxpayer must take into account the full amount of the charitable contribution in determining taxable income. *See also* Rev. Rul. 56-407, 1956-2 CB 564 (all deductions must be taken in computing self-employment income); CCA 200022051 (Apr. 6, 2000) (same); TAM 7917002 (Nov. 21, 1978) (failure to deduct interest to reduce AMT); GCM 33522 (May 24, 1967) (background memo for Revenue Ruling 67-460). *But see* PLR 8504003 (Sept. 5, 1984) (capital gain deduction could be avoided to reduce AMT).

The above cited rulings did not deal with a fact pattern in which a taxpayer intentionally refused to substantiate the deduction or meet the record-keeping requirements. IRC § 6001; Treas. Reg. § 1.6001-1(a). There certainly are provisions where a failure to substantiate the deduction prevents the deduction from being allowed. E.g., IRC §§ 170 (charitable contributions), 274 (meals and entertainment). For other deductions it may be a challenge to convince the IRS or a court that the deduction should be disallowed based solely on a failure to substantiate or maintain records.

It should be noted that the BEAT regulations permit taxpayers to permanently waive a deduction to avoid being subject to BEAT in a taxable year. This is only permitted for that limited purpose and in an amount that is reasonable. Treas. Reg. § 1.59A-3(c)(6)(i); TD 9910, 85 Fed. Reg. 64346, 64350. As a result, it is doubtful that it would be a useful tool in avoiding a NUBIL.

Foreign Loss Corporation. There is some uncertainty as to how to determine the amount of NUBIG or NUBIL of a foreign corporation. For purposes of determining the base annual section 382 limit of a foreign corporation, only assets and liabilities that are effectively connected with a US trade or business are taken into account. IRC § 382(e)(3). There is no equivalent rule that limits the computation of NUBIG and NUBIL to assets that are effectively connected with a US trade or business. Thus, it would appear that NUBIG or NUBIL is computed by taking into account the fair market value and US tax basis of the worldwide assets of a foreign corporation that undergoes an ownership change. CCA 200238025 (June 14, 2002); 1997 FSA Lexis 17. It should be noted that determining the US tax basis of the assets of a foreign corporation can be a daunting task.

Balance Limitation. Determining the amount of NUBIG or NUBIL is relevant for purposes of determining which rule applies, if any (NUBIG, NUBIL, or neither). In addition, the computation is necessary to determine the amount of the remaining NUBIG or NUBIL balance limitation.

The starting point for the remaining NUBIG or NUBIL balance is the amount of the NUBIG or NUBIL, as appropriate. The remaining balance is then adjusted at the end of every taxable year that is within the recognition period, by the amount of RBIG or RBIL recognized during such year, as appropriate, that is taken into account during the taxable year. IRC § 382(h)(1)(A)(ii), (B)(ii).

Notice 2003-65

If a loss corporation adopts either the section 338 or 1374 approach, the amount of NUBIG or NUBIL is determined based upon the rules described in section 1.1374-3(a) of the Treasury regulations. Notice 2003-65, §§ III.A, IV.A. The amount of NUBIG and NUBIL generally equals the net gain or loss that would be recognized on a hypothetical sale of assets to an unrelated party immediately before the ownership change.

Section 1.1374-3(a) provides for a formula for determining the amount of NUBIG or NUBIL. The amount of NUBIG or NUBIL (before application of the threshold requirement) equals (i) the amount realized from a hypothetical asset sale, less (ii) deductible liabilities, less (iii) the adjusted basis of the loss corporation's assets, adjusted by (iv) section 481 adjustments that would be taken into account in the hypothetical asset sale, and increased by (v) any RBIL that would be disallowed under section 382, 383, or 384 as a deduction in the hypothetical asset sale. Treas. Reg. § 1.1374-3(a).

The above formula is applied on the basis that the loss corporation sold all of its assets to an unrelated third party immediately before the ownership change. The amount realized from the hypothetical asset sale is based on a sale of assets (including goodwill) for fair market value. The buyer is treated as assuming all of the liabilities of the loss corporation in the sale. Notice 2003-65, § III.A; Treas. Reg. § 1.1374-3(a)(1).

For purposes of the section 338 approach, contingent liabilities are taken into account in determining the hypothetical amount realized based on the estimated liability immediately before the ownership change. The hypothetical amount realized is not readjusted to reflect changes in estimate or settlement. Notice 2003-65, § IV.A. The notice is silent as to the treatment contingent liabilities under the section 1374 approach.

Although there is some uncertainty as to the computation of the hypothetical amount realized in the context of an insolvent loss corporation, in an actual asset sale of underwater assets the amount realized generally equals the amount of liabilities assumed. Treas. Reg. § 1.1001-2(a)(1), (4)(ii), (b), (c) Ex. (1). As a result, it appears that the hypothetical amount realized equals the full amount of liabilities assumed and is not limited to the fair market value of the assets. Essentially, taking into account the full amount of liabilities allows taxpayers to take into account "built-in" COD income in determining NUBIG or NUBIL.

Notice 2003-65 does not explicitly state whether built-in COD income affects the computation of NUBIG or NUBIL. However, the notice does cryptically state that the reduction in basis under section 1017 does not affect the amount of NUBIG or NUBIL. Notice 2003-65, §§ III.B.2.b, IV.D. This could simply mean that adjusted basis is taken into account for NUBIG or NUBIL purposes without taking into account future adjustments under section 1017.

In Private Letter Ruling 201051019 (Sept. 14, 2010), the IRS ruled that a corporation that was in bankruptcy (and presumably insolvent) could take into account all of the liabilities that existed immediately before the ownership change in determining the hypothetical amount realized. For this purpose, the amount of the liabilities was determined based upon their adjusted issue price. The IRS confirmed this result even if the pre-change liabilities were subsequently discharged, in whole or in part, during the recognition period (including the change date). PLR 201051019. Subsequent to issuing Private Letter Ruling 201051019, government representatives have expressed doubt (from a policy standpoint) about taking into account built-in COD income (that is subsequently excluded) in determining NUBIG or NUBIL.

There is uncertainty under the notice as to the effect of excluded COD income on the remaining NUBIG or NUBIL balance. It is possible that the remaining balance should be adjusted to the extent of the exclusion. The section 108 exclusion and attribute reduction rules were intended to generally provide the same effect on tax attributes as if there was no exclusion. That is, the exclusion was intended to avoid a tax liability

(but not intended to result in a windfall with respect to tax attributes). S. Rep. 96-1035, p. 10 (1980) (“Congressional intent of deferring, but eventually collecting tax on, ordinary income realized from debt discharge”). If a loss corporation has taxable COD income in conjunction with the ownership change, the COD income would generally be taken into account for NUBIG purposes and would be treated as an RBIG. Treating the COD income as an RBIG would reduce the remaining NUBIG balance. If the same taxpayer excludes the COD income, the COD income would not be treated as an RBIG. As a result, a reduction in the remaining NUBIG balance may be required to avoid granting a taxpayer that excludes the income an unjustified benefit.

As an example of the concepts described in the above paragraph, assume that a loss corporation realizes COD income of \$10 million on the change date. Before the change date, the loss corporation had an NOL carryforward of \$15 million and a NUBIG of \$13 million (taking into account the COD income). If the COD income is taxable, the corporation would have an RBIG of \$10 million. This allows the taxpayer to offset the COD income against an NOL deduction of \$10 million, leaving a \$5 million NOL carryforward and a remaining NUBIG balance of \$3 million (\$13 million less \$10 million). If the COD income is excluded, then the NOL would be reduced to \$5 million under the attribute reduction rules (same as in the taxable scenario). But absent an adjustment, the remaining NUBIG balance would equal \$13 million (\$10 million greater than in the taxable scenario). As a result, a \$10 million adjustment to the remaining NUBIG balance may be necessary to avoid an unwarranted result. Such an adjustment does not appear to be required if the taxpayer reduces asset basis under section 1017 (instead of carryforwards). Notice 2003-65, §§ III.B.2.b, IV.D (NUBIG and NUBIL are not adjusted by basis reduction).

In determining the amount of NUBIG or NUBIL, there is an adjustment for deductible liabilities. This category takes into account liabilities that are included in the hypothetical amount realized to the extent a deduction would be allowed when the liability is paid. Treas. Reg. § 1.1374-3(a)(2). For example, damages for tort liabilities are not deductible until paid. IRC § 461(h)(2)(C). As a result, to the extent damages for such liabilities are taken into account in determining hypothetical amount realized they are reversed out as a deductible liability in the calculation of NUBIG or NUBIL. The IRS has taken the position that a liability for prepaid income (deferred revenue) is a deductible liability. CCA 201629007 (Feb. 29, 2016).

Under the section 338 approach, contingent liabilities are taken into account in determining the hypothetical amount realized based on the estimated liability immediately before the ownership change. It would appear that any adjustment for deductible liabilities should be limited to the amount taken into account for amount realized purposes.

Any RBIL that would result in a disallowed (or deferred) deduction in the hypothetical asset sale under section 382, 383, or 384 is a positive adjustment in the formula. Treas. Reg. § 1.1374-3(a)(5). It appears that this rule applies to ownership changes (and acquisitions subject to section 384) that occurred prior to the ownership change for which the computation is being performed. For example, if a loss corporation had two ownership changes within five years of each other and had a NUBIL with respect to the first ownership change, the loss corporation may be able to reduce the NUBIL on the second ownership change (or increase a NUBIG) by losses and deductions that would be deferred under section 382 in a hypothetical asset sale.

Notice 2003-65 Example. Lossco undergoes an ownership change. Immediately before the ownership change, Lossco had assets with a fair market value of \$100 million and adjusted basis of \$10 million. Lossco had total liabilities of \$60 million, \$30 million of which related to a tort claim for which a deduction had not yet been taken. The hypothetical amount realized equals \$100 million (the fair market value of the assets). The amount is reduced by the sum of the adjusted basis of the assets (\$10 million) and the deductible liabilities (\$30 million). As a result, Lossco has a NUBIG of \$60 million. Notice 2003-65, Ex. 1.

Other examples of how NUBIG and NUBIL are computed under the section 338 and 1374 approaches can be found in Examples 2 and 10 of Notice 2003-65.

Proposed Section 382(h) Regulations

Under the proposed rules, the amount of NUBIG and NUBIL generally equals the net gain or loss that would be recognized on a hypothetical sale of assets to an unrelated party immediately before the ownership change. A NUBIG is the positive amount of the calculation and a NUBIL is a negative amount of the calculation. Prop. Reg. §§ 1.382-2(a)(9), (10), -7(c)(3).

The proposed section 382(h) regulations provides for a formula for determining the amount of NUBIG or NUBIL. The amount of NUBIG or NUBIL (before application of the threshold requirement) equals:

- the amount realized from a hypothetical asset sale,
- decreased by the aggregate adjusted basis of the loss corporation's assets,
- decreased by the amount of any deductible liability of the loss corporation,
- increased or decreased by any section 481 adjustments,
- increased or decreased by built-in income and deduction items, and
- increased by COD income that is taken into account in the first year of the recognition period (if certain requirements are met).

Prop. Reg. § 1.382-7(c)(3)(i). Each of these items needs a longer explanation.

If a loss corporation enters or leaves a consolidated group on the change date, the principles of section 1.1502-76(b) of the Treasury regulations applies for purposes of determining the treatment of any income, gain, deduction or loss under the proposed section 382(h) rules. Section 1.1502-76 provides for rules where a member enters or leaves a consolidated group in the middle of the group's taxable year. Items that are includible in the taxable year that ends on the change date (due to the end of the day rule), are not treated as recognized or taken into account during the recognition period. Treas. Reg. 1.1502-28(b)(11). As a result, such items are not taken into account for purposes of computing NUBIG or NUBIL. In dealing with these provisions, the anomalous treatment of the change date should be taken into account.

One example of the application of this timing rule with respect to consolidated groups, is for COD income that is taxable in the taxable year ending on the change date. Such income is not taken into account in the determination of NUBIG or NUBIL. Another example, is an asset that is disposed of on the change date and gain or loss is includable in the taxable year ending on the change date. Such gain or loss is not taken into account in the determination of NUBIG or NUBIL. Prop. Reg. § 1.382-7(c)(2)(ii).

The proposed rules provide for an anti-duplication rule. Appropriate adjustments are required to be made to the computation of NUBIG and NUBIL so that no item of economic gain or loss is duplicated. Prop. Reg. § 1.382-7(e)(1).

The proposed rules require consistency with the change year allocation rules of section 1.382-6 of the Treasury regulations. An amount is not included in the calculation of NUBIG or NUBIL if the amount is properly allocable to the pre-change period and included in the determination of the loss corporation's taxable income or NOL for the change year. Prop. Reg. § 1.382-7(c)(2)(i).

It should be noted that for purposes of the change year allocation rules, the change date is part of the pre-change period under general section 382 rules but is part of the post-change period (i.e., included in the

recognition period) for RBIG and RBIL purposes. As a result, the answer as to which period an item ends up could change depending upon whether it is an RBIG or RBIL or not.

Hypothetical Amount Realized. Like Notice 2003-65, the formula under the proposed rules starts with the amount realized from a hypothetical asset sale. The loss corporation is treated as having sold all of its “section 382 assets” at fair market value to an unrelated third party. Unlike Notice 2003-65, the hypothetical buyer is generally treated as not assuming any liabilities of the loss corporation.

The hypothetical amount realized is subject to the limitations of section 382(h)(8). Prop. Reg. § 1.382-7(c)(3)(i)(A). Section 382(h)(8) generally limits the amount realized in certain circumstances (for NUBIL purposes only) and is discussed in more detail above. The proposed rules do not provide for rules for the application of section 382(h)(8).

For purposes of determining the amount of the hypothetical amount realized, only the fair market value of “section 382 assets” are taken into account. Prop. Reg. § 1.382-7(c)(3)(i)(A)(2). A section 382 asset is an asset that was owned by the loss corporation immediately before the ownership change. It specifically includes goodwill and other intangible assets. Prop. Reg. § 1.382-7(b)(10).

Assets described in section 382(h)(3)(B)(ii) are not treated as section 382 assets. These items include (i) cash and cash items, and (ii) marketable securities for which the value does not substantially differ from adjusted basis. IRC § 382(h)(3)(B)(ii). The proposed rules treat all accounts receivables, that were not acquired in the ordinary course of business, as an item described in section 382(h)(3)(B)(ii). Prop. Reg. § 1.382-7(b)(10). These assets are not taken into account for determining either amount realized or basis. As a result, any built-in gain or loss attributable to section 382(h)(3)(B)(ii) assets does not affect the computation of NUBIG or NUBIL.

For purposes of determining the amount realized with respect to inventory, the fair market value immediately before the ownership change is determined based upon the “amount that a willing buyer would pay a willing seller for the inventory in a purchase of all the [loss] corporation’s assets by a buyer that expects to continue to operate the [loss] corporation’s business.” Treas. Reg. § 1.1374-7(a). For this purpose, there is a presumption that (i) the buyer and seller are not under any compulsion to buy or sell, and (ii) both have reasonable knowledge of all of the relevant facts. *Id.*; Prop. Reg. § 1.382-7(c)(3)(iii)(B), (e)(2). This generally means that inventory is valued based on a bulk sale of the inventory. In many cases, this will result in a discount over the value of the inventory on a piece-by-piece basis. Revenue Procedure 2003-51, 2003-2 CB 121, provides guidelines for the use of taxpayers and the IRS in valuing inventory in an asset sale or a section 338 transaction. Presumably, this guidance would be useful for purposes of determining NUBIG or NUBIL.

Assets that are secured by nonrecourse liabilities receive special treatment if the liability is “inadequately secured.” In such case, the amount realized takes into account the amount of the debt (instead of the fair market value of the assets). Treas. Reg. § 1.1001-2(a)(1), (4)(1), (c) Ex. (2); Prop. Reg. § 1.382-7(c)(3)(i)(A)(1). A nonrecourse liability is considered to be inadequately secured if the adjusted issue price of the debt exceeds the fair market value of the assets that secure the liability (computed as if the assets were not secured by a nonrecourse liability). Prop. Reg. § 1.382-7(b)(5).

A nonrecourse liability is defined to have the same meaning as that term has in section 1.1001-2(a)(4)(i) of the Treasury regulations. Prop. Reg. § 1.382-7(b)(7). Section 1.1001-2(a)(4)(i) does not have a definition of nonrecourse liabilities. Examples in section 1.1001-2 apply a test based on whether the taxpayer has personal liability or not. Treas. Reg. § 1.1001-2(c). As a result, a nonrecourse liability would appear to include (i) a liability where the terms limit recourse to an asset or a pool of assets, (ii) a liability incurred

by a disregarded entity (that is wholly-owned by the taxpayer), PLR 201644018 (July 28, 2016) (ruling 11), and (iii) a liability incurred by partnership if the taxpayer is a limited partner or has limited liability. However, there is a multitude of situations where the law is not very well developed, e.g., the impact of guarantees on the analysis.

As an example of the application of the nonrecourse rules, assume that a disregarded LLC has assets with a fair market value of \$600 thousand and liabilities of \$1 million. If the loss corporation has no personal liability for the obligations of the LLC, the amount realized with respect to the assets would equal \$1 million (the amount of the nonrecourse debt). Prop. Reg. § 1.382-7(f)(3) Ex. 3. However, if those assets had a value of \$1.1 million, the nonrecourse liabilities would not be considered inadequately secured and the amount realized would take into account the fair market value of the assets (\$1.1 million).

In certain cases, the discharge of a nonrecourse liability in the first year of the recognition period can be treated as an RBIG. Prop. Reg. § 1.382-7(d)(2)(iv). The amount of NUBIG or NUBIL is not adjusted to reflect RBIG treatment. Prop. Reg. § 1.382-7(d)(2)(iv)(D).

The treatment of liabilities for purposes of determining hypothetical amount realized is a major difference between the treatment under the proposed rules and Notice 2003-65. The notice takes into account all liabilities and the proposed rules only take into account nonrecourse liabilities (and only if they are inadequately secured).

Aggregate Adjusted Basis. The computation of the aggregate adjusted basis of the assets is determined by taking into account the sum of the adjusted basis of all of the assets owned by the loss corporation immediately before the ownership change. Assets described in section 382(h)(3)(B)(ii) (cash and cash items and certain receivables) are not taken into account for purposes of computing the aggregate adjusted basis. This is similar to the treatment of such assets for purposes of computing the hypothetical amount realized. Prop. Reg. § 1.382-7(b)(10), (c)(3)(i)(B).

If a loss corporation realizes COD income in the first year of the recognition period with respect to recourse liabilities, the aggregate adjusted basis is subject to reduction if the COD income is excluded under section 108 (e.g., under the bankruptcy or insolvency exceptions). The aggregate adjusted basis is reduced to the extent the basis of the loss corporation's section 382 assets are reduced under section 1017 pursuant to the attribute reduction rules. The amount of COD income is not treated as an RBIG. Prop. Reg. § 1.382-7(c)(3)(ii)(B)(iii). No similar adjustment is required with respect to assets that are subject to nonrecourse liabilities. Prop. Reg. § 1.382-7(f)(3) Ex. 3(ii)(B). Since the adjustment only applies to section 382 assets, the adjustment does not appear to apply to the reduction in basis of assets acquired after the ownership change but in the change year.

The basis of assets is adjusted, immediately before an ownership change, by the amount of any adjustment that would apply if the section 382 assets were sold immediately before the ownership change. As an example, if a loss corporation owns a partnership interest, the basis could be adjusted under section 1.163(j)-6(h)(3)(i) of the Treasury regulations if the loss corporation disposes of its partnership interests. Prop. Reg. § 1.382-7(c)(3)(iii)(E), (f)(5) Ex. 5.

Deductible Liabilities. In determining the amount of NUBIG or NUBIL, there is an adjustment for deductible liabilities. This category takes into account the portion of any liability (which exists immediately before the ownership change) if the loss corporation would be allowed a deduction upon payment of the liability (or payment or accrual after removal of a contingency, if the liability is contingent). Prop. Reg. § 1.382-7(c)(3)(i)(C), (D).

In determining the amount that is deductible, certain limitations are ignored. The ignored limitations are (i) the capital loss limitation of section 1211(a), (ii) taxable income limitations, and (iii) timing limitations. Prop. Reg. § 1.382-7(c)(3)(i)(C), (D). A taxable income limitation is a limitation set forth in the Code that is based on, or derived from, the amount of the loss corporation's taxable income (e.g., charitable contribution deductions). Prop. Reg. § 1.382-7(b)(12)(i). A timing limitation is a limitation set forth in the Code that defers the timing of a deduction (e.g., payments to related persons under section 267(a)(2) and the passive activity loss rules of section 469). Prop. Reg. § 1.382-7(b)(12)(ii).

The adjustment for deductible liabilities can create a potential anomaly for prepaid income. Prepaid income is not treated as an RBIG or as an adjustment to NUBIG or NUBIL. Treas. Reg. § 1.382-7(a); Prop. Reg. § 1.382-7(d)(2)(vi). However, the cost of fulfilling the contract could be treated as a deductible liability. CCA 201629007 (Feb. 29, 2016). This appears to result in a net negative adjustment to the amount of NUBIG or NUBIL. The IRS is aware of this anomaly with respect to prepaid income. We understand that they intend to fix the issue when the regulations are finalized.

As an example of how prepaid income is treated under the proposed regulations, assume a loss corporation received \$100 million before an ownership change as an advance payment of services to be performed after the ownership change date. If the cost of fulfillment was \$60 million, it appears possible that the amount of NUBIG or NUBIL would be reduced by \$60 million. The \$100 million of income would not be treated by the proposed rules as an adjustment.

Notice 2003-65 also had an adjustment for deductible liabilities. However, Notice 2003-65 also took into account the amount of liabilities for purposes of computing the hypothetical amount realized. So for an insolvent loss corporation, the deductible liabilities did not cause a net negative adjustment. Under the proposed rules, recourse liabilities are not taken into account in determining NUBIG or NUBIL and the deductible liability adjustment can cause a net negative adjustment.

Notice 2003-65 did not treat an item as a deductible liability if the deduction would have been disallowed (or limited) in a hypothetical asset sale by section 382, 383, or 384. (Technically, Notice 2003-65 treated the item as a deductible liability and then reversed out the amount, resulting in a net of zero.) Treas. Reg. § 1.1374-3(a)(5). The proposed rules do not adopt this rule. In any case, these provisions would generally be a timing limitation. However, there might be uncertainty as to whether section 382 is still a timing limitation when the limit is deemed to be zero (e.g., the COBE rule of section 382(c) is violated).

The determination of the amount of a deductible liability depends on whether the liability is a contingent or a non-contingent liability. The proposed rules do not define either term. However, a liability is treated as a contingent liability if it is contingent immediately before the ownership change. Prop. Reg. § 1.382-7(c)(3)(i)(D). Presumably, a non-contingent liability is any liability that is not a contingent liability.

For a non-contingent liability, the amount of the deductible liability is the amount of the deduction that would be allowed at the time of payment. Prop. Reg. § 1.382-7(c)(3)(i)(C). For a contingent liability, the amount of the deductible liability is the amount of the deduction that would be allowed at the time of accrual or payment (and after the contingency is removed). However, only the estimated value of the liability immediately before the ownership change is taken into account in determining the amount that is a deductible liability. Prop. Reg. § 1.382-7(c)(3)(i)(D).

In determining the amount of a deductible liability (whether contingent or non-contingent), potential deductions for capital losses are taken into account. In addition, the deductible amount is determined without regard to any taxable income or timing limitation. As a result, the possibility that the deduction

may not be allowed (or deferred) as result of a capital loss, taxable income, or timing limitation is ignored. Prop. Reg. § 1.382-7(c)(3)(i)(C), (D).

If a contingent liability is reflected on the face of the most recently issued financial statements, then the estimated value of the contingent liability is the amount reflected on such financial statements. The estimated value is not adjusted later to reflect the actual amount of the liability when the contingency is removed. This rule only applies to financial statements that are “applicable financial statements,” within the meaning of section 451(b)(3) (and the applicable regulations). For this purpose, the ordering rules in section 451(b)(3) that give precedent to one type of statement over another are ignored. Prop. Reg. § 1.382-7(c)(3)(iii)(A). The proposed regulations are silent as to what happens if there are two applicable financial statements that are issued simultaneously and both show different liabilities. The proposed regulations are also silent as to whether a loss corporation can rely on the amount shown on a financial statement that does not qualify as an applicable financial statement.

It is possible that an item could be treated as a deductible liability, as well as a built-in deduction item. Notwithstanding this possibility, it does not appear that the items are intended to be double counted. Prop. Reg. § 1.382-7(e)(1).

Section 481 Adjustments. The NUBIG or NUBIL amount is adjusted by any section 481 adjustments that would have been taken into account in a hypothetical asset sale. Prop. Reg. § 1.382-7(c)(3)(i)(E). As a result, if a loss corporation changes an account method before an ownership change, the future unrealized section 481 adjustments are taken into account.

Built-in Income and Deductions Items. There is also an adjustment for built-in income and deduction items. This takes into account all items that would have been taken into account as an RBIG or RBIL, as the case may be, if they were properly taken into account during the recognition period. Prop. Reg. § 1.382-7(c)(3)(i)(F), (G). It appears that both built-in income and deduction items are taken into account regardless of whether the loss corporation has a NUBIG or NUBIL (even though a built-in income item would not be treated as an RBIG if the loss corporation had a NUBIL, and vice versa). The amount of built-in income and deduction items (for NUBIG and NUBIL purposes) do not take into account any hypothetical gain or loss from the disposition of an asset. Prop. Reg. § 1.382-7(c)(3)(i)(F), (G), (d)(2)(ii), (3)(ii).

Notice 2003-65 did not generally provide for an adjustment for built-in income and deduction items. Such an adjustment appears to be required by statute. IRC § 382(h)(6)(C). As a result, a loss corporation with significant net built-in income items might want to choose the proposed rules over Notice 2003-65.

COD Income. Generally, built-in COD income is not treated as a built-in income item or as an adjustment to the computation of NUBIG or NUBIL (other than the adjustment for nonrecourse liabilities and for basis reductions described above). Prop. Reg. § 1.382-7(c)(3)(ii)(A). However, a loss corporation is permitted (but not required) to treat certain COD income that is taken into account in the first year of the recognition period as an adjustment to NUBIG or NUBIL. Taxpayers can use these provisions to switch from a NUBIL to a NUBIG (or to meet the de minimis exception to having a NUBIG or NUBIL). Prop. Reg. § 1.382-7(c)(3)(ii)(B). It appears that if a loss corporation chooses to take into account COD income that is realized in the first year, it must take into account all of its COD income realized in the first year of the recognition period. Prop. Reg. § 1.382-7(c)(3)(iii)(D).

COD income that is taken into account during the first twelve months of the recognition period is eligible for an adjustment to the amount of NUBIG or NUBIL if the income relates to the cancellation of a recourse liability. To be eligible, the COD income must generally be included in gross income (i.e., not eligible for exclusion). This amount is also generally treated as an RBIG. Prop. Reg. § 1.382-7(b)(4), (c)(3)(ii)(B)(1).

Even if the COD income is realized after the change date, the adjustment is made in its entirety as of the change date. Prop. Reg. § 1.382-7(c)(3)(iii)(D). For COD income that is realized after the change year, this could require the loss corporation to amend the change year return to reflect the change in the amount of NUBIG or NUBIL.

In certain cases, COD that is realized but excluded under section 108(a) can be eligible for adjustment if it is taken into account during the first twelve months of the recognition period. This will be the case to the extent that the attribute reduction rules of sections 108(b) and 1017 reduce tax attributes that are not subject to limitation by section 382 or 383. Under current law there appear to be only two such attributes, (i) passive activity loss and credit carry forwards, and (ii) basis of assets. IRC § 108(b)(2); Treas. Reg. § 1.382-2(a)(2).

The reduction in basis of assets is only taken into account as an attribute that is not subject to section 382 or 383 if the assets were not held at the time of the ownership change. Prop. Reg. § 1.382-7(c)(3)(ii)(B)(2). This relates to the fact that the basis of assets is not reduced under section 1017 until the first day of the taxable year following the realization of excluded COD income. IRC § 1017(a). As a result, an asset that is acquired after the change date is not subject to the RBIL rules but could be subject to attribute reduction. The proposed rules could have also allowed for costs that are capitalized after the change date under the same principal, but did not. Prop. Reg. § 1.382-7(c)(3)(ii)(B)(2) (no adjustment for COD income that results in a reduction in basis of assets held at the time of the ownership change).

The adjustment for COD income is limited. If the loss corporation is under the jurisdiction of a bankruptcy court on the change date (in an action that results in the discharge of recourse liabilities), then the limitation equals the amount of all of loss corporation's recourse liabilities (immediately before the ownership change) that are discharged by order of the court in that action. Prop. Reg. § 1.382-7(b)(4), (8)(i), (c)(3)(iii)(C).

The limitation computation for non-bankrupt entities is more complicated. In such cases, the limitation generally equals the excess, if any, (computed immediately before the ownership change) of (i) the aggregate adjusted issue price of the loss corporation's recourse liabilities, over (ii) the sum of the fair market value of the assets of the loss corporation. This excess generally equals the amount by which the loss corporation was insolvent immediately before the ownership change.

For purposes of computing the amount of liabilities in the formula described in the above paragraph, recourse liabilities are not taken into account if they would not be treated as a liability for purposes of the insolvency exception of section 108(a)(1)(B). Nonrecourse liabilities are also not taken into account as a liability under this formula (since they are already taken into account). In addition, the fair market value of the assets are reduced (but not below zero) by any nonrecourse liability that secures the assets (immediately before the ownership change). Prop. Reg. § 1.382-7(b)(4), (8)(ii), (c)(3)(iii)(C).

COD Income Adjustment Example. As an example of how these rules work, assume that a loss corporation had recourse liabilities of \$60 million and nonrecourse liabilities of \$180 million (immediately before an ownership change). The loss corporation has assets with a fair market value of \$200 million (all subject to the nonrecourse liabilities). In the first year of the recognition period (and during the change year), the loss corporation realizes COD income of \$20 million, which is excluded under the insolvency exception. The loss corporation elects to reduce the basis of assets by \$20 million. If, under the section 1017 ordering rules, only the basis of assets acquired after the change date are reduced, the limitation on the adjustment would be \$40 million (recourse liabilities of \$60 million, less fair market value of assets of \$20 million (\$200 million less nonrecourse liabilities of \$180 million)). Since the amount of COD income is below the limit, the entire amount of \$20 million qualifies for the elective adjustment. *See* Prop. Reg. § 1.382-7(f)(3) Ex. 3(ii)(B).

The proposed rules provide procedural requirements in order for a loss corporation to choose to take into account COD income that is realized in the first year of the recognition period. The loss corporation is required to reflect any adjustments for COD income on the section 382 statement for the change year. If some of the COD income is realized in a taxable year that is after the change year, the loss corporation is required to amend the return to reflect the change and to amend the section 382 statement. Prop. Reg. § 1.382-7(c)(3)(iii)(D).

There is uncertainty as to how this procedural requirement is to be applied. The section 382 statement that is required by section 1.382-11 of the Treasury regulations only requires a disclosure that an ownership change has occurred and requires a listing of tax attributes that are subject to sections 382 and 383. For a loss corporation with a NUBIL, presumably the amount of the disclosed NUBIL would be reflected on the revised statement (taking into account the adjustment for COD income). However, a loss corporation with a NUBIG is not required to disclose the amount of the NUBIG (or the fact that a NUBIG exists). There is uncertainty as to how the adjustment would be reflected on the revised statement if the adjustment only affects the amount of the NUBIG.

Under the anti-duplication rules of the proposed rules, appropriate adjustments must be made to ensure that the limitations on the total amount of adjustments to NUBIG or NUBIL take into account the amount of COD income that is excluded under section 108(a) and reduce the basis of the loss corporation's assets. Prop. Reg. § 1.382-7(e)(1).

NUBIG/NUBIL Example. Lossco experienced an ownership change. Immediately before the ownership change, Lossco had (i) section 382 assets with a fair market value of \$100 million and a basis of \$90 million, (ii) a fixed liability of \$30 million for which a deduction would be allowed upon payment, and (iii) a contingent liability with an estimated amount of \$20 million which would be deductible upon removal of the contingency and payment. In such case, the NUBIL for Lossco would be \$40 million (\$100 million less the sum of \$90 million, \$30 million, and \$20 million). Prop. Reg. § 1.382-7(f)(1) Ex. 1. This answer would generally have been the same under Notice 2003-65 (ignoring the uncertainty as to how to handle contingent liabilities under the section 1374 approach).

D. RBIG and RBIL

The determination of the amount of RBIG and RBIL is relevant for the application of the NUBIG and the NUBIL rules. However, RBIGs are only relevant to the NUBIG rule and RBILs are only relevant to the NUBIL rule.

An RBIG is a gain that is recognized during the recognition period on the disposition of an asset that was held by the old loss corporation immediately before the change date. IRC § 382(h)(2)(A)(i). The amount of the RBIG with respect to the disposition is limited to the unrealized built-in gain (UBIG). The UBIG equals the excess of the fair market value of the asset over its adjusted basis. The UBIG is determined as of the change date. IRC § 382(h)(2)(A)(ii). If the gain recognized is less than the amount of the UBIG, the entire gain is an RBIG. If the asset had an unrealized built-in loss (UBIL) (as defined below), then none of the gain is considered an RBIG.

Under the NUBIG rule, a loss corporation that takes the position that some or all of a gain is an RBIG has the burden of establishing (i) that the asset was held immediately before the change date, and (ii) the amount of the UBIG. IRC § 382(h)(2)(A); Notice 2003-65, § II. It appears that any recognition period gain not meeting this substantiation requirement is not treated as an RBIG.

An RBIL is a loss that is recognized during the recognition period on the disposition of an asset that was held by the old loss corporation immediately before the change date. IRC § 382(h)(2)(B)(i). The amount of the RBIL with respect to the disposition is limited to the UBIL. The UBIL equals the excess of the adjusted basis of the asset over its fair market value. The UBIL is determined as of the change date. IRC § 382(h)(2)(B)(ii). If the loss recognized is less than the amount of the UBIL, the entire loss is an RBIL. If the asset had a UBIG, then none of the loss is considered to be an RBIL.

Under the NUBIL rule, a loss corporation that takes the position that some or all of a loss recognized during the recognition period is not an RBIL has the burden of establishing (i) that the asset was not held immediately before the change date, or (ii) the amount of the UBIL. IRC § 382(h)(2)(B); Notice 2003-65, § II. It appears that any recognition period loss not meeting this substantiation requirement is treated as an RBIL.

Any depreciation, amortization, or depletion deduction allowed during the recognition period is treated as an RBIL to the extent attributable to a UBIL. A loss corporation has the burden of establishing that any recognition period depreciation, amortization, or depletion deduction should not be treated as an RBIL. IRC § 382(h)(2)(B). It appears that any such deduction not meeting this substantiation requirement is treated as an RBIL.

The Treasury Department has the authority to issue regulations to prescribe rules regarding property held by the loss corporation on the change date that was acquired (or subsequently transferred) in a nonrecognition transaction. IRC § 382(h)(9). Regulations have been promulgated that apply only to members of a consolidated group. Under these regulations, property is treated as having been held by the loss corporation at the beginning of the recognition period if the property's adjusted basis is determined (directly or indirectly), in whole or in part, by reference to the adjusted basis of other property that was held at the beginning of the recognition period. Treas. Reg. § 1.1502-91(h)(4). For example, if the loss corporation holds property with a UBIG at the beginning of the recognition period and subsequently exchanges the property for stock in a section 351 transaction, this regulation permits the loss corporation to treat some or all of the gain on a subsequent sale of the stock as an RBIG. For taxpayers that are not members of a consolidated group, there is uncertainty as to how to apply the NUBIG and NUBIL rules in the absence of regulations.

In Notice 90-27, 1990-1 CB 336, the IRS announced that it intends to issue regulations regarding the correct treatment of installment sales of assets with a UBIG. If the asset is sold either before the ownership change or during the recognition period, such regulations will allow taxpayers to treat the amount of gain taken into account after the end of the recognition period as an RBIG. Notice 90-27. The IRS announced that Notice 90-27 would be withdrawn and made obsolete effective on the day after the proposed section 382(h) regulations become final. REG-125710-18, 84 Fed. Reg. 47455, 47462 (2019).

There is some uncertainty as to whether gain that is recharacterized as ordinary income can be treated as an RBIG. For example, some or all of the gain from the sale or exchange of stock in a CFC can be treated as dividend income pursuant to section 1248. Similarly, some or all of the gain from the disposition of a market discount bond can generally be treated as interest income pursuant to section 1276. It is possible that the ordinary income under sections 1248 and 1276 (and similar provisions) is still treated as gain from the sale or exchange of ordinary property pursuant to section 64.

In Private Letter Ruling 201051020 (Nov. 12, 2009), the IRS ruled that gain that is recharacterized as dividend income pursuant to section 1248 can be treated as an RBIG. The taxpayer represented that it would apply the section 338 approach to the ownership change. It is not clear whether the approach taken by the taxpayer affected the IRS' conclusion.

There is currently uncertainty as to how to apply the section 382 rules with respect to an unabsorbed capital loss deduction (i.e., a capital loss in excess of capital gains that is carried forward for five years) that is an RBIL. An RBIL is defined as “any loss recognized during the recognition period on the disposition of any asset.” IRC § 382(h)(2)(B). This language strongly suggests that a recognized capital loss can be an RBIL even if the loss is carried forward and eventually expires. See NYSBA Section of Taxation, *Report on Prop. Reg. § 1.1502-91(g)(7): Determining Section 382 Net Unrealized Built-in Gain and Loss of a Consolidated Group*, Ex. 10, 2012 TNT 136-82. The applicable regulations provide that only currently allowable amounts that are absorbed (i.e., offset taxable income) are taken into account in applying the limitations of sections 382 and 383. Treas. Reg. § 1.383-1(d)(2), (3)(i), (ii) Ex. (1) (application of limitation on use of business credits). This provision could be applied to delay the treatment of a capital loss as an RBIL until the loss is deductible (i.e., in the year the taxpayer has a capital gain to offset the loss).

It should be noted that if the unabsorbed capital loss is correctly treated as an RBIL, there is a potential for tax-planning (or an abusive transaction, depending upon one’s point of view). A taxpayer could sell or exchange a capital asset to recognize a capital loss just to reduce (or eliminate) the remaining NUBIL balance. For example, if a taxpayer had a capital asset with a UBIL and a depreciable asset with a UBIL, some of the depreciation deductions could be treated as an RBIL. If the taxpayer sold the capital loss asset, the reduction (or elimination) of the remaining NUBIL balance might allow the taxpayer to avoid treating the depreciation deductions as RBILs.

In FAA 20151701F (Feb. 20, 2015), the taxpayer entered into a cost sharing agreement with a foreign subsidiary to develop technology after an ownership change occurred. Under the rules of section 1.482-7T of the temporary Treasury regulations (as then in effect), the taxpayer was entitled to a platform contribution transaction (PCT) payment from the subsidiary. The taxpayer took the position that the PCT payment was an RBIG since it was attributable to the period before the change date. The IRS disagreed with treatment as an RBIG based on facts missing from the record and the possibility that the taxpayer’s section 382 and 482 treatments were inconsistent.

The statutory language suggests that the determination of RBIG, RBIL, UBIG, and UBIL is on a separate asset basis. However, most taxpayers prepare these calculations based upon a class of assets as a simplifying convention. For example, the UBIG or UBIL for inventory might be determined based upon the difference between the gross value and basis of the inventory as a class. If it is determined that the inventory has a net UBIG, the taxpayer might ignore the possibility that some items of inventory have a UBIL on a gross basis.

A taxpayer that applies the rules on a class basis is merely estimating the amount of RBIG and RBIL instead of making the full determination required by statute. Taxpayers have generally been permitted to estimate amounts, in other contexts, when there is some basis for estimating the amount and the estimation is reasonable. However, the benefit of the doubt always runs against the taxpayer when estimation is used. See, e.g., *Cohan v. Comm’r*, 39 F.2d 540, 543-44 (2d Cir. 1930) (business deductions); *Nitto v. Comm’r*, 13 TC 858, 866 (1949) (gross income); *Serianni v. Comm’r*, 80 TC 1090, 1093 (1983) (allocation of legal expenses), *aff’d*, 765 F.2d 1051 (11th Cir. 1985); *Complex Media v. Comm’r*, TC Memo 2021-14 (determination of basis of acquired assets); Rev. Proc. 2011-35, 2011-1 CB 890 (stock basis received in a transferred basis transaction); Rev. Proc. 2011-42, 2011-2 CB 318 (statistical sampling methodologies). It is doubtful that the class approach (or other estimation techniques) can be used for extraordinary items.

Section 338 Approach

Under the section 338 approach, the amount of RBIGs and RBILs are determined by comparing the actual treatment of items of income, gain, deduction, and loss by the loss corporation with the treatment of such items under a hypothetical section 338 election. For purposes of determining the treatment under the

hypothetical section 338 election, the loss corporation is treated as applying the accounting methods that the taxpayer actually uses. Notice 2003-65, § IV.B. For example, a loss corporation that applies the accrual method of accounting would apply the accrual method in determining the treatment of items under a hypothetical section 338 election (even if the new target corporation in a real section 338 election would have been allowed to adopt the cash method).

Sale or Exchange of Assets. Under the section 338 approach, gains and losses from the sale or exchange of assets are treated as RBIGs or RBILs by comparing the actual gain or loss with the gain or loss that would have been recognized as a result of a hypothetical section 338 election. Notice 2003-65, § IV.B.1. For example, assume that a loss corporation sells an asset for \$100 million during the recognition period. If the actual basis of the asset on the sale date is \$20 million and the fair market value of the asset on the change date is \$30 million, then the actual gain is \$80 million and the hypothetical gain is \$70 million. The excess of these two amounts (\$10 million) is the amount that is treated as an RBIG.

The treatment described in Notice 90-27 for installment sales also applies under the section 338 approach. The treatment under Notice 90-27 is expanded to cover a situation where gain assets are transferred by one member of a consolidated group to another in a deferred intercompany transaction (section 1.1502-13 of the Treasury regulations) and the transferee sells the asset in an installment sale during the recognition period. Notice 2003-65, § IV.B.1.

Foregone Amortization. The chief benefit of the section 338 approach for loss corporations subject to the NUBIG rule is the treatment of foregone amortization. The section 338 approach treats assets with a UBIG as generating RBIGs even in the absence of a disposition or gross income. The amount of any RBIG is computed by comparing the actual amount of cost recovery deductions (e.g., depreciation or amortization) with the amount that would have been allowed if a hypothetical section 338 election had been made. Notice 2003-65, § IV.B.2; PLR 201106001 (Nov. 10, 2010) (license of intangible asset). For example, assume a loss corporation has goodwill with a fair market value of \$150 million and adjusted basis of zero. The section 197 amortization from a hypothetical section 338 election would be \$10 million per taxable year. As a result, the loss corporation would generally be entitled to increase the section 382 limitation for five years of foregone amortization during the recognition period (\$50 million). *See* Notice 2003-65, Ex. 11-12.

There is some uncertainty as to how to compute foregone amortization when the loss corporation is insolvent before the ownership change. Under the section 338 approach, many taxpayers take the position that built-in COD income is taken into account for purposes of computing NUBIG or NUBIL. *See* PLR 201051019 (Sept. 14, 2010). It is possible that built-in COD income is taken into account for purposes of determining the amount of foregone amortization since the calculation is determined based upon a hypothetical section 338 election (just like the calculation of NUBIG or NUBIL). However, this position does appear to be an unintended result and may be considered to be aggressive. In any case, it does appear that (as discussed above) that the remaining NUBIG balance is reduced by any excluded COD income, which could eliminate the benefit of taking into account built-in COD income in determining foregone amortization.

There is also uncertainty as to how to compute foregone amortization where some of the consideration is contingent. It is clear under the notice that the fair market value of contingent consideration is taken into account for purposes of determining the amount of NUBIG or NUBIL. The notice does not state whether contingent consideration is taken into account for purposes of determining the amount of foregone amortization that is treated as an RBIG. The notice has conflicting statements in this regard. The notice states that:

[T]he 338 approach assumes that, for any taxable year, an asset that had a built-in gain on the change date generates income equal to the cost recovery deduction that would have been allowed for such asset under the applicable Code section *if an election under section 338 had been made with respect to the hypothetical purchase*. Therefore, with respect to an asset that had a built-in gain on the change date, the 338 approach treats as RBIG an amount equal to the excess of the cost recovery deduction that would have been allowable with respect to such asset *had an election under section 338 been made for the hypothetical purchase* over the loss corporation's actual allowable cost recovery deduction. The cost recovery deduction that would have been allowed to the loss corporation had an election under section 338 been made with respect to the hypothetical purchase will be *based on the asset's fair market value on the change date* and a cost recovery period that begins on the change date.

Notice 2003-65, § IV.B.2 (emphasis added).

The above quoted paragraph states twice that the hypothetical cost recovery deduction should be based on a hypothetical section 338 election. However, the last sentence concludes that the hypothetical deduction is based on the asset's fair market value on the change date. Generally, it is true that amount of basis allocated to an asset where a section 338 election is made equals its fair market value. However, that would not necessarily be true if part of the consideration is contingent. Similar issues may apply to the assumption of contingent liabilities.

If a purchaser is treated as acquiring assets pursuant to a section 338 election, the basis generally does not include contingent consideration (and in some cases, contingent liabilities). Treas. Reg. §§ 1.338-5(a), (b)(1)(i), (2)(i), (c), 1.1012-1(g)(1), 1.1274-2(g). The basis is increased (except for the portion allocable to interest) when the contingent consideration is paid. Treas. Reg. §§ 1.338-5(b)(ii), -7(a), (b), (e) Ex. 4, 1275-4(c)(4), (7) Ex. 1. The law is not as clear where contingent liabilities are concerned. The section 338 regulations in some examples state that general principles of tax law determine when basis is increased, Treas. Reg. § 1.338-7(e) Ex. 1(iv), 4(i), and in another example states that the basis is increased when economic performance occurs. Treas. Reg. § 1.338-5(b)(iii) Ex. 2.

Where the basis increase pursuant to a settlement of a contingency is allocable to intangible assets, the increased basis is amortized under section 197 over the remainder of the fifteen-year amortization period. That is, retroactive amortization is not permitted. Treas. Reg. § 1.197-2(f)(2). It appears that a similar approach applies to increased basis that is allocable to tangible assets. Prop. Reg. § 1.168-2(d)(3)(i), (ii) Ex. (2).

As an example of how foregone amortization applies where some of the stock of the loss corporation was acquired with contingent consideration, assume that the stock of a loss corporation is acquired on January 1, 2020 for \$15 million in cash and contingent consideration of \$100 million. On January 1, 2022, the purchaser pays \$30 million of contingent consideration (\$4 million of which is allocable to interest). If the only asset of the loss corporation is goodwill and there are no liabilities, the foregone amortization in 2020 and 2021 (based upon a hypothetical section 338 election) would be \$1 million per year (\$15 million over 15 years). In 2022 through 2024, additional foregone amortization of \$2 million per year (\$26 million over 13 years) would be allowed with respect to the basis adjustment caused by the payment of the contingent consideration. However, the loss corporation might take the position that the fair market value of the contingent consideration is taken into account in determining foregone amortization based on the use of the term "fair market value" in the notice.

Similar issues regarding the computation of foregone amortization apply with respect to so-called “bargain purchases.” That is, the purchase price for the stock is less than the aggregate fair market value of the tangible assets. In such case, the intangible assets receive no basis where a section 338 election is made. The basis of tangible assets is reduced based on the residual method. Treas. Reg. § 1.338-6(b). For example, assume that a loss corporation is acquired for \$7 million. The only asset of the loss corporation is a piece of equipment that has a value of \$10 million. The reduced purchase price relates to the expectation of future losses. If section 338 applied to the transaction, the basis of the equipment would be \$7 million. This would appear to be the correct amount to use for purposes of determining foregone amortization under the section 338 approach. However, some taxpayers might treat the basis as being equal to \$10 million based upon the reference to fair market value in the notice.

An additional complexity in computing the amount of foregone amortization is dealing with the relevant cost recovery rules for short periods. This is a result of the fact that ownership changes rarely occur on the last day of a taxable year. For example, if an ownership change occurs on June 29 with respect to a calendar year taxpayer, it appears that the foregone amount would be determined as if the loss corporation acquired the assets on June 30 in a six month taxable year. IRC. § 338(a)(2).

The amortization deduction under section 197 is computed on a monthly basis (i.e., assets are treated as acquired on the first day of the month of acquisition). Treas. Reg. § 1.197-2(f)(1)(i), (iv). As a result, it appears that the loss corporation in the above example would be entitled to seven months of hypothetical amortization of an intangible asset (i.e., from June 1 to December 31) in determining the amount of foregone amortization. In such case, the loss corporation might be entitled to sixty one months of foregone amortization, instead of the sixty months that is implied by the length of the recognition period.

For purposes of computing the hypothetical depreciation deduction under the modified accelerated cost recovery system (MACRS) of section 168, it appears that the acquired assets will generally be treated as acquired in the middle of the taxable year (unless the mid-month or mid-quarter convention applies). IRC § 168(d)(1), (4); Treas. Reg. § 1.168(d)-1(a). In the case of a short taxable year, that would mean the middle of the short year. Similar to section 197, the short year takes into account the number of full or partial months in the year. Based on the prior example of an acquisition on June 30, the loss corporation would generally be entitled to 3 ½ months of hypothetical depreciation (half of a seven month taxable year). Rev. Proc. 89-15, 1989-1 CB 816, § 4.01(1)(a), .02.

The fact that the taxable year in which the asset was first placed in service was a short taxable year, means that the MACRS tables cannot be used to determine the hypothetical depreciation in subsequent taxable years. Taxpayers can use either (i) the allocation method (using the tables but taking into account the fractional years), or (ii) the simplified method (using the applicable depreciation rate). Under either method, the loss corporation must switch to the straight-line method at an appropriate time. Rev. Proc. 89-15, § 4.03. Having to take into account these rules greatly complicates the computation of foregone amortization for assets that are subject to depreciation under MACRS.

Depreciation. Under the NUBIL rule, some or all of the depreciation, amortization, or depletion deductions with respect to assets with a UBIL are treated as RBILs. The amount of any RBIL under the section 338 approach is computed by comparing the actual amount of the deduction with the amount that would have been allowed in a hypothetical section 338 election. Notice 2003-65, § IV.B.3; PLR 201106001 (license of intangible asset).

Depreciation Example. A loss corporation has an asset with a fair market value of \$70 thousand and an adjusted basis of \$150 thousand. The asset is depreciable over 7 years and the loss corporation has elected the straight-line method. At the time of the ownership change, the asset has

a remaining depreciable life of three years. For the first three years, the actual depreciation will equal \$50 thousand (\$150 thousand over three years) and the hypothetical depreciation will equal \$10 thousand (\$70 thousand over seven years). As a result, the depreciation that is treated as an RBIL equals \$40 thousand, generally, for each of the first three years. However, since the UBIL is \$80 thousand (\$150 thousand less \$70 thousand), only the \$40 thousand difference for the first two years is treated as an RBIL. *See* Notice 2003-65, Ex. 13.

The TCJA made changes to the bonus depreciation provisions of section 168(k). The statute increased the allowance from 50% to 100% (lower percentages apply after 2022). The statutory change resulted in reconsideration of the treatment of bonus depreciation under Notice 2003-65. The Treasury Department and the IRS determined that applying bonus depreciation was inappropriate. As a result, in determining RBIGs and RBILs under the section 338 approach, the hypothetical cost recovery deduction is determined without regard to the bonus depreciation rules of section 168(k). This rule only applies to ownership changes that occur after May 8, 2018. Notice 2018-30, § 3, 6, 2018-21 IRB 610. The IRS announced that Notice 2018-30 would be withdrawn and made obsolete effective on the day after the proposed section 382(h) regulations become final. REG-125710-18, 84 Fed. Reg. 47455, 47462 (2019).

Section 1374 Approach

Under the section 1374 approach, the amount of RBIGs and RBILs are determined based upon the rules described in sections 1.1374-4 and -7 of the Treasury regulations. Generally under this approach, the amount of built-in income and deductions are determined by comparing the actual treatment of items of income and deduction by the loss corporation with the treatment of such items by an accrual method taxpayer.

Under the section 1374 approach, gains and losses from the sale or exchange of assets are treated as RBIGs or RBILs based upon the statutory rules described above. Treas. Reg. § 1.1374-4(a)(1); Notice 2003-65, § III.B.1. For example, assume that a loss corporation sells an asset for \$100 million during the recognition period. If the basis of the asset is \$20 million (both at the time of the sale and at the change date) and the fair market value of the asset on the change date is \$30 million, then the actual gain is \$80 million and the UBIG is \$10 million. The amount that is treated as an RBIG is limited to the UBIG of \$10 million.

For purposes of determining the UBIG or UBIL with respect to inventory, the fair market value immediately before the ownership change is determined based upon the “amount that a willing buyer would pay a willing seller for the inventory in a purchase of all the [loss] corporation’s assets by a buyer that expects to continue to operate the [loss] corporation’s business.” Treas. Reg. § 1.1374-7(a). For this purpose, there is a presumption that (i) the buyer and seller are not under any compulsion to buy or sell, and (ii) both have reasonable knowledge of all of the relevant facts. *Id.*

For purposes of determining whether inventory sold or exchanged during the recognition period was held immediately before the ownership change, the method of accounting used for the inventory is applied. As a result, inventory held on the change date for which the first-in, first-out (FIFO) method is applied generally is treated as the first inventory sold after the change date. On the other hand, inventory for which the last-in, first-out (LIFO) method is applied is generally treated as not disposed of during the recognition period. However, LIFO inventory is treated as disposed of if the taxpayer recognizes gain or loss due to the reduction in a LIFO layer. If a loss corporation changes its method of accounting for inventory with a principal purpose of avoiding tax, the former method continues to apply to identify dispositions. Treas. Reg. § 1.1374-7(b).

The treatment described in Notice 90-27 for installment sales also applies under the section 1374 approach. Treas. Reg. § 1.1374-4(h)(1); Notice 2003-65, § III.B.1. The treatment under Notice 90-27 is expanded to cover a situation where gain assets are transferred by one member of a consolidated group to another in a deferred intercompany transaction (section 1.1502-13 of the Treasury regulations) and the transferee sells the asset in an installment sale during the recognition period. Notice 2003-65, § III.B.1.

The section 1374 approach does not apply the concept of foregone amortization. In addition, income generated by an asset is not treated as an RBIG. Notice 2003-65, § III.B.2.a(i). For example, royalty income received from the license of a patent is not treated as an RBIG. Notice 2003-65, Ex. 6.

Under the NUBIL rule, some or all of the depreciation, amortization, or depletion deductions with respect to assets with a UBIL are treated as RBILs. Under the section 1374 approach, a loss corporation can use any reasonable method to determine the amount of a deduction that is treated as a UBIL. The method described above with regard to the section 338 approach is mentioned in Notice 2003-65 as an acceptable method. Notice 2003-65, § III.B.2.a(ii), Ex. 7.

Many loss corporations determine the amount of any depreciation, amortization, or depletion that is an RBIL by applying a “proportional” approach. Under this approach, the cost recovery deduction is treated as an RBIL based on the ratio of the UBIL for the asset over the total basis.

Depreciation Example. A loss corporation has an asset with a fair market value of \$70 thousand and an adjusted basis of \$150 thousand. The amount of the UBIL is \$80 thousand. The asset is depreciable over 7 years and the loss corporation has elected the straight-line method. At the time of the ownership change, the asset has a remaining depreciable life of three years. For the first three years, the depreciation will equal \$50 thousand (\$150 thousand over three years). Of this amount, approximately \$27 thousand dollars is treated as an RBIL under the proportional approach. In the example under the section 338 approach, the RBIL in each of the first two years was \$40 thousand. On these facts, the proportional approach achieves a more favorable result. The proportional approach will not always be more favorable and loss corporations should generally compare the calculations before choosing an approach.

The TCJA made changes to the bonus depreciation provisions of section 168(k). The statute increased the allowance from 50% to 100% (lower percentages apply after 2022). The statutory change resulted in reconsideration of the treatment of bonus depreciation under Notice 2003-65. Treasury Department and the IRS determined that applying bonus depreciation was inappropriate. As a result, in determining RBIGs and RBILs under the section 1374 approach, the hypothetical cost recovery deduction is determined without regard to the bonus depreciation rules of section 168(k). This rule only applies to ownership changes that occur after May 8, 2018. Notice 2018-30, §§ 3, 6, 2018-21 IRB 610. The IRS announced that Notice 2018-30 would be withdrawn and made obsolete effective on the day after the proposed section 382(h) regulations become final. REG-125710-18, 84 Fed. Reg. 47455, 47462 (2019).

Proposed Section 382(h) Regulations

Under the proposed section 382(h) regulations, the amount of RBIG and RBIL is generally determined based upon rules that are similar to the section 1374 approach of Notice 2003-65. The proposed rules have separate rules for determining the amount of an RBIG and an RBIL. Prop. Reg. §§ 1.382-2(a)(11), (12), -7(d).

The proposed rules explicitly provide for matching principles between the determinations of the amount of a NUBIG/NUBIL and an RBIG/RBIL. The rules provide that no amount is to be treated as an RBIG or

RBIL if that amount was not properly included in the determination of NUBIG or NUBIL. However, exceptions are allowed if expressly provided in the proposed rules. Prop. Reg. § 1.382-7(d)(1). This is a key difference between the proposed section 382(h) regulations and Notice 2003-65, which did not require matching.

Under the proposed rules, gain or loss recognized on the disposition of an asset during the recognition period, is treated as an RBIG or RBIL, as the case may be, to the extent treated as such under the statute. Prop. Reg. § 1.382-7(d)(2)(ii), (3)(ii).

Income taken into account with respect to stock is not treated as an RBIG. This includes dividends (and amounts treated as dividends under section 1248) and income inclusion items (such as subpart F income and GILTI). Prop. Reg. § 1.382-7(d)(2)(ii). The position taken by the proposed regulations seems reasonable for certain items (e.g., ordinary quarterly dividends). For other items, this aspect of the proposed rules does not seem to meet the requirements of the statute for the built-in income and deduction rules are defined to include income and deduction items that are “attributable” to the pre-change period. IRC § 382(h)(6)(A), (B). Dividends under section 1248 are actual gains from the sale of stock that has been recharacterized as a dividend. Such gains appear to meet the statutory requirement for an RBIG. *See* PLR 201051020 (Nov. 12, 2009). Similarly, income inclusion items that result in an increase in basis (reducing future RBIGs or increasing future RBILs) would also appear to meet the statutory requirement for an RBIG (e.g., subpart F income and GILTI inclusions. IRC § 961(a)). The proposed regulations are unclear as to whether deemed gains under section 301(c)(3) (distributions in excess of E&P and basis) can be treated as an RBIG.

Like Notice 90-27, the proposed rules extend the recognition period for certain installment sales. These rules apply if the asset is sold before the change date (or during the recognition period) and the installment method is used to defer the gain. In such case, gain recognized during or after the recognition period can be treated as an RBIG (if the other requirements are met). Treas. Reg. § 1.1374-4(h)(1); Prop. Reg. § 1.382-7(d)(2)(v). A similar rule applies if a member of a consolidated group transfers a built-in gain asset to another member before or during the recognition period and the transferee sells the asset before the close of the recognition period. Such deferred gain can be treated as an RBIG, even if it is taken into account after the recognition period. Prop. Reg. § 1.382-7(d)(2)(v).

The proposed rules do not treat foregone depreciation or amortization (or similar amounts) as an RBIG. Specifically, the rules provide that cost recovery deductions on an appreciated asset are not treated as generating an RBIG. Prop. Reg. § 1.382-7(d)(2)(i). The IRS has stated that they are considering some approaches that would allow for foregone amortization to be treated as an RBIG in limited situations. Emily L. Foster, *IRS Rethinking Loss Limitation Rules on Wasting Assets*, 166 Tax Notes 802 (2020).

Special rules are provided for cost recovery deductions for RBIL purposes. A cost recovery deduction is a deduction for (i) depreciation under sections 167 or 168, (ii) amortization of intangible assets (including under sections 167 and 197) and capitalized expenditures (under sections 195(b)(1)(B), 248, or 1245(a)(2)(C)), or (iii) depletion under section 611. Prop. Reg. § 1.382-7(b)(2).

A cost recovery deduction with respect to a section 382 asset is treated as an RBIL to the extent of the excess, if any, of (i) the actual deduction taken into account (or the amount actually allowable, if greater), over (ii) a recomputed deduction as if the adjusted basis were reduced on the change date to the fair market of the asset. The recomputed deduction amount takes into account (i) the method of accounting applied for cost recovery deduction purposes, (ii) the remaining useful life, (iii) the recovery or amortization period, and (iv) the convention actually used by the loss corporation. Prop. Reg. § 1.382-7(d)(3)(iii). This is similar to proportional method that some taxpayers were applying under the section 1374 approach.

Amortization Example. Assume that Lossco owns a patent on the change date with a fair market value of \$125 million and an adjusted basis of \$275 million. The patent is amortizable under section 197 over fifteen years (\$55 million per year) and has a remaining amortization period of five years. If the amortization were recomputed by using the fair market value as the adjusted basis, the annual amortization would equal \$25 million (\$125 million over five years). As a result, the annual RBIL with respect to amortization would equal \$30 million (actual of \$55 million, less hypothetical of \$25 million). The remaining deduction of \$25 million is not subject to limitation. Prop. Reg. § 1.382-7(f)(2) Ex. 2.

E. Built-in Income and Deductions

Both the NUBIG and NUBIL rules provide for the treatment of built-in income and deduction items.

Under the NUBIG rule, a built-in income item is treated as an RBIG in the taxable year in which the income is properly taken into account. IRC § 382(h)(6)(A). A built-in income item is income “which is properly taken into account during the recognition period but which is attributable to periods before the change date.” *Id.*

Under the NUBIL rule, a built-in deduction item is treated as an RBIL in the taxable year for which the amount is allowable. IRC § 382(h)(6)(B). A built-in deduction item is a deduction “which is allowable as a deduction during the recognition period (determined without regard to any carryover) but which is attributable to periods before the change date.” *Id.*

The amount of any NUBIG or NUBIL is adjusted for any built-in income or deduction item which would be treated as an RBIG or RBIL if such amounts were properly taken into account as income or allowable as a deduction during the recognition period. IRC § 382(h)(6)(C). It appears that the amount of NUBIG or NUBIL is adjusted by both potential built-in income and deduction items. In addition, it appears that built-in income and deductions items that are not anticipated to be taken into account or allowable during the recognition period are treated as adjustments to the amount of NUBIG or NUBIL. For example, a built-in deduction item that is not anticipated to be allowable as a deduction until the tenth anniversary of the ownership change (i.e., after the end of the recognition period) would appear to be treated as an adjustment to the amount of NUBIG or NUBIL.

Under the statute, an item is considered to be a built-in income or deduction item if the item is “attributable” to the pre-change period. IRC § 382(h)(6)(A), (B). There is uncertainty as to what standard should be used. Based on the language, it could be based on the economics or tax accounting. The statute was changed in 1988. Technical and Miscellaneous Revenue Act of 1988, PL 100-647, § 1006(d)(22). Before then the standard was based on whether the item “accrued” before the change date. IRC § 382(h)(6) (as then in effect). This suggests an intent by Congress to reject a tax accounting (accrual) approach. Notwithstanding this legislative history, the IRS has generally adopted the tax accounting approach with respect to the section 338 and 1374 approaches, as well as with respect to the proposed section 338(h) regulations.

Regulations have been issued with respect to the treatment of prepaid income (sometimes referred to as “deferred revenue”). Under these regulations, prepaid income is not treated as an RBIG. For this purpose, prepaid income is any “amount received prior to the change date that is attributable to performance occurring on or after the change date.” Treas. Reg. § 1.382-7(a). Examples of prepaid income include income that is deferred under sections 451(c) (advance payments) and 455 (subscription income). Treas. Reg. § 1.382-7(b); see also CCA 201629007 (Feb. 29, 2016).

It is possible that income and deductions that are deferred under a provision of the Code or regulations could be treated as built-in income or deduction items under the statute. Examples of deferred items include (i) section 267 (related party deductions and losses), (ii) section 1.1502-13 of the Treasury regulations (intercompany transactions), and (iii) section 465 (at risk rules). *See* Treas. Reg. § 1.1502-91(g)(1), (h)(3); Blue Book, p. 320-21.

In 1991, the IRS announced that forthcoming regulations will determine the application of the built-in item rules to credits. TD 8352, 1991-2 CB 67. No such regulations have been promulgated or proposed.

In Notice 87-79, 1987-2 CB 387, the IRS announced that taxable COD income that is integrally related to an ownership change but that is recognized after an ownership change can be treated as a built-in income item. Notice 87-79. This notice cannot be relied upon if the loss corporation chooses to adopt the section 338 or 1374 approach. Notice 2003-65, §§ III.B.2.b, IV.D. In addition, the IRS announced that Notice 87-79 would be withdrawn and made obsolete effective on the day after the proposed section 382(h) regulations become final. REG-125710-18, 84 Fed. Reg. 47455, 47462 (2019).

There is uncertainty as to whether COD income that is excluded (e.g., under the section 108 bankruptcy or insolvency exclusions) can be treated as a built-in income item under the statute. The IRS in two letter rulings from the 1990s appears to have treated COD income as a built-in income item but only to the extent that the basis of assets is reduced under section 1017. PLR 9409037 (Dec. 7, 1993) (for NUBIG and NUBIL purposes); PLR 9226064 (Mar. 31, 1992) (for UBIG and UBIL purposes as well). It appears that the position of the IRS at the time of the rulings was that excluded COD income was not a built-in income item if NOLs (or other carryforwards) were reduced or the income resulted in “black hole income” (i.e., no corresponding attribute reduction). A similar distinction between basis reduction and carryforward reduction exists with respect to excluded COD income for E&P purposes. *See* IRC § 312(l)(1) (excluded COD income included in E&P except to the extent of basis reduction).

The deduction of business interest expense is limited by section 163(j) for certain taxpayers. To the extent a deduction is disallowed, the excess is carried forward (and can be subject to the limitations of section 382, if there is an ownership change). IRC §§ 163(j)(1), (2), 382(d)(3); Treas. Reg. §§ 1.163(j)-2(b), (c), 1.382-(a)(1)(i)(A). The regulations clarify that interest that is carried forward under section 163(j) (i.e., a “disallowed business interest expense”) as of the change date is not treated as an RBIL. In addition, current-year business interest expense in the change year that is allocable to the pre-change period is not treated as an RBIL if it is disallowed by section 163(j) (i.e., becomes disallowed business interest expense). Treas. Reg. § 1.382-7(a)(7), (d)(5).

Before the enactment of the TCJA, section 163(j) generally only applied if interest was paid or accrued to a related person who was not subject to US federal income tax on the interest (e.g., tax exempt organization and foreign persons). IRC § 163(j)(1)(A), (3)(A) (as in effect for taxable years beginning on or before December 31, 2017). Interest that was disallowed under old section 163(j) could be carried forward, but is generally subject to limitation under new section 163(j). The interest that was disallowed under old section 163(j) is referred to in the section 163(j) regulations as “disallowed disqualified interest.” Treas. Reg. §§ 1.163(j)-1(b)(12), -2(c)(1), -5(b)(2), -11(c)(1).

Disallowed disqualified interest (i.e., interest that has been carried forward under old section 163(j)) is generally not considered to be a pre-change loss (and is not generally subject to limitation under section 382) if the ownership change occurred before November 13, 2020. Disallowed disqualified interest with respect to later ownership changes (or for which the taxpayer or a related person choose to apply the section 163(j) regulations retroactively) is considered to be a pre-change loss that is subject to limitation under section 382. Treas. Reg. §§ 1.163(j)-11(c)(4), 1.382-2(a)(2)(vi), (7).

There is some uncertainty as to whether disallowed disqualified interest that is not treated as a prechange loss (i.e. with respect to pre-November 13, 2020 ownership changes) can be treated as an RBIL. The regulation that generally exempts disallowed disqualified interest from treatment as a pre-change loss has a cross-reference to section 382(h)(6)(B). Treas. Reg. § 1.163(j)-11(c)(4)(i). This suggests a possible intent to treat such interest as an RBIL. However, section 1.382-7(d)(5) of the Treasury regulations clearly states that section 382 disallowed business interest carryforwards are not treated as RBILs. The definition of section 382 disallowed business interest carryforwards includes disallowed disqualified interest, as of the date of the ownership change. Treas. Reg. § 1.382-2(a)(7)(i). It would appear that this more specific statement that such interest is not an RBIL should prevail over the cross-reference in the regulations.

Gain or loss that is recognized is only treated as an RBIG or RBIL if it is from a disposition of an asset. IRC § 382(h)(2)(A), (B). In certain instances, taxpayers are permitted to write-off the basis of an asset that is not disposed of. Examples of such allowable deductions include sections 165 (worthlessness) and 166 (bad debts). It would appear that such a deduction is not pursuant to a disposition of an asset. As a result, it is possible that such a deduction is only treated as an RBIL if it is a built-in deduction. Such a deduction does not fit well with the statutory language which requires that the deduction must be “attributable” to the period before the change date. However, it does seem reasonable to treat a worthlessness deduction as a built-in deduction to the extent that the UBIL with respect to the asset was treated as a component of the NUBIL calculation. The IRS has treated a bad debt deduction as a built-in deduction in guidance, Treas. Reg. § 1.1374-4(f); Prop. Reg. § 1.382-7(d)(3)(iv); Notice 2003-65, § III.B.2.b, but has not issued guidance on section 165 worthlessness deductions.

The issue of whether an ordinary worthless securities deduction under section 165(g) can be treated as a built-in deduction is more complicated. A loss is generally allowed by section 165 to a taxpayer when an asset becomes wholly-worthless during a taxable year. Treas. Reg. §§ 1.165-1(a), (b), (c)(1), (d)(1), -2, -5(b). If the asset is a security (i.e., corporate stock or stock option or certain debt obligations) that is a capital asset, section 165(g)(1) provides for a deemed sale or exchange of the asset on the last day of the taxable year (for income tax purposes). IRC § 165(g)(1), (2); Treas. Reg. §§ 1.165-4(a), (d) -5(a), (c), (f). As a result, a taxpayer will generally recognize a long-term capital loss from the worthlessness of a security. Based on the deemed sale or exchange, the loss would be treated as an RBIL (if the other requirements are met).

Section 165(g)(3) provides an exception to capital loss treatment for a taxpayer that is a US corporation that has a worthlessness deduction with respect to a security of a corporate subsidiary (if the subsidiary meets an active business requirement). If the exception applies, the subsidiary security is not treated as a capital asset for purposes of section 165(g)(1). IRC § 165(g)(3); Treas. Reg. § 1.165-5(d). As a result, there does not appear to be a deemed sale or exchange (or a disposition) if a loss is taken pursuant to section 165(g)(3).

It is very possible that a worthless loss deduction under section 165(g)(3) is not treated as a built-in deduction (i.e., it is treated differently from other write-off deductions). Section 382(g)(4)(D) generally treats the subsidiary as undergoing an ownership change if the parent corporation takes a worthlessness deduction and continues to own the subsidiary stock as of the close of the taxable year. (Section 382(g)(4)(D) is discussed at length above in the ownership change section of this paper.) That intent of the provision was to prevent a parent corporation from receiving a double benefit (a worthless stock loss and the subsidiary tax attributes). H. Rep. 100-391 (1987). This legislative history suggests that only one of the two benefits is to be subject to limitation by section 382.

Section 338 Approach

Under the section 338 approach, the amount of built-in income and deduction items are determined by comparing the actual treatment of items of income and deduction by the loss corporation with the treatment of such items under a hypothetical section 338 election. For purposes of determining the treatment under the hypothetical section 338 election, the loss corporation is treated as applying the accounting methods that the taxpayer actually uses. Notice 2003-65, § IV.B. As described above, regulations have been issued with respect to the treatment of prepaid income, but not other items.

Under the section 338 approach, deductions related to liabilities that were contingent on the change date are generally treated as RBILs. However, the amount treated as an RBIL is limited to the estimated amount of the contingent liability on the change date. Notice 2003-65, § IV.C. For example, if the estimated contingent liability on the change date was \$25 million and the loss corporation pays \$30 million during the recognition period, the amount treated as an RBIL is limited to \$25 million. Notice 2003-65, Ex. 14. This estimated amount is generally the same amount that was taken into account for purposes of computing the NUBIG or NUBIL.

Taxable COD income that is recognized during the recognition period can be treated as an RBIG under the section 338 approach. RBIG treatment applies to COD income with respect to debt obligations that were incurred before the ownership change. The amount that is treated as an RBIG is limited to the excess of (i) the adjusted issue price of the debt obligation, over (ii) the fair market value of the obligation. The limit is determined as of the change date. Notice 2003-65, § IV.D.

If a loss corporation realizes COD income that is excluded under section 108, special rules apply. The notice states that the excluded COD income is generally not treated as an RBIG under the section 338 approach. Notice 2003-65, Ex. 15. If the loss corporation reduces the basis of its assets under section 1017 during the recognition period, the reduction is treated for RBIG purposes (but not NUBIG or NUBIL purposes) as occurring before the ownership change. This treatment increases the amount that can be treated as an RBIG if the asset is sold during the recognition period. Notice 2003-65, § IV.D. As an example, if an asset had a UBIG of \$50 thousand and the basis is reduced under section 1017 by \$10 thousand, then the recomputed UBIG is \$60 thousand. Notice 2003-65, Ex. 15. The benefit of the increase in the UBIG with regard to reductions in basis under section 1017 is limited to the excess of (i) the adjusted issue price of the debt obligation, over (ii) the fair market value of the obligation. The limit is determined as of the change date. Notice 2003-65, § IV.D.

Adjustments under section 481 are treated as an RBIG or RBIL under the section 338 approach to the extent the adjustment is taken into account during the recognition period and it relates to items attributable to the period before the ownership change. Whether an item is attributable to the period before the ownership change is determined under principles for determining RBIG and RBIL. Treas. Reg. § 1.1374-4(d)(1); Notice 2003-65, § IV.E. Section 481 adjustments can be treated as an RBIG or RBIL even if the method change occurs during the recognition period. Treas. Reg. § 1.1374-4(d)(2) Ex. 1-2.

Section 1374 Approach

Under the section 1374 approach, the amount of built-in income and deduction items are determined by comparing the actual treatment of items of income and deduction by the loss corporation with the treatment by an accrual method taxpayer. Notice 2003-65, § III.B.2.a.

An item of income is generally treated as an RBIG if it is taken into account during the recognition period and an accrual method taxpayer would have included the income before the change date. For purposes of

determining the treatment by an accrual method taxpayer, elective methods are only taken into account if actually used by the loss corporation. Treas. Reg. § 1.1374-4(b)(1). For examples of the treatment of cash method taxpayers under this rule see Examples 3 through 5 of Notice 2003-65.

Under the section 1374 approach, prepaid income is generally not treated as an RBIG. Treas. Reg. § 1.1374-4(b)(3) Ex. 4. However, if a taxpayer properly takes into account prepaid income before the change date and changes its method of accounting to one which results in the income being taken into account during the recognition period (subject to a section 481 adjustment), the income may be treated as an RBIG. Treas. Reg. § 1.1374-4(b)(3) Ex. 5.

An item of deduction is generally treated as an RBIL if it is taken into account during the recognition period and an accrual method taxpayer would have deducted the amount before the change date. For purposes of determining the treatment by an accrual method taxpayer, elective methods are only taken into account if actually used by the loss corporation. Treas. Reg. § 1.1374-4(b)(2).

For purposes of determining whether a deduction is an RBIL, certain portions of the economic performance rule are ignored. Under the economic performance rules, an accrual method taxpayer is not entitled to deduct certain amounts until paid. IRC § 461(h)(2)(C); Treas. Reg. § 1.461-4(g). For purposes of determining the accrual method treatment under the section 1374 approach, this rule is generally ignored. Treas. Reg. § 1.1374-4(b)(2); Notice 2003-65, § III.B.2.a.

For items described in paragraphs (2) through (7) of section 1.461-4(g) of the Treasury regulations, an amount that is paid and deducted during the recognition period is treated as an RBIL if it accrued (ignoring economic performance) before the change date. The items that are described in paragraphs (2) through (7), include liabilities related to (i) workers compensation claims, (ii) tort claims, (iii) breach of contract claims, (iv) claims related to violations of laws, (v) rebates, refunds, and similar payments, (vi) awards, prizes, jackpots, and similar payments, (vii) fees under warranty or service contracts, (viii) insurance premiums, (ix) taxes (other than foreign income taxes and certain real estate taxes), (x) licensing or permit fees, and (xi) all payments the treatment of which is not described in the economic performance rules. Treas. Reg. § 1.461-4(g). As an example, a loss corporation settled a lawsuit before the ownership change but was not obligated to make the payment until two years after the change date. The payment is generally deductible when paid under the economic performance rules and is treated as an RBIL. Treas. Reg. § 1.1374-4(b)(3) Ex. 3.

Under the section 1374 approach, deductions related to liabilities that were contingent on the change date are generally not treated as RBILs. This is because accrual method taxpayers are generally not entitled to deduct contingent amounts until they become fixed and determinable. If the lawsuit in the example from the previous paragraph was not settled until after the change date, then the amounts paid would not be an RBIL. Treas. Reg. § 1.1374-4(b)(3) Ex. 2.

Certain deductions that are not treated as RBILs under the general rule for built-in deduction items described above can still be treated as an RBIL. Special rules are provided for items that are deductible under either section 267(a)(2) (related party expense and interest payments) or 404(a)(5) (deferred compensation plans). Treas. Reg. § 1.1374-4(c).

A deduction that is allowed under section 267(a)(2) is treated as an RBIL if it is deductible during the recognition period and (i) all events have occurred establishing the fact of the liability before the change date, (ii) the “exact” amount can be determined before the change date, and (iii) the amount is paid in the first two and one-half months of the recognition period. The requirement of payment in the first two and one-half months does not apply if the payment is made to a related party owning, directly or indirectly by

attribution under applicable section 267 rules, less than 5% of the loss corporation (by vote and value). The 5% ownership test is determined both on the change date and at the time the payment is made. Treas. Reg. § 1.1374-4(c)(1).

A deduction that is allowed under section 404(a)(5) is treated as an RBIL if it is deductible during the recognition period and (i) all events have occurred establishing the fact of the liability before the change date, (ii) the “exact” amount can be determined before the change date, and (iii) the amount is not paid to a related person to which section 267(a)(2) applies. Treas. Reg. § 1.1374-4(c)(2). Examples of the application of this rule can be found in section 1.1374-4(c)(3) of the Treasury regulations.

Any bad debt deduction taken during the first twelve months of the recognition period is generally treated as an RBIL. This treatment only applies with respect to debts owed by the loss corporation at the beginning of the recognition period. Treas. Reg. § 1.1374-4(f); Notice 2003-65, § III.B.2.b. It appears that deductions taken after the twelve month period are not treated as RBILs. PLR 201105031 (Apr. 30, 2010). This rule appears to only apply to bad debt deductions under section 166 and not to worthless security deductions under section 165.

Any taxable COD income that is recognized during the first twelve months of the recognition period is generally treated as an RBIG. This treatment only applies with respect to debts owed by the loss corporation at the beginning of the recognition period. Treas. Reg. § 1.1374-4(f); Notice 2003-65, § III.B.2.b, Ex. 8. There is uncertainty as to the treatment of income recognized after the twelve-month period.

If a loss corporation realizes COD income that is excluded under section 108, special rules apply. The notice states that the excluded COD income is generally not treated as an RBIG under the section 1374 approach. Notice 2003-65, Ex. 9. If the loss corporation reduces the basis of its assets under section 1017 during the first twelve months of the recognition period, the reduction is treated for RBIG purposes (but not NUBIG or NUBIL purposes) as occurring before the ownership change. This treatment increases the amount that can be treated as an RBIG if the asset is sold during the recognition period. Notice 2003-65, § III.B.2.b. As an example, if an asset had a UBIG of \$50 thousand and the basis is reduced under section 1017 by \$10 thousand (pursuant to COD income realized in the first twelve months of the recognition period), then the recomputed UBIG is \$60 thousand. Notice 2003-65, Ex. 9.

Adjustments under section 481 are treated as an RBIG or RBIL under the section 1374 approach to the extent the adjustment is taken into account during the recognition period and it relates to items attributable to the period before the ownership change. Whether an item is attributable to the period before the ownership change is determined under principles for determining RBIG and RBIL (including the accrual method rule described above). Treas. Reg. § 1.1374-4(d)(1). Section 481 adjustments can be treated as an RBIG or RBIL even if the method change occurs during the recognition period. Treas. Reg. § 1.1374-4(d)(2) Ex. 1 (RBIL related to pre-change omitted item), 2 (RBIG related to pre-change duplicated item).

Special rules apply with respect to deemed distributions under section 995(b)(2) (DISC terminations) and the completed contract method of accounting. *See* Treas. Reg. § 1.1374-4(e), (g).

Proposed Section 382(h) Regulations

Under the proposed section 382(h) regulations, the amount of built-in income or deduction items is generally determined based upon rules that are similar to the section 1374 approach of Notice 2003-65. The proposed rules have separate rules for determining the amount of an RBIG and an RBIL. Prop. Reg. § 1.382-7(d).

The proposed rules provide for an anti-duplication rule. Appropriate adjustments are required to the computation of RBIG and RBIL so that no item of economic gain or loss is duplicated. In addition, the rules require that appropriate adjustments must be made in applying the provisions to ensure that no amount of NUBIG or NUBIL is utilized in a duplicative manner. Prop. Reg. § 1.382-7(e)(1).

Income Items – General. Under the proposed rules, an item of income is generally treated as an RBIG if it is taken into account during the recognition period and an accrual method taxpayer would have properly included the income before the change date. For purposes of determining the treatment by an accrual method taxpayer, elective methods are only taken into account if actually used by the loss corporation. Prop. Reg. § 1.382-7(d)(2)(i). For examples of the treatment of cash method taxpayers under this rule see Examples 3 through 5 of Notice 2003-65.

Prepaid income is not treated as an RBIG. This applies to any amount received before the change date that is attributable to performance that occurs on or after the change date. Examples of the application of the rule include income that is deferred under sections 451(c) (advance payments) and 455 (prepaid subscription payments). Prop. Reg. § 1.382-7(d)(2)(vi).

COD Income. Generally, COD income is not treated as an RBIG. However, there are exceptions that can apply for recourse and nonrecourse liabilities. COD income from discharge of a recourse liability is only treated as an RBIG if the loss corporation chooses to treat some of the COD income that is realized in the first twelve months of the recognition period as an adjustment to the amount of NUBIG or NUBIL (see above discussion). In such case, the entire amount of the adjustment is considered to be an RBIG. Prop. Reg. § 1.382-7(d)(2)(iii), (f)(3), (4) Ex. 3, 4.

There is also an exception for the discharge of nonrecourse liabilities. COD income that is taken into account during the first twelve months of the recognition period is eligible for adjustment if the income relates to the cancellation of a nonrecourse liability. To be eligible, the COD income must generally be included in gross income (i.e., not eligible for exclusion). Prop. Reg. § 1.382-7(b)(3), (d)(2)(iv)(A).

In certain cases, COD with respect to a nonrecourse liability that is realized but excluded under section 108(a) can be eligible for adjustment if it is taken into account during the first twelve months of the recognition period. This will be the case to the extent that the attribute reduction rules of sections 108(b) and 1017 reduce tax attributes that are not subject to limitation by section 382 or 383. Under current law there appear to be only two such attributes, (i) passive activity loss and credit carry forwards, and (ii) basis of assets. IRC § 108(b)(2); Treas. Reg. § 1.382-2(a)(2).

The reduction in basis of assets is only taken into account as an attribute that is not subject to section 382 or 383 if the assets were not held at the time of the ownership change. Prop. Reg. § 1.382-7(d)(ii)(A), (B). This relates to the fact that the basis of assets is not reduced under section 1017 until the first day of the taxable year following the realization of excluded COD income. IRC § 1017(a). As a result, an asset that is acquired after the change date is not subject to the RBIL rules but could be subject to attribute reduction. The proposed rules could have also allowed for costs that are capitalized after the change date under the same principal, but did not. Prop. Reg. § 1.382-7(d)(ii)(A), (B) (no adjustment for COD income that results in a reduction in basis of assets held at the time of the ownership change).

The amount of COD income with respect to the discharge of a nonrecourse liability that is treated as an RBIG is limited to the excess of the adjusted issue price of the debt over the fair market value of the assets secured by the debt (determined immediately before the ownership change). Prop. Reg. § 1.382-7(d)(2)(iv)(C). The proposed rules state that the amount of UBIG or UBIL is recomputed to take into

account any reduction in basis under section 1017 with respect to COD income realized in the first year of the recognition period related to the discharge of a nonrecourse liability. Prop. Reg. § 1.382-7(d)(2)(iv)(D).

Deduction Items – General. An item of deduction is generally treated as an RBIL if it is properly taken into account during the recognition period and an accrual method taxpayer would have deducted the amount before the change date. For purposes of determining the treatment by an accrual method taxpayer, elective methods are only taken into account if actually used by the loss corporation. Prop. Reg. § 1.382-7(d)(3)(i).

For purposes of determining whether an accrual-method taxpayer would have been allowed a deduction before the change date, certain deduction limitations are ignored. The ignored limitations are (i) taxable income limitations and (ii) timing limitations. Prop. Reg. § 1.382-7(d)(3)(i). A taxable income limitation is a limitation set forth in the Code that is based on, or derived from, the amount of the loss corporation's taxable income (e.g., charitable contribution deductions). Prop. Reg. § 1.382-7(b)(12)(i). A timing limitation is a limitation set forth in the Code that defers the timing of a deduction (e.g., payments to related persons under section 267(a)(2) and the passive activity loss rules of section 469). Prop. Reg. § 1.382-7(b)(12)(ii). The section 1374 approach generally did not ignore timing differences.

For example, if a loss corporation accrues a royalty to a related person and the deduction is deferred under section 267(a)(2), the deduction would be an RBIL if taken into account during the recognition period. In such case, the deduction would have been allowed to an accrual-method taxpayer before the change date. However, the deduction was deferred due to a timing difference.

Under the section 1374 approach, certain portions of the economic performance rule were ignored. Treas. Reg. § 1.1374-4(b)(2); Notice 2003-65, § III.B.2.a. Under the economic performance rules, an accrual method taxpayer is not entitled to deduct certain amounts until paid. IRC § 461(h)(2)(C); Treas. Reg. § 1.461-4(g). For purposes of determining the accrual method treatment under the section 1374 approach, this rule is generally ignored. Treas. Reg. § 1.1374-4(b)(2); Notice 2003-65, § III.B.2.a. The proposed section 382(h) regulations have not adopted the special rule under the section 1374 approach for economic performance. This rule in the section 1374 approach generally resulted in a larger number of potential deductions being treated as RBILs and greatly added to the complexity.

In computing the amount of a NUBIL, deductible liabilities with respect to both fixed and contingent debt are treated as a negative adjustment. Prop. Reg. § 1.382-7(c)(3)(i)(C), (D). The actual deduction of such amounts during the recognition period is treated as an RBIL. The amount treated as an RBIL is limited to the amount taken into account for NUBIL purposes. Thus, for contingent debt the limitation is based on the estimated amount of the deductible liability. Prop. Reg. § 1.382-7(d)(3)(v).

Any bad debt deduction that arises during the recognition period is treated as an RBIL if it relates to a debt that was owed to the loss corporation immediately before the ownership change. The amount treated as an RBIL is limited to the UBIL on the underlying debt. Prop. Reg. § 1.382-7(d)(3)(iv). The Section 1374 approach had a simplifying convention that treated bad debts realized in the first twelve months of the recognition period as an RBIL. Treas. Reg. § 1.1374-4(f); Notice 2003-65, § III.B.2.b. The proposed rules require tracing instead of allowing a twelve-month convention. It is surprising that the proposed rules did not adopt the first-year convention since they adopted a first-year convention for COD income.

The proposed rules do not provide a rule for worthless loss deductions under section 165. There is uncertainty if such a deduction is covered by any of the proposed rules governing RBILs. Where an asset becomes worthless, there is no disposition of the asset (unless the asset is also abandoned). As a result, it is possible that the proposed rule that treats a loss recognized on the disposition of an asset does not apply. See Prop. Reg. § 1.382-7(d)(3)(ii).

It appears that a worthless loss that relates to a “security” which is a capital asset meets the disposition requirement for RBIL treatment, since section 165(g)(1) deems there to be a sale or exchange on the last day of the taxable year for purposes of subtitle A (Income Taxes) of the Code. The timing aspect of this rule could result in a pre-change worthless securities deduction being treated as an RBIL. This deemed disposition rule applies to losses with respect to (i) shares of stock in a corporation, (ii) a right to subscribe for, or receive, a share of stock, or (iii) a debt obligation issued by a corporation or government (or political subdivision) that has interest coupons attached or is in registered form. IRC § 165(g)(1), (2); Treas. Reg. § 1.165-5(a-c). The deemed sale or exchange rule does not apply if (i) the taxpayer is a US corporation, (ii) the taxpayer owns 80% or more of the stock of the issuer (by vote or value) and excluding pure preferred stock, and (iii) the issuer meets a 90% active gross receipts test. IRC § 165(g)(1); Treas. Reg. § 1.165-5(d), (j).

Adjustments under section 481 are treated as an RBIG or RBIL under the proposed rules to the extent the adjustment is taken into account during the recognition period and it relates to items attributable to the period before the ownership change. Whether an item is attributable to the period before the ownership change is determined under principles for determining RBIG and RBIL (including the accrual method rule described above). Treas. Reg. § 1.1374-4(d)(1); Prop. Reg. § 1.382-7(d)(4)(i). Section 481 adjustments can be treated as an RBIG or RBIL even if the method change occurs during the recognition period. Treas. Reg. § 1.1374-4(d)(2) Ex. 1 (RBIL related to pre-change omitted item), Ex. 2 (RBIG related to pre-change duplicated item).

Special rules apply with respect to the completed contract method of accounting (as described in section 1.460-4(d) of the Treasury regulations). The rules apply to contracts for which the corporation began performance before the beginning of the recognition period and for which income or a deduction is allowed during the recognition period. The income or deduction will be an RBIG or RBIL by comparing the taxpayer’s treatment under the completed contract method with the results under the percentage of completion method. Treas. Reg. § 1.1374-4(g); Prop. Reg. § 1.382-7(d)(4)(ii).

F. Partnership Items

The Code does not provide for special treatment of partnership items in applying the NUBIG or NUBIL rules. However, both the section 338 and 1374 approaches, as well as the proposed section 382(h) regulations, require the application of special rules if a loss corporation owns a partnership interest immediately before an ownership change. Treas. Reg. § 1.1374-4(i); Prop. Reg. § 1.382-7(d)(4)(iii); Notice 2003-65, § IV.E. These rules apply to determine the effect on RBIGs and RBILs of a distributive share of partnership items.

These rules require a significant amount of work by the partnership. Not all partnerships are equipped, or willing to prepare these calculations.

The partnership rules require a distributive share of partnership items to be analyzed under a four step process. The steps are:

- Step One. Apply the NUBIG and NUBIL rules to the loss corporation’s distributive share of partnership items. In this step, a determination of RBIG or RBIL treatment is made as if the items had originated and been taken into account directly by the loss corporation. These are the “partnership section 382(h) items.” Treas. Reg. § 1.1374-4(i)(1)(i).
- Step Two. Determine the loss corporation’s RBIG or RBIL without partnership section 382(h) items. Treas. Reg. § 1.1374-4(i)(1)(ii).

- Step Three. Determine the loss corporation's RBIG or RBIL with partnership section 382(h) items. Treas. Reg. § 1.1374-4(i)(1)(iii).
- Step Four. Determine the "partnership RBIG" or "partnership RBIL." This is the difference between Step Three and Step Two. Treas. Reg. § 1.1374-4(i)(1)(iv).

The partnership RBIG determined in Step Four is limited to the excess of the "RBIG limitation" (described below) over partnership RBIGs taken into account in prior taxable years. Treas. Reg. § 1.1374-4(i)(2)(i). The partnership RBIL determined in Step Four is limited to the excess of the "RBIL limitation" (described below) over partnership RBILs taken into account in prior taxable years. Treas. Reg. § 1.1374-4(i)(2)(ii).

If a loss corporation disposes of a partnership interest during the recognition period, the amount treated as an RBIG is limited to the excess (if any) of (i) the RBIG limitation, over (ii) partnership RBIGs during the recognition period. Similarly, the amount treated as an RBIL is limited to the excess (if any) of (i) the RBIL limitation, over (ii) partnership RBILs during the recognition period. Treas. Reg. § 1.1374-4(i)(3), (8) Ex. 7.

The RBIG or RBIL limitation equals (i) the amount realized from a hypothetical sale of the partnership interest, less (ii) the adjusted basis of the partnership interest, adjusted by (iii) partnership section 481 adjustments that would be taken into account in a hypothetical sale. The above formula is applied on the basis that the loss corporation sold its partnership interest to a third party immediately before the ownership change. The amount realized from the hypothetical asset sale is based on a sale for fair market value. Treas. Reg. § 1.1374-4(i)(4)(i).

If the result of the above formula is a positive amount, the RBIG limitation equals that amount and the RBIL limitation is zero. If the result of the above formula is a negative amount, the RBIL limitation equals that amount and the RBIG limitation is zero. Treas. Reg. § 1.1374-4(i)(4)(ii).

The above-described partnership rules do not apply in any taxable year in the recognition period if (i) the fair market value of the partnership interest immediately before the ownership change is less than \$100 thousand, and (ii) the loss corporation has owned less than 10% of the partnership (by capital and profits) at all times during the taxable year and prior periods within the recognition period. Treas. Reg. § 1.1374-4(i)(5)(i). The fair market value of the partnership interest generally includes any asset held by the loss corporation immediately before the ownership change that was contributed to the partnership during the recognition period. Treas. Reg. § 1.1374-4(i)(5)(ii). This small investment exception does not apply if the partnership was formed or availed of with a principal purpose of tax avoidance. Treas. Reg. § 1.1374-4(i)(5)(iii).

Special rules apply with respect to gain or loss under section 704(c). For purposes of section 382 only, the loss corporation's section 704(c) gain or loss amount is not reduced during the recognition period, except for amounts treated as RBIG or RBIL under these partnership rules. Treas. Reg. § 1.1374-4(i)(6), (8) Ex. 8.

If a partnership distributes an asset to the loss corporation, the gain or loss from a disposition during the recognition period can be treated as an RBIG or RBIL. This can apply if (i) a loss corporation owns an interest in the partnership immediately before the ownership change, (ii) the partnership owns the asset immediately before the ownership change, (iii) the partnership distributes the asset to the loss corporation during the recognition period, and (iv) the loss corporation disposes of the asset during the recognition period. In such case, the loss corporation is treated as owning the asset directly immediately before the ownership change. The loss corporation's RBIG or RBIL with respect to the asset is the same as the partnership's RBIG or RBIL. Treas. Reg. § 1.1374-4(i)(7), (8) Ex. 9.

Examples of the application of the partnership rules can be found in section 1.1374-4(i)(8) of the Treasury regulations.

Interaction with Section 163(j). The deduction of business interest expense is limited by section 163(j) for certain taxpayers. To the extent a deduction is disallowed, the excess is carried forward (and can be subject to the limitations of section 382, if there is an ownership change). IRC §§ 163(j)(1), (2), 382(d)(3); Prop. Reg. §§ 1.163(j)-2(b), (c), 1.382-(a)(1)(i)(A). Regulations issued in 2020 provide that “disallowed business interest carryforwards” are not treated as RBILs. Treas. Reg. § 1.382-7(d)(5).

The proposed section 382(h) regulations provide for a different treatment for disallowed business interest under section 163(j) that is allocated from a partnership. Such interest can be treated as an RBIL. To give some context, the section 163(j) rules apply on an entity basis to partnerships that incur business interest expense. The disallowed portion of the business interest (i.e., the excess business interest expense) is allocated to the partners (and not carried forward to a future taxable year of the partnership). In such case, the partner is treated as incurring the excess business interest expense in the next taxable year (or a subsequent taxable year) but only to the extent of any excess taxable income (the amount by which the section 163(j) limitation exceeds the amount of deductible business interest) allocated from the partnership. The partnership business interest that is deemed to be incurred by the partner is subject to the section 163(j) limitation at the partner level. IRC § 163(j)(4); Treas. Reg. § 1.163(j)-6.

The proposed section 382(h) regulations treat a disallowed business interest carryforward from a partnership to a partner as an RBIL in certain circumstances. Such a deduction is treated as an RBIL if it is deductible by the corporate partner during the recognition period but is attributable to a pre-change period of the change year or a taxable year prior to the ownership change.

In determining whether a deduction of excess business interest expense is attributable to the pre-change period of a change year, the period allocation rules of section 1.382-6 of the Treasury regulations apply. The convention used by the taxpayer (closing of the books or pro rata allocation) used by the taxpayer for section 1.382-6 purposes also is applied to allocate the excess business interest expense deduction. Prop. Reg. § 1.382-7(d)(3)(vi)(A)(1). In addition, the excess business interest is taken into account in chronological order (i.e., earliest year first). Prop. Reg. § 1.382-7(d)(3)(vi)(A)(2).

The amount of NUBIG or NUBIL is not adjusted to take into account any RBILs with respect to excess business interest expense. Prop. Reg. § 1.382-7(d)(3)(vi)(B). It should be noted that a partner reduces the basis in a partnership interest to the extent of any allocation of excess business interest expense. Treas. Reg. § 1.163(j)-6(h)(2). This basis adjustment increases the amount of any NUBIG or decreases the amount of any NUBIL.

A partner can be allocated excess business interest expense that is characterized as “negative section 163(j) expense” (i.e., business interest expense that is suspended due to the basis limitation of section 704(d)). Negative section 163(j) expense is not treated as excess business interest expense in any subsequent taxable year until the expense is no longer suspended under section 704(d). Treas. Reg. § 1.382-6(h)(1), (2). The proposed section 382 regulations do not address whether deductions resulting from allocations of negative section 163(j) deductions are RBILs. Prop. Reg. § 1.382-7(b)(6), (d)(3)(vi)(A); REG-125710-18, 84 Fed. Reg. 47455, 47462 (2019).

The Treasury Department and the IRS have requested comments as to whether excess business interest expense or negative section 163(j) expense should be treated as a built-in deduction or as a pre-change loss. REG-125710-18 (as amended), 84 Fed. Reg. at 47462.

Section 163(j) Example. Lossco is a corporation that is a 50% partner in the PRS partnership. In 2019, PRS incurs deductible business interest expense of \$145 million. PRS' section 163(j) limit for 2019 is \$45 million. As a result, PRS has excess business interest expense of \$100 million. PRS allocates \$50 million of the excess business interest expense to Lossco.

Lossco experiences an ownership change on December 31, 2019. Lossco has a NUBIL of \$40 million.

In 2020, PRS incurs deductible business interest expense of \$20 million. PRS's section 163(j) limitation is \$100 million. As a result, PRS' excess taxable income for 2020 is \$80 million. PRS allocates \$40 million of the excess taxable income to Lossco.

In 2020, Lossco incurs deductible business interest expense of \$60 million. Lossco's section 163(j) limitation for 2020 is \$25 million. In addition, Lossco's section 382 limit for 2020 is \$30 million. Lossco has no attributes subject to section 382 or 383 other than a potential RBIL.

Lossco was allocated excess business interest expense in 2019 of \$50 million. In 2020, Lossco was allocated \$40 million of excess taxable income. As a result, Lossco can treat \$40 million of the excess business interest expense as incurred in 2020. The remaining \$10 million is carried forward to 2021 as excess business interest expense.

In 2020, Lossco is treated as having incurred deductible business interest expense of \$100 million (\$60 million directly and \$40 million of excess business interest expense from PRS). The section 163(j) limitation is \$25 million. As a result, Lossco can deduct \$25 million in 2020. The remaining \$75 million of business interest expense carries forward to 2021. *See* Treas. Reg. § 1.163(j)-6(o)(1).

The amount of excess business interest from PRS that is deductible in 2020 is an RBIL since it is deductible during the recognition period but is attributable to a pre-change year (2019). Under the ordering rules, business interest that is an RBIL is deductible before business interest that is not an RBIL. Prop. Reg. § 1.383-1(d)(1)(ii). As a result, \$25M of the excess business interest is deductible in 2020 but subject to section 382. The RBIL of \$25 million in 2020 is fully deductible since the section 382 limitation is \$30 million. Lossco can apply the \$5 million of unused section 382 limitation to increase the section 382 limitation in 2021.

In 2021, Lossco has a disallowed business interest expense carryforward of \$75 million (\$15 million of which is subject to section 382). The unused section 382 limitation from 2020 equals \$5 million. In addition, PRS has unabsorbed excess business interest from 2019 allocable to Lossco of \$10 million. Prop. Reg. § 1.382-7(f)(5) Ex. 5.

It should be noted that the discussion in this example related to the computation of RBILs is based on the proposed section 382(h) regulations. Taxpayers are free to take positions that differ from the results discussed herein.

VII. Insolvent Loss Corporations

This section discusses the special section 382 rules that apply where a loss corporation restructures its debt or equity in a bankruptcy, receivership, or other proceeding or receives assistance from the federal government. Paragraph (l)(5) and (l)(6) of section 382 apply to an ownership change that occurs in a bankruptcy or similar proceeding. Various rules embodied in the Code and regulations (as well as guidance

from the IRS and the Treasury Department) apply to situations in which a loss corporation receives assistance from the federal government.

Special rules apply if an ownership change occurs in a bankruptcy or similar proceeding. In such instance, one of two alternative regimes may apply to the ownership change. If section 382(l)(5) applies to the ownership change, the section 382 limitation generally does not apply. Alternatively, if section 382(l)(6) applies, the base annual section 382 limitation is enhanced and is generally determined based upon the value of the stock immediately after the transaction.

If a transaction would otherwise meet the requirements of both paragraph (l)(5) and (l)(6) of section 382, the transaction will be treated as meeting only the requirements of paragraph (l)(5). IRC § 382(l)(6); Treas. Reg. § 1.382-9(j). In such instance, a new loss corporation can make an election not to have paragraph (l)(5) apply (and apply paragraph (l)(6) instead). IRC § 382(l)(5)(H); Treas. Reg. § 1.382-9(i). The election is made by attaching a statement to the tax return for the year that includes the change date. To be valid, the election must be made by the extended due date of the return. The election, once made, is irrevocable. Treas. Reg. § 1.382-9(i). It appears that the IRS did not retain authority to permit a taxpayer to revoke an election.

A. Title 11 or Similar Case

The provisions of paragraphs (l)(5) and (l)(6) of section 382 only apply if the loss corporation is under the jurisdiction of a court in a “title 11 or similar case.” IRC § 382(l)(5)(A)(i); (6); Treas. Reg. § 1.382-9(a). To qualify under one of the two provisions, the transaction resulting in the ownership change must either be ordered by the court or pursuant to a plan approved by the court. Treas. Reg. § 1.382-9(a).

The term “title 11 or similar case” is defined to include a case under title 11 of the United States Code. IRC §§ 368(a)(3)(A)(i), 382(l)(5)(G), (l)(6); Treas. Reg. § 1.382-9(a). Title 11 is more commonly referred to as the United States Bankruptcy Code. As a result, if a loss corporation is under the jurisdiction of a United States Bankruptcy Court the proceeding will generally be treated as a title 11 or similar case.

The term “title 11 or similar case” is also defined to include a “receivership, foreclosure, or similar proceeding in a federal or State court” or, with respect to a financial institution, an agency. IRC § 368(a)(3)(A)(ii), (D). There is a great deal of uncertainty as to which proceedings can qualify as a “similar case.” The legislative history of the current language indicates that its meaning is to be the same as under section 371. S. Rep. 96-1035, p. 35, n.3 (1980). Section 371 was effective for proceedings begun on or before September 30, 1979, IRC § 370(a) (as in effect before repeal), and was repealed in 1990 as deadwood. Omnibus Budget Reconciliation Act of 1990, PL 101-508, § 11801(a)(19). Before its repeal, section 371 provided rules for reorganizations in receivership and bankruptcy proceedings. Section 371 was replaced by the type G reorganization rules.

Only one case or ruling has been found as to what types of proceedings qualify as a “receivership, foreclosure, or similar proceeding” under section 371. In GCM 34230 (Nov. 28, 1969), the IRS discussed the factors under which a proceeding under Chapter XI of the National Bankruptcy Act of 1898 (the predecessor of the current Bankruptcy Code) would qualify. In the proceeding, 90% of the assets were transferred to a successor corporation for the benefit of creditors. The IRS view enunciated in the ruling was that a judicial proceeding must “effect a substantive modification or alteration of the proprietary interests in the corporate enterprise: i.e., one in which the proprietary interest in the business enterprise is, at least to some extent, assumed by those persons who were creditors of the enterprise at the time of its insolvency.” *Id.* In the IRS’ view a mere arrangement to modify the terms of a corporation’s debt or the mere appointment of a receiver would not qualify.

It is difficult to determine the meaning of GCM 34230 under current law because of the subsequent overhaul of both the bankruptcy laws and the tax rules relating to insolvency cases. It appears that it was the IRS' view that it is not the type of proceeding that matters but the significance of the change in the corporate structure. However, it is not clear from the analysis whether the above-IRS concerns were based on interpreting the meaning of "receivership, foreclosure, or similar proceeding" or based on ensuring that the judicial continuity of interest requirement was met.

Special rules apply to agency receiverships which involve financial institutions (e.g., an FDIC receivership). In the case of a "receivership, foreclosure, or similar proceeding before a federal or State agency" which involves a "financial institution," the agency is treated as a court for purposes of determining whether the proceeding qualifies as a "title 11 or similar case." IRC § 368(a)(3)(D). For this purpose, a financial institution is defined with reference to sections 581 and 591 and generally includes specified domestic (i) banks, (ii) trust companies, (iii) building and loan associations, (iv) savings and loan associations, (v) savings banks, and (vi) cooperative banks. IRC §§ 581, 591, 7701(a)(19).

If a loss corporation is under the jurisdiction of a foreign court, the foreign proceeding cannot qualify as a title 11 or similar case. The statutory definition refers only to federal and state courts. Amendments to the United States Bankruptcy Code made in 2005 have added rules under chapter 15 for an ancillary case in United States Bankruptcy Court to recognize a foreign insolvency proceeding. There is currently uncertainty as to which, if any, proceedings under chapter 15 can qualify as a "title 11 or similar case." The IRS did treat a chapter 15 proceeding as a title 11 case for section 108 purposes (exclusion of COD income) in a private ruling. PLR 201510025 (Nov. 6, 2014). In the ruling, the IRS noted that the US bankruptcy court and the foreign court had concurrent jurisdiction over the debtor. Due to the unusual nature of chapter 15 proceedings, it is not known whether concurrent jurisdiction is a feature of a typical chapter 15 case.

Hereafter, we will refer to a title 11 or similar case using the less cumbersome term "bankruptcy case."

Delaware Compromise or Arrangement. Structuring debt workouts under the corporate reorganization provisions of Delaware corporate law may yield the section 382 benefits of bankruptcy without some of the business concerns. It appears that a Delaware compromise or arrangement falls within the meaning of "receivership, foreclosure, or similar proceeding" and could be treated as a title 11 or similar case for section 382(l)(5) and (l)(6) purposes. See Martin D. Ginsburg, Jack S. Levin, Donald E. Rocap, *Mergers Acquisitions, and Buyouts*, § 1210.2.1.5(3) (December 2021 update) (Delaware proceeding "should" qualify).

A compromise or arrangement under Delaware law provides a relatively simple, expeditious, and tax-efficient alternative to filing a prepackaged bankruptcy petition. Frequently, where the creditors and shareholders of a corporation agree to a workout of a corporation's liabilities, the corporation files a prepackaged bankruptcy petition. A prepackaged bankruptcy petition is a petition in which a proposed plan of liquidation or reorganization is attached. In such case, all of the major parties would have agreed in advance to vote for the proposed plan. The advantage of a prepackaged bankruptcy plan is that frequently it is possible to get court approval for the plan on an expedited basis. However, even with the expedited procedures, the process can frequently be slow and expensive. Additionally, there is a possibility that persons with small claims could challenge the plan as unfair to them.

As an alternative to a prepackaged bankruptcy petition, a corporation may be able to petition for a Delaware compromise or arrangement to achieve some of the same tax result as a bankruptcy (and reduce professional fees). A Delaware compromise or arrangement is a seldom-used provision of Delaware law. Section 102(b)(2) of the Delaware General Corporation Law authorizes a Delaware corporation to include a provision in its certificate of incorporation to permit a court supervised compromise or arrangement

between the corporation and its creditors and/or its shareholders. Where this provision is included in the certificate of incorporation, the corporation, a creditor or a shareholder thereof, may bring an action in a Delaware court of equity to order a special meeting of creditors and/or shareholders to consider a proposed compromise or arrangement. Del. Code Ann., tit. 8, § 102(b)(2).

Where the corporate charter does not contain the language described in the previous paragraph, a first step is to modify the charter to include the language. If a corporation is incorporated in a state other than Delaware, it is still possible to apply this idea. It may be possible to reincorporate in Delaware as an initial step and adopt the required language in the new charter. In addition, certain other states have adopted similar provisions. Ginsburg *supra*, n. 153 (New York, Michigan, Pennsylvania, Kansas, Missouri, Oklahoma, Louisiana, and West Virginia).

A compromise or arrangement is considered approved by the parties if a majority in number (representing three-fourths in value) of the creditors (or class thereof) and/or the shareholders (or class thereof) agree to the plan. Said another way, for a plan to be effective, the Delaware statute requires a favorable vote by a majority of the relevant class of shareholders and/or creditors who hold three-fourths of a class of stock and/or debt. The vote is on a class-by-class basis. Unaffected classes of creditors or shareholders would generally not be entitled to vote. *Id.* For example, trade creditors would generally not vote on a plan (or be notified) that leaves their rights unaffected but results in a compromise with respect to the subordinated creditors and shareholders.

To become effective, a Delaware court of equity must sanction the compromise or arrangement. *Id.* Pursuant to section 302 of the Delaware General Corporation Law, a petition for a compromise or arrangement is filed with the Delaware Court of Chancery.

No statutory guidance is given as to standards for the Court of Chancery to use in deciding whether to sanction the compromise or arrangement. Since a proceeding is an equitable proceeding, the court has a great deal of discretion in deciding whether to sanction the compromise or arrangement. In our experience, the Court of Chancery processes these applications quickly (typically in a few days). *See, e.g., In re R.A.B. Holdings*, 2005 Del. Ch. Lexis 212 (court order signed two days after meeting of creditors and shareholders). The court has sanctioned plans even where the shareholder/creditor approval is not unanimous. *Id.*; *In re Coordinated Apparel, Inc.*, 1991 Del. Ch. Lexis 235.

Generally, the Court of Chancery can administer and enforce any court-approved compromise or arrangement. Del. Code Ann., tit. 8, § 302. The court would appear to have equitable powers to compel the participating parties to comply with the agreed-to compromise or arrangement (but subject to the limitations described in the following paragraph).

A disadvantage to a Delaware proceeding is that the ability to enforce the compromise or arrangement is constrained. A bankruptcy plan of liquidation or reorganization can be enforced against non-participating creditors and shareholders. Although the Delaware statute allows for enforcement against non-participants, the provisions of Delaware law may be in violation of the Supremacy Clause of the United States Constitution and it is possible that they may not be enforceable. *See International Shoe Co. v. Pinkus*, 278 US 261, 265 (1929) (Federal bankruptcy law overrides all similar state laws); *Jerry Davidson, Inc. v. Michigan Nat'l Bank*, 220 NW 2d 714 (Mich. Ct. App. 1974) (similar Michigan reorganization provision could not discharge claims of objecting creditors).

A tax disadvantage to a Delaware proceeding is that the bankruptcy exclusion of COD income would not apply. IRC § 108(a)(1)(A). Such exclusion does not apply to a “similar case.” IRC § 108(d)(2). The insolvency exclusion could still apply in many cases. However, the insolvency exclusion only applies to

the extent the corporation is insolvent (i.e., liabilities exceed the FMV of the assets). IRC § 108(a)(1)(B), (3), (d)(3). The bankruptcy exclusion has no such limitation. In any case, since the cost of either exclusion is a reduction in tax attributes, IRC § 108(b), the limitation on the amount of the exclusion, in many cases, only results in a timing difference. Whether the limitation on the amount of the exclusion has a material impact will depend on the facts and circumstances. In certain circumstances, there could be a material initial tax cost.

B. Section 382(l)(5)

Where the provisions of section 382(l)(5) apply, the NOLs (and other tax attributes) of the loss corporation are generally allowable and are not subject to limitation under section 382. However, any limitation caused by a prior or subsequent ownership change would continue to apply.

In many cases, the provisions of section 382(l)(5) can be of benefit to the loss corporation. However, the benefit of no limitation is tempered by several rules which potentially reduce the utility of section 382(l)(5). In addition, the qualification requirements for section 382(l)(5) are more onerous than the qualification requirements under section 382(l)(6).

Qualification

The provisions of section 382(l)(5) only apply if the loss corporation is under the jurisdiction of a court in a bankruptcy case (immediately before the ownership change). IRC § 382(l)(5)(A)(i); Treas. Reg. § 1.382-9(a), (b)(1). To qualify, the transaction resulting in the ownership change must either be ordered by the court or pursuant to a plan approved by the court. Treas. Reg. § 1.382-9(a), (d)(1).

An additional qualification requirement is that the “pre-change shareholders” and “qualified creditors” (in combination or separately) must own 50% or more of the stock of the new loss corporation after the ownership change. IRC § 382(l)(5)(A)(ii); Treas. Reg. § 1.382-9(b)(2). To meet this requirement, the shareholders and creditors must own stock with at least 50% of the total voting power of the stock of the new loss corporation and a value equal to at least 50% of the total value of the stock of the new loss corporation. IRC § 1504(a)(2). Pure preferred stock is not treated as stock for purposes of determining whether the 50% ownership requirement is met. IRC § 1504(a)(4).

For purposes of the 50% ownership requirement, the shareholder or creditor must have received the shares as a result of being a pre-change shareholder or qualified creditor immediately before the ownership change. IRC § 382(l)(5)(A)(ii); Treas. Reg. § 1.382-9(b)(2). The legislative history indicates that it was intended that only shares received in exchange for stock or qualified indebtedness are taken into account. Stock received by a shareholder for new consideration (including cash or guarantees) was not intended to be taken into account. Similarly, stock purchased from other shareholders in the transaction was not intended to be taken into account. H. Rep. 100-795, p. 51 (1988).

Pre-change shareholders and creditors sometimes receive rights to subscribe for additional shares in a bankruptcy plan of reorganization. A question arises as to whether shares issued upon exercise of the rights count towards the 50% test since the shares are arguably issued for new consideration. The IRS in Private Letter Ruling 200818020 (Jan. 29, 2008) treated shares issued to creditors pursuant to the exercise of a subscription right as received in satisfaction of qualified indebtedness. The creditors under the bankruptcy plan received both stock and rights to subscribe for additional shares. The subscription rights allowed the creditors to acquire stock at a significant discount to the anticipated market price. The ruling did not apply to creditors to the extent they received subscription rights in their capacity as a backstop guarantor. PLR

200818020. A more recent ruling treated shares issued pursuant to a backstop guarantee as received in satisfaction of qualified indebtedness. PLR 201750006 (Sept. 18, 2017).

In Private Letter Ruling 201322032 (Feb. 26, 2013), the IRS ruled that a bankrupt loss corporation that was 100% owned by a qualified settlement fund (within the meaning of section 1.468B-1(c) of the Treasury regulations) after the ownership change met the requirements of section 382(l)(5). The fund was 100% owned by qualified creditors of the loss corporation. A qualified settlement fund is a trust (from a state law standpoint) that is taxed under a regime that is similar to the tax regime for C corporations. Treas. Reg. § 1.468B-2. The taxpayer represented that the fund would own 50% or more of the stock (by vote and value) after the ownership change. PLR 201322032.

In an alternative qualification test, the 50% ownership requirement can be met with respect to a corporation that is in control of the loss corporation (if the controlling corporation is also in a bankruptcy case). In such case, pre-change shareholders and qualified creditors would need to own 50 or more of the stock of the controlling corporation immediately after the loss corporation's ownership change. IRC § 382(l)(5)(A)(ii); Treas. Reg. § 1.382-9(b)(2). It appears that "control" for this purpose means ownership of at least 80% of the combined voting power of all classes of voting stock and at least 80% of each class of non-voting stock (including Pure Preferred Stock). IRC § 368(c) (definition of "control" for certain purposes of subchapter C, including section 382).

There is a great deal of uncertainty as to how the controlling corporation rule applies. For example, does it only apply to first-tier subsidiaries or do attribution rules apply to provide section 382(l)(5) treatment to all lower-tier subsidiaries. In addition, the provision requires that the controlling corporation must also be in bankruptcy. There is uncertainty as to the significance of the use of the term "bankruptcy," instead of "title 11 or similar case."

The statute is also unclear as to whether "controlling corporation" status is determined immediately before or after the ownership change. Since the stock ownership test is determined immediately after the ownership change, that would suggest control is determined immediately after the ownership change. However, the rule requires that the controlling corporation must also be in bankruptcy. Since an acquiring corporation would not normally be in bankruptcy, this suggests that control is tested immediately before.

There is also uncertainty as to the role that the controlling corporation rule is intended to play (as the legislative history is silent on this point). For example, if P owns 100% of S and P issues stock to qualified creditors resulting in an ownership change to both P and S, many taxpayers would take the position that S meets the requirements of section 382(l)(5) (without need of the controlling corporation rule, see below). In such case, S has an ownership change and is in bankruptcy, and a pre-change shareholder (P) owns 100% of the stock of S after the ownership change. As a result, the controlling corporation provision may just serve as a back stop for the position in such circumstance.

Pre-change Shareholder. No guidance has been issued as to the meaning of the term "pre-change shareholder." It is possible that a shareholder that acquired shares before the transaction that resulted in the ownership change may not be treated as a pre-change shareholder in appropriate circumstances. Potential factors that might be taken into account include, the proximity in time of the share purchase and the ownership change, the status of the bankruptcy case at the time the shares were purchased, and the intent of the shareholder. See 1997 FSA Lexis 237 (purchaser of "when issued" shares not a pre-change shareholder); CCA 200915033 (Dec. 24, 2008) (purchaser in advance of pre-packaged bankruptcy not treated as a pre-change shareholder).

There is uncertainty as to whether and how constructive ownership rules apply for purposes of determining whether someone is a pre-change shareholder (and the amount of stock they own). It is possible that the constructive ownership rules apply “in determining ownership of stock” for purposes of section 382. IRC § 382(l)(3)(A). *But see* Temp. Reg. § 1.382-2T(h)(1) (constructive ownership rules “generally” apply). It is also possible that the constructive ownership rules do not apply by analogy to the exception (described below) for purposes of determining qualified creditors (since the rules for pre-change shareholders are reserved). Treas. Reg. § 1.382-9(d)(2)(ii). If the constructive ownership rules do apply, then it appears that the rule that generally results in a person not owning stock for section 382 purposes if the stock is attributed to someone else does not apply (as the regulations turn off the rule for this purpose). Treas. Reg. § 1.382-4(b)(2). So if a partnership is a shareholder, the constructive ownership rules could treat the partners as shareholders. But if they did, the partnership would also be treated as a shareholder and might qualify as a pre-change shareholder.

There is also uncertainty as to how to apply the rules when the loss corporation is a subsidiary of another corporation. For example, if P owns 100% of S and P issues stock to creditors resulting in an ownership change to both P and S, it is possible that P could be treated as a pre-change shareholder of S potentially resulting in S qualifying for section 382(l)(5) treatment (assuming that it was in bankruptcy and other requirements are met). We understand that the IRS is dubious about treating a parent corporation as a pre-change shareholder. However, without treating the parent corporation as a pre-change shareholder it may be challenging for a subsidiary to qualify as the rules require that the subsidiary’s qualified creditors own more than 50% of the subsidiary or the parent corporation after the ownership change. This may not be possible if the subsidiary’s creditors receive fewer shares than the parent’s creditors.

Qualified Creditor. A qualified creditor is a creditor that is the beneficial owner of “qualified indebtedness” (immediately before the ownership change). Treas. Reg. § 1.382-9(d)(1). Ownership of stock by a creditor is determined without regard to constructive ownership rules. Treas. Reg. § 1.382-9(d)(1).

Shares received by qualified creditors only count towards the 50% ownership requirement to the extent received in satisfaction (full or partial) of qualified indebtedness, including accrued interest. IRC § 382(l)(5)(E). To count towards the 50% ownership requirement, the shares must also be received in a transaction that is ordered by the court or pursuant to a plan approved by the court. Treas. Reg. § 1.382-9(d)(1).

Qualified indebtedness is a debt obligation of the old loss corporation that (i) has been owned by the same beneficial owner for the period beginning 18 months before the bankruptcy case was filed and ending on the date the debt is exchanged for stock, or (ii) arose in the ordinary course of the old loss corporation’s trade or business and has been owned by the same beneficial owner at all times. IRC § 382(l)(5)(E); Treas. Reg. § 1.382-9(d)(2)(i). Beneficial ownership of debt is determined without regard to constructive ownership rules. Treas. Reg. § 1.382-9(d)(2)(ii).

A debt obligation is treated as having arisen in the ordinary course of the old loss corporation’s trade or business if the obligation was incurred in connection with the “normal, usual, or customary conduct of business.” Treas. Reg. § 1.382-9(d)(2)(iv). It does not matter whether the obligation funds ordinary or capital expenditures. The regulations list numerous categories of debt obligations that will qualify as ordinary course indebtedness. These regulations are very inclusive and include the following:

- trade debt;
- a tax liability;
- a liability arising from an employment relationship (past or present);

- a liability arising from a business relationship (past or present) with a supplier, customer, or competitor;
- a liability arising from a tort or a breach of warranty or statutory duty;
- a debt incurred to pay an expense that is either deductible under section 162 or included in cost of goods sold; or
- a claim that arose upon the rejection of a burdensome contract or lease pursuant to a bankruptcy case if the contract or lease arose in the ordinary course.

Treas. Reg. § 1.382-9(d)(2)(iv); *see also* PLR 201750006 (Sept. 18, 2017) (debt issued pursuant to draws under a letter of credit issued as security for surety bond).

One obligation that does not qualify as ordinary course indebtedness is debt that was acquired for a principal purpose of being exchanged for stock. Treas. Reg. § 1.382-9(d)(2)(iv). It also appears that a debt obligation that was incurred to acquire stock or assets of another corporation generally will not be treated as ordinary course indebtedness.

An obligation will not be treated as qualified indebtedness if the debt of the loss corporation is held by a special purpose entity and other requirements are met. This provision applies if (i) the beneficial owner of the debt is a corporation or other entity that is a “5% entity” immediately after the ownership change of the loss corporation, (ii) the beneficial owner had an ownership change on any day during the “applicable period,” and (iii) debt of the old loss corporation represents more than 25% of the gross assets of the beneficial owner (by value and excluding cash or cash equivalents) on the change date. Treas. Reg. § 1.382-9(d)(4)(i). The intent behind this rule is to prevent investors from avoiding the holding period requirement through use of an entity formed to facilitate the indirect sale of loss corporation debt.

A “5% entity” is an entity through which a 5% shareholder owns an indirect ownership interest in the new loss corporation. Treas. Reg. § 1.382-9(d)(3)(i), (4)(i)(C). Special rules for purposes of determining 5% shareholder or 5% entity status are described below with respect to the small shareholder presumption.

The applicable period is the period beginning 18 months before the bankruptcy case was filed (or the day the 5% entity acquired the debt, if later) and ending on the loss corporation’s change date. Treas. Reg. § 1.382-9(d)(4)(ii). The determination as to whether the 5% entity has had an ownership change is made under general principles of section 382 without regard to whether the 5% entity is a loss corporation. For this purpose, the testing period begins no earlier than the later of (i) the day three years before the change date, (ii) the day that is 18 months before the bankruptcy case was filed, or (iii) the day the 5% entity acquired the debt. Treas. Reg. § 1.382-9(d)(4)(iii).

A loss corporation may, if it chooses, rely on penalty of perjury statements signed by the 5% entity stating that the exception for special purpose entities does not apply. Treas. Reg. § 1.382-9(d)(4)(iv). The regulation does not state, for no known reason, that the statement cannot be relied upon if known to be false. *Compare* Temp. Reg. § 1.382-2T(k)(1)(ii).

Small Shareholder Presumption. A loss corporation is permitted (but not required) to treat a creditor that does not acquire 5% of the new loss corporation as having owned the debt obligation for its entire existence (the “small shareholder presumption”). Treas. Reg. § 1.382-9(d)(3)(i). The small shareholder presumption, where it applies, allows the loss corporation to avoid determining the holding period for the debt that was exchanged for a less than 5% interest. For ordinary course indebtedness, the application of this rule generally permits treating small shareholders as qualified creditors. For other indebtedness, a small shareholder will only be treated as a qualified creditor under the rule if the debt was originally issued more than 18 months before the filing date.

A creditor is treated as not acquiring a 5% interest if the creditor does not become either a 5% shareholder or a “5% entity” immediately after the ownership change. Treas. Reg. § 1.382-9(d)(3)(i). A “5% entity” is an entity through which a 5% shareholder (or shareholder group) owns an indirect ownership interest in the new loss corporation. Treas. Reg. § 1.382-9(d)(3)(i). Based upon this definition, a 5% entity includes an entity that directly owns 5% or more of the stock of the loss corporation (since any public group with respect to the entity would be treated as a 5% shareholder). Treas. Reg. § 1.382-9(d)(3)(iv)(C) (P2).

A 5% entity also includes an entity that owns less than 5% of the stock of the loss corporation but has a shareholder that is a 5% shareholder. For example, if three wholly-owned subsidiaries of an individual each own 4.9% of the stock of the loss corporation, all three entities are 5% entities because a 5% shareholder has an interest in each such entity. Treas. Reg. § 1.382-9(d)(3)(iv)(C) (P3, P4, and P5). Similarly, if an individual that has a direct interest in a loss corporation of 7.5% owns 10% of an entity that owns 3% of the loss corporation, the entity is a 5% entity. However, if the loss corporation did not have actual knowledge of the individual's ownership of the entity, the entity would not be a 5% entity (since it only owned 3%). Treas. Reg. § 1.382-9(d)(3)(iv)(B) (P1).

In determining whether a person is a 5% shareholder or 5% entity, the general section 382 and the special section 382(l)(5) option attribution rules are not applied. Treas. Reg. § 1.382-9(d)(3)(ii)(C). Instead, special option attribution rules apply. Any option to acquire or dispose of stock of the new loss corporation is taken into account if (i) the loss corporation has actual knowledge of the option immediately after the ownership change, and (ii) treating the option as exercised would cause the person to be treated as either a 5% shareholder or a 5% entity. The definition of an option is the same for purposes of this rule as it is for purposes of the general section 382 option attribution rules. Treas. Reg. § 1.382-9(d)(3)(ii)(D).

In certain cases, a group of shareholders can be treated as an entity (that could be treated as a 5% entity) if the loss corporation has actual knowledge of a coordinated acquisition of its debt. Two or more shareholders are treated as an entity if there is “coordinated acquisition” of indebtedness through a “formal or informal understanding among themselves, for a principal purpose of exchanging the indebtedness for stock.” Treas. Reg. § 1.382-9(d)(3)(ii)(A). The regulations state that the principal factor in determining whether the requisite “understanding” exists is “whether the investment decision of each member of a group is based upon the investment decision of one or more other members.” Treas. Reg. § 1.382-9(d)(3)(ii)(A). In other words, is the person acquiring debt independently or based on the knowledge that others are also buying debt. *See* Treas. Reg. § 1.382-3(a)(1)(ii) Ex. 2 (group of friendly investors assembled by management).

In determining whether a person is a 5% shareholder or 5% entity, a loss corporation must take into account any actual knowledge as to the stock ownership of a person. Actual knowledge, if it exists, overrides certain limitations on the application of the entity attribution rules, and the family attribution rules. Treas. Reg. § 1.382-9(d)(3)(ii)(B). For example, if an individual owns 4% of a loss corporation directly and 2% indirectly by attribution, the individual is ordinarily not treated as a 5% shareholder. However, if the loss corporation has actual knowledge of both interests, the individual is treated as a 5% shareholder. *See* Temp. Reg. § 1.382-2T(g)(4) Ex. (3).

An example of when the small shareholder presumption applies can be found in the example described in section 1.382-9(d)(3)(iv) of the Treasury regulations.

The small shareholder presumption does not apply to debt that is beneficially owned “by a person whose participation in formulating a plan of reorganization makes evident to the loss corporation (whether or not the loss corporation had previous knowledge) that the person has not owned the indebtedness for the requisite period.” Treas. Reg. § 1.382-9(d)(3)(i). It appears that the drafters intended to apply these rules to speculators that participate in the formulation of the plan and thereafter sell some or all of their debt.

NYSBA Tax Section, “Report on Proposed Section 382(l)(5) Regulations,” Report # 768, p. 5, 93 TNT 167-27 (July 28, 1993). The preamble to the regulations states that “this exception applies regardless of whether the participant exchanges the indebtedness for stock pursuant to the plan or transfers the indebtedness to other persons prior to the effective date of the plan.” TD 8529 (Jan 14, 1994).

A potential example where the participation in the plan exception could apply is where a party claiming to own 51% of a class of debt participates in negotiations for a plan of reorganization in which the holders of that class ultimately receive 100% of the stock. If the loss corporation determines that there are no 5% shareholders, immediately after the ownership change, the transaction may not qualify for section 382(l)(5) treatment due to the inference that 51% of the stock is held by persons that acquired the stock from a person that participated in formulating the plan.

It should be noted that some tax practitioners do not apply the anti-speculator interpretation discussed above. Instead, they apply the participation exception to any person that is an active participant in plan formulation. Still others only apply the exception if they have actual knowledge of the participation in the plan, but do not request any information as to which parties participated.

Special rules apply if the ownership interests in a loss corporation are structured by a person with an interest in a loss corporation to avoid treating the person as a 5% shareholder or 5% entity for a principal purpose of circumventing a section 382 limitation. In such case, the shareholder’s actual ownership (including by attribution) is taken into account, but only if the loss corporation has actual knowledge of the ownership interest. Treas. Reg. § 1.382-9(d)(3)(ii)(B).

The small shareholder presumption does not apply to any shareholder that is a 5% shareholder or 5% entity immediately after the ownership change. In such case, the actual holding period of the debt held by the shareholder must be determined. Treas. Reg. § 1.382-9(d)(3)(iii). Similarly, for loss corporations that choose not to apply the small shareholder presumption, the actual holding period must be determined.

Holding Period. For purposes of determining the holding period of debt, the regulations provide for tacking of ownership periods. If a debt obligation of the old loss corporation is transferred in a “qualified transfer,” the transferee is treated as having owned the debt during the period it was owned by the transferor. Treas. Reg. § 1.382-9(d)(5)(i). A qualified transfer is a transfer of debt that meets one of the below requirements:

- a customary loan syndication transaction if the transfer is within 90 days of the origination of the loan;
- a transfer of newly-incurred debt pursuant to an underwriting if the underwriter transfers the debt during a transitory period;
- a transfer in which the transferee receives a transferred basis in the debt (or the basis is determined under section 1014 (transfer from a decedent) or 1015 (gift);
- a transfer in satisfaction of a right to receive a pecuniary bequest;
- a transfer pursuant to a divorce or separation instrument;
- a transfer pursuant to a subrogation in which the transferee acquires a claim against the loss corporation by reason of a payment to a claimant under an insurance policy, guarantee, letter of credit, or similar security arrangement; or
- a customary commercial factoring transaction in which an accounts receivable is transferred within thirty days after the account arose to a transferee that regularly engages in such transactions.

Treas. Reg. § 1.382-9(d)(5)(ii).

In addition, a qualified transfer includes a transfer between related persons. A transferor is related to a transferee if they have a relationship specified in either section 267(b) or 707(b) (substituting “at least 80%” for “more than 50%” each place it appears). Treas. Reg. § 1.382-9(d)(5)(ii)(A). Under sections 267(b) and 707(b) (as modified), a person is generally related to another if they are members of a family or there is some element of at least 80% common control.

A transfer of a debt obligation is not treated as a qualified transfer if the transferee acquired the debt obligation “for a principal purpose of benefiting from the losses of the loss corporation” by either (i) exchanging the debt for stock pursuant to a bankruptcy case, or (ii) selling the debt at a profit that reflects the economic value of section 382(l)(5). Treas. Reg. § 1.382-9(d)(5)(iii).

An additional tacking rule is provided for debt-for-debt exchanges. If the old loss corporation satisfies an old debt obligation with a new debt obligation through a debt-for-debt exchange (actual or deemed pursuant to section 1001), the holding period of the new debt includes the period during which the holder owned the old debt. In addition, the new debt is treated as ordinary course indebtedness if the old debt was ordinary course indebtedness. Treas. Reg. § 1.382-9(d)(5)(iv).

Private Letter Ruling 201750006 (Sept. 18, 2017) dealt with the holding period of shares issued in a rights offering. In a bankruptcy plan, holders of qualified indebtedness received stock and rights to acquire additional stock for cash. The original debt met the 18-month holding period requirement. The IRS treated shares that were acquired pursuant to the rights offering as having been received in satisfaction of qualified indebtedness. The ruling was limited to creditors that did not become 5% shareholders or 5% entities. PLR 201750006.

The IRS in Private Letter Ruling 201750006 also ruled on the treatment of debt obligations that were issued in a qualified reopening pursuant to section 1.1275-2(k) of the Treasury regulations. Under section 1.1275-2(k), additional later-issued debt obligations that are issued in a qualified reopening are treated as having the same issue date as the original debt obligations for OID purposes. In the ruling, the original debt met the 18-month requirement, but the additional debt instruments were issued within the 18-month period. The IRS treated such additional debt obligations as meeting the 18-month holding period requirement. The ruling was limited to creditors that did not become 5% shareholders or 5% entities. PLR 201750006.

Option Attribution. The section 382(l)(5) regulations provide for option attribution rules that differ from the general section 382 option attribution rules (as well as the option attribution rules applied under section 382(l)(5) for purposes of determining whether a person is a 5% shareholder or 5% entity). Under the section 382(l)(5) option attribution rule, an option with respect to stock can be treated as exercised by the holder of the option. The shares that are subject to the option are attributed to or away from the holder depending upon the type of option. The section 382(l)(5) option attribution rule only applies for purposes of determining whether the section 382(l)(5) ownership requirement is met.

Under the section 382(l)(5) option attribution rule, an option is treated as exercised at the time of the ownership change if a deemed exercise of the option would cause the transaction to fail the ownership requirement of section 382(l)(5). For example, an option held by a new investor to acquire 51% of the stock at any time in the following three years would be treated as exercised and would cause section 382(l)(5) to not apply. Treas. Reg. § 1.382-9(e)(1), (3) Ex. 1, 2.

An option that would, if exercised, result in an increase in the stock owned by pre-change shareholders and qualified creditors is not treated as exercised if it is owned as a result of being a pre-change shareholder or qualified creditor. Treas. Reg. § 1.382-9(e)(1). As a result, if options are issued to both qualified creditors

and to third parties, only the options issued to third parties are treated as deemed exercised. Treas. Reg. § 1.382-9(e)(3) Ex. 3(b).

For purposes of determining whether the ownership requirement is met, the deemed exercise of unissued shares (or treasury stock) results in a corresponding increase in the amount of outstanding stock. Similarly, the deemed exercise of a right to transfer outstanding stock to the loss corporation (or a right of the loss corporation to acquire its stock) results in a corresponding decrease in the amount of outstanding stock. Treas. Reg. § 1.382-9(e)(1); Temp. Reg. § 1.382-2T(h)(4)(vii)(A), (B).

If an option that was treated as exercised on the change date subsequently lapses unexercised (or the owner of the option irrevocably forfeits the right to acquire stock pursuant to the option), then the option can be treated as if it was never issued. This rule does not apply if any person owning the option (at any time on or after the change date) acquires additional shares (or an option to acquire additional shares) on or after the ownership change and on or before the lapse or forfeiture of the option. Treas. Reg. § 1.382-9(e)(2)(i), (3) Ex. 3(e).

If an option that was not treated as exercised on the change date (because it was owned by a pre-change shareholder or qualified creditor) subsequently is actually exercised, then the shares received from exercise of the option may be treated as if they were issued on the change date. This rule only applies if the option is actually exercised within three years of the change date by the shareholder who acquired the option under the plan as a result of being a pre-change shareholder or qualified creditor. Treas. Reg. § 1.382-9(e)(2)(i), (3) Ex. 3(c), (d); Temp. Reg. § 1.382-2T(h)(4)(viii).

If a loss corporation determines that section 382(l)(5) applies as a result of a subsequent event (i.e., a lapse or actual exercise), the loss corporation is permitted to file an amended return for a prior taxable year (subject to any applicable statute of limitations rule). In such instance, the loss corporation must make corresponding adjustments on amended returns for all affected taxable years (subject to any applicable statute of limitations rule). Treas. Reg. § 1.382-9(e)(2)(iii).

As a general rule, an “option” for purposes of the section 382(l)(5) option attribution rule includes an instrument that is considered to be an option to acquire stock under general tax principles. In addition, the term includes “a warrant, a convertible debt instrument, an instrument other than debt that is convertible into stock, a put, a stock interest subject to risk of forfeiture, and a contract to acquire or sell stock.” Temp. Reg. § 1.382-2T(h)(4)(v). An item described in the previous sentence is treated as an option without taking into account whether or not it is currently exercisable or contingent. Treas. Reg. § 1.382-9(e)(1); Temp. Reg. § 1.382-2T(h)(4)(iii).

For purposes of the section 382(l)(5) option attribution rule, an option to acquire an option to acquire stock (and any series of such options) is treated as an option to acquire stock. Treas. Reg. § 1.382-9(e)(1); Temp. Reg. § 1.382-2T(h)(4)(iv).

The applicable regulations list several options that are exempt from the section 382(l)(5) option attribution rule. The options that are eligible for exemption are described below.

Long-held options with respect to actively-traded stock are exempt from the section 382(l)(5) option attribution rule. The exemption applies to an option with respect to stock (i) which is actively traded on an “established securities market” (within the meaning of section 1273(b)) for which market quotations are readily available, (ii) which has been continuously owned by the same person for at least three years, and (iii) where the fair market of the stock exceeds the exercise price for the stock on the change date. Treas. Reg. § 1.382-9(e)(1); Temp. Reg. § 1.382-2T(h)(4)(x)(A).

Pre-petition debt which is convertible into a fixed-dollar amount of stock is exempt from the section 382(l)(5) option attribution rule. The exemption applies to a debt instrument that is convertible into (or payable in) stock if (i) the debt was issued before the filing date of the bankruptcy case, (ii) the economic terms of the debt are equivalent to nonconvertible debt because the right to receive stock is determined in a fixed-dollar amount based upon the fair market value of the stock determined at or about the date the stock is transferred, and (iii) the method for determining the fair market value of the stock is not intended to (and does not) provide the owner with a participation in any appreciation of any stock of the issuer. Treas. Reg. § 1.382-9(e)(1); Temp. Reg. § 1.382-2T(h)(4)(x)(B).

An option that is exercisable only upon death, disability, or mental incapacity of an owner of the loss corporation is exempt from the section 382(l)(5) option attribution rule if the option was entered into between owners of the loss corporation (or an owner and the loss corporation itself). Treas. Reg. § 1.382-9(e)(1); Temp. Reg. § 1.382-2T(h)(4)(x)(D).

A right to receive (or obligation to issue) stock in payment of interest or dividends by the issuing corporation is exempt from the section 382(l)(5) option attribution rule if the debt or stock was issued before the filing date of the bankruptcy case. Treas. Reg. § 1.382-9(e)(1); Temp. Reg. § 1.382-2T(h)(4)(x)(E).

A right to acquire loss corporation stock pursuant to a default under a loan agreement is exempt from the section 382(l)(5) option attribution rule if the loan was (i) made by a bank (as defined in section 581), an insurance company (as defined in section 1.801-3(a) of the Treasury regulations), or a qualified trust under section 401(a) (a US stock bonus, pension, or profit-sharing plan), and (ii) entered into by the lender in the ordinary course of the trade or business of the lender. Treas. Reg. § 1.382-9(e)(1); Temp. Reg. § 1.382-2T(h)(4)(x)(G).

An agreement to acquire or sell stock that is exercisable solely upon the retirement of a non-corporate owner of the loss corporation is exempt from the section 382(l)(5) option attribution rule if (i) the agreement was entered into between non-corporate owners of the loss corporation (or a non-corporate owner and the loss corporation itself), (ii) each of such owners actively participated in the management of the loss corporation's trade or business, and (iii) the agreement was entered into at a time the loss corporation was not a loss corporation. Treas. Reg. § 1.382-9(e)(1); Temp. Reg. § 1.382-2T(h)(4)(x)(H).

A poison pill plan is not an option subject to the section 382(l)(5) option attribution rule so long as the rights obtained by shareholders may be redeemed by the corporation for a nominal amount. Treas. Reg. § 1.382-9(e)(1); Temp. Reg. § 1.382-2T(h)(4)(x)(Z) (as in effect on September 5, 1990); Rev. Rul. 90-11, 1990-1 CB 10.

Consequences

Where section 382(l)(5) applies to an ownership change, the provisions of section 382(a) do not apply. IRC § 382(l)(5)(A); Treas. Reg. § 1.382-9(b). As a result, there are no limitations under either section 382 or 383 with respect to the ownership change that qualifies for section 382(l)(5) treatment. Any limitations with respect to prior ownership changes continue to apply.

The cost of avoiding limitations under section 382 and 383 under the Code is that various other unfavorable provisions apply. First, the NOL carryforwards (and other tax attributes) are recomputed to remove certain interest deductions (i.e., the interest haircut rule). Second, the NOL carryforwards (and other tax attributes) become valueless (i.e., the section 382 limit is zero) if a second ownership change occurs within two years. Third, the benefits under section 382(l)(5) can be subject to challenge under section 269.

Since there is no section 382 limitation imposed as a result of an ownership change that qualifies under section 382(l)(5), many of the complicated rules described above that apply with respect to the determination of the section 382 limitation do not apply. Examples of rules that do not apply are the NUBIG, corporate contraction, and capital contribution rules. The COBE rules also do not apply. Treas. Reg. § 1.382-9(m)(1). However, the regulations under section 269 incorporate some of the requirements of the COBE rules with respect to section 382(l)(5).

Interest Haircut. Where section 382(l)(5) applies to an ownership change, the interest haircut rule applies. In such case, the NOLs (and other tax attributes, including disallowed business interest carryforwards) that can be carried forward to a post-change year are recomputed as if no interest deduction was allowable with respect to debt obligations that are converted into stock pursuant to the bankruptcy case. In determining the amount of interest that is disallowed, interest is taken into account only if it is paid or accrued by the old loss corporation during (i) a taxable year that ends within the three-year period preceding the taxable year that includes the change date, or (ii) the period beginning on the first day of the taxable year that includes the change date and ending on the change date. IRC § 382(l)(5)(B).

As a general rule, a corporation can realize an amount of COD income on the transfer of stock to a creditor in satisfaction of accrued interest. IRC § 108(e)(8). However, no COD income is realized with respect to the discharge of accrued interest to the extent the interest results in a reduction of tax attributes under the interest haircut rule. IRC § 382(l)(5)(C).

The interest haircut rule requires a reduction in tax attributes that are carried forward to a post-change year. The term “post-change year” is defined as any taxable year ending after the change date. IRC § 382(d)(2). Thus, the taxable year that includes the change date is a post-change year. As a result, it appears that the tax attributes are reduced at the beginning of the taxable year that includes the change date.

Many loss corporations that have an ownership change under section 382(l)(5) also have COD income that is excluded under the section 108 bankruptcy exception in the same taxable year. Where COD income is excluded under section 108, the taxpayer is required to reduce NOLs and other tax attributes. IRC § 108(b). There is some uncertainty as to the interplay of the section 108 attribute reduction rules and the interest haircut rule. Under the section 108 attribute reduction rules, the tax attributes are generally reduced at the end of taxable year in which COD income is realized. IRC § 108(b)(4)(A); *Gitlitz v. Comm’r*, 531 US 206, 218 (2001). Since tax attributes that are carried to the taxable year that includes the change date (i.e., to a post-change year) are reduced under the interest haircut rule, it is possible that the attributes are reduced under the interest haircut rule before the application of the section 108 attribute reduction rule.

There is also uncertainty as to the amount of interest that is subject to the haircut. The statute refers to interest that is paid or accrued on “indebtedness which was converted into stock.” IRC § 382(l)(5)(B). Some taxpayers take the position that the portion of the debt that was forgiven was not converted into debt and is not subject to the haircut. As an example, assume a loss corporation has outstanding bonds with an adjusted issue price of \$700 million. If the holders receive cash of \$400 million and stock with a fair market value of \$200 million, there is uncertainty as to whether \$200 million (the debt-for-stock component) or \$300 million (including the COD income component) is the amount of debt that was converted into stock. (The position that the \$400 million that was paid in cash is not subject to the haircut appears to be a safer position.)

In 2020, the Treasury Department and the IRS in the preamble to the section 163(j) regulations, made some interesting comments on the application of the interest haircut. They stated that

because the old loss corporation gets the benefit of treating certain creditors as shareholders for purposes of determining whether the corporation has undergone an ownership change within the meaning of section 382(g), the corporation must treat the debt held by such creditors as equity for Federal income tax purposes. As a result, the corporation must treat the interest payments as non-deductible distributions on equity.

TD 9905, 85 Fed. Reg. 56686, 56744 (2020). This language suggests an interpretation that all of the interest on converted debt is subject to the interest haircut (including the portion that is paid in cash or other property).

In Field Service Advice 200006004 (June 28, 1999), the IRS dealt with a loss corporation that reported taxable income in the taxable year that included an ownership change that qualified under section 382(l)(5). The taxpayer took the position that an interest haircut was not required for interest that accrued in the taxable year that included the change date since there was no NOL in that year to reduce. The IRS disagreed on the basis that the interest deducted in that year affected the amount of NOL carryforward from pre-change taxable years to post-change years. To illustrate the concepts in the ruling, assume that a taxpayer has an NOL of \$500 million that can be carried forward to the taxable year that includes the change date (after application of the interest haircut rule). In the year that includes the change date, the taxpayer reports taxable income of \$100 million (reduced by an interest deduction of \$40 million and before NOL deductions). The taxpayer in FSA 200006004 would have taken the position that the NOL carryforward to the following taxable year is \$400 million (\$500 million, less \$100 million). If the interest deduction had actually been disallowed, the taxpayer would have reported taxable income (before NOL deductions) of \$140 million and reduced the NOL carryforward to \$360 million. The IRS position that the lower amount is carried forward is based on the proposition that it is the carryforward to a post-change year that is subject to reduction, not the NOL in the year in which the interest is paid or accrued.

As a result of the revision of section 163(j) by the TCJA, a question has arisen as to whether a disallowed business interest carryforward is subject to the interest haircut (i.e., does the interest need to be recomputed). The Treasury Department and the IRS have stated the haircut applies to any carryforward from a taxable year ending during the three-year period preceding the change year (or the pre-change period in the change year). TD 9905 at p. 236-37.

Second Ownership Change. Special rules apply if a new loss corporation undergoes a second ownership change within two years of an ownership change that qualifies under section 382(l)(5). In such case, the section 382 limitation with respect to the second ownership change is zero. In addition, section 382(l)(5) cannot apply to the second ownership change even if the loss corporation is under the jurisdiction of a bankruptcy court. IRC § 382(l)(5)(D); Treas. Reg. § 1.382-9(n)(1). This provision does not affect the ability of the loss corporation to use NOLs (and other tax attributes) to offset taxable income attributable to the period before the second ownership change.

It appears that if a second ownership change within two years occurs then the “zero” section 382 limitation cannot be increased by RBIGs. *Compare* IRC § 382(l)(5)(D) *with* IRC § 382(c) (COBE rule). The Blue Book indicates that the provision was intended to result in the “elimination” of the NOL carryforwards. Blue Book, p. 322.

The harsh result of a “zero” section 382 limitation upon a second ownership change is a significant risk of applying the provisions of section 382(l)(5). In many instances, the new loss corporation adopts charter provisions to restrict purchases and sales by 5% shareholders to reduce the risk of a second ownership change. See the above discussion of defensive measures in Section II.E.

Where there is significant risk of a second ownership change, new loss corporations generally elect not to apply the provisions of section 382(l)(5). Many such corporations are helped in predicting the future as a result of the timing of the election (i.e., on a timely-filed return for the tax year that includes the change date). In many cases, a significant portion of the two-year period has already occurred by the time that the election is due. For example, if a calendar year new loss corporation emerges from bankruptcy on June 30, 2008, the decision as to whether to elect out does not need to be made until October 15, 2009 (the extended due date of the 2008 tax return). At that time, 15 ½ months of the 24 month period have already elapsed.

It is interesting to note that it may be possible to avoid the problems of a second ownership change by structuring an acquisition as an asset sale (or by making a section 338 election). Since the COBE rule does not apply in the context of section 382(l)(5) there does not appear to be a requirement that the business be continued.

Sections 269 & 1129(d)

If an ownership change meets the qualification requirements for section 382(l)(5), it is possible that the IRS could disallow some or all of the benefits of section 382(l)(5) if subparagraph (a)(1) or (a)(2) of section 269 applies to the ownership change. IRC § 269(a), (c)(1). It is also possible that the IRS could object to the confirmation of the bankruptcy plan of reorganization pursuant to section 1129(d) of the Bankruptcy Code.

Section 269. The benefits of section 382(l)(5) can potentially be disallowed under section 269 if the principal purpose of the transaction is tax avoidance (i.e., reduction of tax) or evasion of federal income tax. Section 269 can apply if the requirements of paragraphs (a)(1) or (a)(2) of section 269 are met. Section 269(a)(1) applies to stock acquisitions and section 269(a)(2) applies to asset acquisitions.

Section 269(a)(1) applies if any person (or persons) acquires control, directly or indirectly, of a corporation and the principal purpose for the acquisition of control was evasion or reduction of US federal income tax by “securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy.” IRC § 269(a); Treas. Reg. § 1.269-3(a). The formation of a new corporation can be subject to section 269(a)(1) since the person or persons did not control the entity immediately before. Treas. Reg. §§ 1.269-1(c), -3(b)(2), (3). However, it is possible that section 269(a)(1) does not apply to the revival of a dormant corporation. *The Challenger, Inc. v. Comm’r*, TC Memo 1964-338. *But see* FSA 200134008 (Mar. 15, 2001) (subsidiary had never engaged in business); FSA 200117020 (Jan. 24, 2001) (same).

Section 269(a)(2) applies if (i) any corporation acquires property, directly or indirectly, of another corporation, (ii) the transferor corporation is not controlled, directly or indirectly, by the acquiring corporation (or its shareholders) immediately before the acquisition, (iii) the acquiring corporation receives a transferred basis in the property from the transferor corporation, and (iv) the principal purpose for the acquisition of property was evasion or reduction of US federal income tax by “securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy.” IRC § 269(a); Treas. Reg. § 1.269-3(a).

Evasion or reduction of tax is the principal purpose for an acquisition if that purpose exceeds in importance any other purpose. In determining the purpose for an acquisition, the entire circumstances of the transaction and course of conduct are to be scrutinized. It should be noted that a claim that the acquisition would have occurred even without the tax benefits will not be sufficient, on its own, to avoid the principal purpose test. Treas. Reg. § 1.269-3(a).

For purposes of section 269, control means the ownership of at least 50% of the stock of the corporation (by vote or value). IRC § 269(a); Treas. Reg. § 1.269-1(c). It appears that pure preferred stock is treated as

stock for section 269 control purposes. There do not appear to be any constructive ownership rules. *Brick Milling Co. v. Comm’r*, TC Memo 1963-305; Rev. Rul. 80-46, 1980-1 CB 62.

The drafters of the predecessor of section 269 appear to have intended to allow for a form of attribution. The Senate Report indicated that the parent of a controlled or affiliated group had control of lower-tier members of the group. Thus, “a mere shift in the form of control--from direct to indirect, from indirect to direct, or from one form of indirect to another form of indirect--cannot, therefore, amount to the acquisition of control.” S. Rep. 78-627, p. 60 (1943). As a result, a parent corporation may be able to acquire the stock of a lower-tier subsidiary without acquiring control for section 269 purposes. FSA 199915009 (Dec. 23, 1998). However, the same committee report indicated that a transfer of the stock of a subsidiary downstream (as opposed to upstream) would result in an acquisition of control that could be subject to section 269. S. Rep. 78-627, at 61.

Where creditors of a troubled corporation acquire stock of the corporation, the stock is acquired for control purposes when the creditors acquire beneficial ownership of the stock (and not when the creditors gained effective control over the operations or economic control over the equity). For this purpose, creditors of a bankrupt corporation are treated as acquiring beneficial ownership of stock no earlier than the confirmation date of the plan of reorganization. Where the creditors acquire control of a corporation (alone or in conjunction with other persons), the principal purpose of the acquisition is determined as of the date beneficial ownership of the stock is acquired. Treas. Reg. § 1.269-5(b).

There are not many authorities that have discussed the circumstances in which an acquisition of control by creditors will meet the principal purpose test. The issue was discussed by a bankruptcy judge in the confirmation order for the plan of reorganization for Washington Mutual, Inc. and WMI Investment Corp. The judge in the case was trying to determine the value of the assets (including the NOLs) for bankruptcy plan purposes. One party raised the issue that the NOLs were valueless as a result of the application of section 269. The judge concluded that the principal purpose of the acquisition was not the avoidance of tax. It was acknowledged that the conclusion was not binding on the IRS. The court noted that most of the cases that applied section 269 dealt with an acquisition of a corporation with NOLs to reduce the tax on a profitable business. That situation was distinguished from a bankruptcy where the creditors are receiving stock simply in repayment of debt owed to them. The judge noted that most of the new shareholders will receive debtor stock not by election or choice, but by default (by operation of the payment ordering rules under the Bankruptcy Code). The court discounted the fact that certain creditor attempted to determine the value of the NOLs as not dispositive. The court also concluded that for the creditors that choose to receive stock instead of cash, the choice was likely based on a view that the stock was undervalued as a business. *In re: Washington Mutual, Inc.*, 461 BR 200, 232-35 (Bankr. D. Del. 2011).

Where section 269 applies, the IRS may disallow any deduction, credit, or other allowance that is available as a result of the acquisition. IRC § 269(a); Treas. Reg. § 1.269-2. The IRS has the authority to allow a part of any amount disallowed if it determines that the allowance will not result in evasion or avoidance of US federal income tax. IRC § 269(c)(1); Treas. Reg. § 1.269-4.

Applicable regulations apply a presumption with respect to an acquisition of control or property in connection with an ownership change that qualifies under section 382(l)(5). Unless the active trade or business requirement (described below) is met, the transaction is presumed to be made for the principal purpose of evasion or avoidance of US federal income tax. This presumption can only be rebutted by strong evidence to the contrary. Treas. Reg. § 1.269-3(d)(1).

A loss corporation meets the active trade or business requirement if “the corporation carries on more than an insignificant amount of an active trade or business during and subsequent to” the bankruptcy case. The

active trade or business carried on does not necessarily need to be the historic trade or business of the loss corporation (*i.e.*, the business conducted most recently). The determination as to whether the active trade or business requirement is met is without regard whether the COBE requirement is met. *Id.*

The determination as to whether the active trade or business requirement is met is based on all of the facts and circumstances. Examples of facts and circumstances that are relevant include (i) the amount of business assets that continue to be used in an active trade or business, (ii) the number of employees in the work force who continue to be employed in the active trade or business. *Id.*

The active trade or business requirement can be met even if the loss corporation ceases to engage in any trade or business activities temporarily for a period of time “in order to address business exigencies.” *Id.* It appears that this relaxation of the requirement only applies if the loss corporation continues to utilize a significant amount of its business assets or work force. *Id.*

The regulations do not have any examples and do not give any insight as to how to interpret the terms “insignificant” and “significant.” In addition, no case or ruling has been found as to how to interpret the provision.

The New York State Bar Association proposed in 1991 that the IRS issue a revenue ruling with the following facts:

Before filing its Chapter 11 petition, L owned and operated six cruise ships that cost more than \$200 million, employed more than 1,000 persons in the various facets of its business and derived revenues in excess of \$60 million per year. In connection with its cruise business, L operated two laundry facilities near the Hudson River piers to handle its linen and other laundry needs. The laundry facilities cost \$400,000 to equip and furnish. L's laundry operations employed 100 persons and grossed more than \$1 million a year by providing laundry service to restaurants and hospitals in the area. L fell on hard times. L filed for Chapter 11 protection. During the course of the Chapter 11 proceedings, L sold all of its cruise ships and terminated all of its employees, except 50 persons employed in the one remaining laundry facility, which continues to gross \$1 million per year. In the Chapter 11 proceeding, L canceled all its outstanding stock and issued new common stock to its Old and Cold creditors.

NYSBA Tax Section, *Report on Suggested Bankruptcy Tax Revenue Rulings*, Ex. 7.1, 91 TNT 9-6 (1991).

The authors of the report concluded that the active trade or business requirement was met since gross income of \$1 million (1.7%) and 50 continuing employees (5%) were not insignificant and the laundry business was actively conducted. *Id.*

The section 269 regulations do not define “active trade or business.” However, the term “active conduct of a trade or business” appears in several places in the Code and regulations thereto. Several regulations interpret the term “active conduct of a trade or business” and its variations. The regulations under section 367(a) require that officers and employees of the corporation carry out “substantial managerial and operational activities” of a trade or business. Treas. Reg. § 1.367(a)-2(b)(3). The regulations under section 355 require “active and substantial management and operational functions,” Treas. Reg. § 1.355-3(b)(2)(iii), and provide numerous examples. Treas. Reg. § 1.355-3(c).

Some taxpayers have taken the position that section 269 cannot be used by the IRS to disallow the benefits of section 382(l)(5), notwithstanding regulations to the contrary. Section 269 generally does not apply

where a taxpayer takes advantage of an explicit tax benefit enacted by Congress. Taking advantage of the provision is not tax avoidance. *Modern Home Fire and Casualty Ins. v. Comm'r*, 54 TC 839 (1970) (benefit of S corporation provisions), *acq.* 1970-2 CB XX; Rev. Rul. 76-363, 1976-2 CB 90 (same); Rev. Rul. 70-238, 1970-1 CB 61 (benefit of Western Hemisphere trade corporation provisions). These taxpayers take the position that only Congress could add the active trade or business requirement that the IRS has imposed in section 269 regulations. See ABA Section of Taxation, *Comments Concerning Proposed Regulations Sections 1.269-3, 1.269-5, 1.269-7, 1.382-2T(h)(4)(x)(J), and 1.382-3*, 91 TNT 203-33 (1991) (belief that a court would strike down the requirement).

Section 1129(d). If taxpayer is under the jurisdiction of a bankruptcy court, a governmental unit can request that a bankruptcy court not confirm a plan of reorganization if the principal purpose of the plan is the avoidance of taxes. This request is made under section 1129(d) of the Bankruptcy Code. The governmental unit can only make the request if it is a party in interest in the case. The provision can be used only to not confirm a plan. It cannot be used as grounds for dismissing a case. *Cohen v. United States*, 191 BR 482, 487 (Dist. Ct. SD Fla. 1995).

The governmental unit has the burden of proof on the issue of avoidance of taxes. 11 USC § 1129(d). Similar to section 269, the provision applies if “the” principal purpose is tax avoidance, and does not apply if tax avoidance is only “a” principal purpose. *In re Rath Packing Co.*, 55 BR 528, 536 (Bankr. ND Iowa 1985).

The IRS rarely makes a claim that a plan should not be confirmed pursuant to section 1129(d). The Internal Revenue Manual states that avoidance of taxes would occur for purposes of section 1129(d) through the “improper or fraudulent use of the Internal Revenue Code substantive tax provisions created or amended by the Bankruptcy Tax Act of 1980.” IRM 34.3.1.1.4(6)a (Jan. 20, 2015). (It is not clear why the abuse has to relate to the Bankruptcy Tax Act of 1980.) The manual instructs IRS personnel to object to a plan if information concerning such avoidance comes to their attention. IRM 34.3.1.1.4(6)b.

The IRS has also stated that an objection under section 1129(d) (or other procedure) should be considered where a feature of the plan is to leave the debtor an insolvent shell company with a large post-confirmation federal income tax to pay. An example of this situation could occur if the debtor transfers substantially all of its assets to a liquidating trust or other entity in a taxable transaction and sufficient assets are not left in the hands of the debtor to pay the tax on the gain. GLB 199928004 (Dec. 1998). The IRS has successfully challenged confirmation of plans where the principal purpose is to avoid paying federal income tax on the transfer of assets. *In re Scott Cable Commun.*, 227 BR 596, 603-04 (Bankr. D. Conn 1998). *But see In re Scott Cable Commun.*, 232 BR. 558 (Bankr. D. Conn. 1999) (approving sale of assets without payment of tax).

Some bankruptcy courts have applied section 1129(d) (or similar concepts) without an objection by a governmental unit. *In re: South Beach Sec.*, 376 BR 881, 893-94 (Bankr. ND Ill. 2007) (objection by US trustee acting in is administrative capacity), *aff'd*, 421 BR 456 (ND Ill. 2009), *aff'd*, 606 F.3d 366 (7th Cir. 2010); *In re Maxim Indus.*, 22 BR 611, 612-13 (Bankr. D. Mass. 1982) (court refused to confirm plan even though no party objected). *But see In re Trans Max Techs.*, 349 BR 80 (Bankr. D. Nev. 2006) (trustee not permitted to object).

A bankruptcy court has held that a debtor is not authorized to move for an order pursuant to section 1129(d) declaring that tax evasion was not the principal purpose of a plan. *In re McLean Indus.*, 132 BR 267, 270 (Bankr. SDNY 1991). However, in one case a debtor was able to adjudicate the tax avoidance motive where the IRS orally raised the issue at a plan modification hearing. *Rath Packing Co.* In any case, it is typical for

debtors to include a finding of no tax motive in the judge's order approving a bankruptcy plan. *See, e.g., Allis-Chalmers Corp. v. Goldberg*, 141 BR 802 (Bankr. SDNY 1992).

The courts have generally refused to confirm a plan where the plan leaves the debtor with "no business, no employees[,] and no assets" other than an NOL (or other tax attribute). *Maxim Industries*, 22 BR at 611, *see also South Beach Sec.*, 376 BR at 894-96.

The Department of Justice (on behalf of the IRS) did raise objections to the confirmation of the bankruptcy plan of reorganization under section 1129(d) with respect to the joint plan of Solyndra LLC and 360 Degree Solar Holdings, Inc. The bankruptcy plan provided for the retention of the stock of the parent corporation by the shareholders. The operating assets of the debtors were liquidated under the plan. After the plan was implemented, it was anticipated that the parent corporation would have a small amount of investment assets and NOLs of \$875-975 million. The shareholders contributed some money to fund pay outs to creditors under the bankruptcy plan. *Solyndra Bankruptcy Plan Confirmed Over IRS Objections*, 2012 TNT 205-2.

The Bankruptcy Court confirmed the plan in Solyndra (without issuing a written opinion), finding that the principal purpose of the plan was not tax avoidance. The court stated that the plan was "proposed with the legitimate and honest purpose of maximizing the value of the Debtor's Estates and to effectuate a distribution of such value to creditors." *In re: Solyndra LLC*, No. 11-12799, p.7 (Bankr. D. Del. Oct. 22, 2012) (confirmation order).

The section 269 regulations state that the fact no governmental unit sought a determination under section 1129(d) is not taken into account for purposes of determining the principal purpose for section 269 purposes. More controversially, the regulations go on to state that any determination by a bankruptcy court under section 1129(d) is not controlling. Treas. Reg. § 1.269-3(e). To complete the circle, the courts have held that section 1129(d) can be used as a grounds to not confirm a plan even if the court believes that section 269 (or other tax provision) would apply to deny all of the debtor's hoped for tax benefits. *In re South Beach Sec.* 606 F.3d at 374-76.

Judge Lifland, in *Allis-Chalmers Corp. v. Goldberg*, 141 BR 802 (Bankr. SDNY 1992), stated that he doubted that the IRS had the authority to promulgate regulations that determine the effect of a court order. 141 BR at 808. Judge Lifland further stated that he doubted that the IRS could use section 269 in general to attack the tax avoidance purpose of a transaction that had been reviewed by a bankruptcy court. He also noted that section 382(l)(5) was specifically enacted to address the issue. He thought the IRS interpretation represented an "unfair and improper construction of the statute." 141 BR at 814. These statements appear to be dicta.

In *Allis-Chalmers*, the IRS notified a debtor, after it emerged from bankruptcy, that the benefits of a bankruptcy plan that met the requirements of section 382(l)(5) may be challenged under section 269. (The debtor had previously received a private letter ruling that the plan qualified under section 382(l)(5).) In the confirmation order for the plan, the bankruptcy court had determined under section 1129(d) that the principal purpose of the plan was not tax avoidance. The taxpayer brought suit against the IRS for a determination that the IRS was estopped from raising section 269 as an issue because of the court's prior holding under section 1129(d). The bankruptcy court held for the IRS on the basis that a declaratory judgment was not an appropriate remedy. The court concluded that neither *res judicata* nor *collateral estoppel* applied because of differences in the tax avoidance determinations of the two statutory provisions. *Id.* Section 382(l)(6)

C. Section 382(l)(6)

Where the provisions of section 382(l)(6) apply, the NOLs (and other tax attributes) of the loss corporation are subject to limitation under section 382. In many cases, the base annual section 382 limitation is greater than it would be with respect to a non-bankruptcy ownership change.

Qualification

The provisions of section 382(l)(6) only apply to an ownership change which occurs in a bankruptcy case. IRC § 382(l)(6); Treas. Reg. § 1.382-9(a). To qualify, the transaction resulting in the ownership change must either be ordered by the court or pursuant to a plan approved by the court. Treas. Reg. § 1.382-9(a).

Under the statute, it appeared that section 382(l)(6) only applied if there was either a type G reorganization (bankruptcy case) or an exchange of debt for stock in a bankruptcy case. IRC § 382(l)(6). The regulations expand the qualification requirement to any ownership change occurring pursuant to a transaction approved or ordered by a court in a bankruptcy case. Treas. Reg. § 1.382-9(j).

The regulations are ambiguous as to whether the loss corporation must be under the jurisdiction of a court in a bankruptcy case for section 382(l)(6) to apply. For example, it is possible that section 382(l)(6) could apply to the transfer of a solvent subsidiary corporation by a bankrupt parent if the transfer is ordered by a bankruptcy court or pursuant to plan approved by the court.

Section 382(l)(6) does not apply if section 382(l)(5) applies. IRC § 382(l)(6); Treas. Reg. § 1.382-9(j). Where the qualification requirements of section 382(l)(5) are met, section 382(l)(6) will apply if the loss corporation elects not to have section 382(l)(5) apply.

Consequences

Where section 382(l)(6) applies to an ownership change, the provisions of section 382(a) apply. As a result, the limitations under section 382 or 383 apply with respect to the ownership change. Any limitations with respect to prior ownership changes also continue to apply.

The base annual section 382 limitation under section 382(l)(6) is computed with reference to the fair market value of the stock of the loss corporation, as it is in more normal circumstances. However, where section 382(l)(6) applies, the value is generally determined immediately after the ownership change (instead of immediately before). Treas. Reg. § 1.382-9(j)(1). As a result, any increase in value from the surrender or cancellation of creditor claims (and other transactions, including the issuance of stock for cash) is taken into account. IRC § 382(l)(6); PLR 201208002 (July 21, 2009) (increase in value from exchange of subsidiary partnership debt for stock taken into account). The value under section 382(l)(6) is limited to the value of the gross assets of the loss corporation immediately before the ownership change. Treas. Reg. § 1.382-9(j)(2), (l)(1).

The NUBIG and NUBIL rules apply in the section 382(l)(6) context. There do not appear to be any special NUBIG or NUBIL rules under section 382(l)(6).

For purposes of determining the value of the stock of the loss corporation under section 382(l)(6), stock includes pure preferred stock, as well as stock that is not treated as stock under the stock recharacterization rule. Treas. Reg. § 1.382-9(k)(1)(i). However, if stock is issued “as part of a plan one of the principal purposes of which is to increase the section 382 limitation without subjecting the investment to the entrepreneurial risks of corporate business operations,” the equity obligation is not treated as stock. Treas.

Reg. § 1.382-9(k)(6)(i). Non-stock interests that are treated as stock under the non-stock recharacterization rule are not treated as stock for section 382(l)(6) value purposes. Treas. Reg. § 1.382-9(k)(1)(ii).

The value of any stock issued in connection with a section 382(l)(6) ownership change is limited to the consideration received by the loss corporation for the issuance of the stock. For this purpose, consideration received equals the amount of any cash and the value of any property received. Where the old loss corporation issues stock in exchange for its debt obligations, the consideration received includes the value of the debt obligations received in the exchange. Treas. Reg. § 1.382-9(k)(7). This provision prevents taxpayers from claiming that the new owners acquired the stock at a bargain and using a value that is higher than the deal price.

The value of the stock is reduced if a “redemption or other corporate contraction” occurs after and in connection with an ownership change (same as for non-bankruptcy ownership changes). Treas. Reg. § 1.382-9(k)(2). However, capital contributions that occur before or in connection with an ownership change are not treated as an item that results in an adjustment to stock value. Treas. Reg. § 1.382-9(k)(4).

The substantial nonbusiness asset rule can apply to reduce the stock value. A reduction is required, if the new loss corporation has substantial nonbusiness assets immediately after the ownership change. For this purpose, the loss corporation only takes into account assets that were held immediately before the ownership change. The 1/3 of value rule is taken into account in determining whether the new loss corporation has substantial nonbusiness assets. Where a reduction for substantial nonbusiness assets is required, the amount of the reduction is determined based upon the nonbusiness assets and liabilities held immediately after the ownership change. Treas. Reg. § 1.382-9(k)(5).

Where the loss corporation is a foreign corporation, the stock value is determined by only taking into account items treated as connected with a US trade or business. Treas. Reg. § 1.382-9(k)(3). There is uncertainty as to whether this rule applies to a CFC for GILTI purposes.

The value under section 382(l)(6) is limited to the value of the gross assets of the loss corporation immediately before the ownership change (the “pre-change assets”). Treas. Reg. § 1.382-9(j)(2), (l)(1). The value of the gross assets is determined without taking into account liabilities. Treas. Reg. § 1.382-9(l)(1); PLR 201208002 (July 21, 2009) (gross assets of subsidiary partnership taken into account).

In determining the value of the pre-change assets, redemptions and other corporate contractions that occur in connection with an ownership change are not treated as an item that results in an adjustment to asset value. Treas. Reg. § 1.382-9(l)(2).

The capital contribution rule can apply to reduce the value of the pre-change assets. As a result, any capital contribution made before the change date is generally treated as an adjustment to value if it was made for a principal purpose of tax avoidance. For purposes of applying the capital contribution rule, a capital contribution includes the receipt of cash or property in exchange for the issuance of debt if “it is part of a plan one of the principal purposes of which is to increase the value of the loss corporation” for section 382(l)(6) purposes. Treas. Reg. § 1.382-9(l)(4).

The substantial nonbusiness asset rule can apply to reduce the value of the pre-change assets. A reduction is required, if the new loss corporation has substantial nonbusiness assets immediately after the ownership change. For this purpose, the loss corporation only takes into account assets that were held immediately before the ownership change. The 1/3 of value rule is taken into account in determining whether the new loss corporation has substantial nonbusiness assets. Where a reduction for substantial nonbusiness assets is

required, the amount of the reduction is determined based upon the nonbusiness assets held immediately before the ownership change. Treas. Reg. § 1.382-9(l)(5).

Where the loss corporation is a foreign corporation, the value of the pre-change assets is determined by only taking into account items treated as connected with a US trade or business. Treas. Reg. § 1.382-9(l)(3). There is uncertainty as to whether this rule applies to a CFC for GILTI purposes.

The COBE rule can apply under section 382(l)(6). Treas. Reg. § 1.382-9(m)(2). As a result, the base annual section 382 limitation will be zero if the new loss corporation does not meet the COBE requirement at all times during the two-year period beginning on the change date. IRC § 382(c)(1). This can be a problem if the loss corporation sells all of its assets (or is treated as selling all of its assets pursuant to a section 338 election) within the two-year period.

D. FDIC Receiverships

Over the years the Federal Deposit Insurance Corporation (FDIC) has been appointed as the receiver for hundreds of failed banks and building and loan associations (failed “banking institutions”). Though transaction scenarios may differ, most recent transactions are generally structured as “whole bank” transactions (that is, an acquisition of all of the deposit liabilities (and underlying investment assets) of the banking institution by a successor banking institution pursuant to a purchase and assumption agreement). Creditors (other than depositors) of the failed banking institution collect on their liabilities from the FDIC, as receiver, as cash becomes available for distribution (including any cash from the sale of investments to the successor banking institution). An FDIC receivership resembles, in many ways, a chapter 7 (liquidating) proceeding under the Bankruptcy Code.

Section 597 and the regulations thereunder provide rules for (and generally govern) the tax treatment of FDIC receiverships and other federally-assisted transactions. Under these rules, the failed banking institution continues to be treated as a corporation for US income tax purposes during the pendency of the receivership.

The failed banking institution continues to file tax returns if it was not a member of a consolidated group. Treas. Reg. § 1.597-4(b). If the failed banking institution was a member of a consolidated group, the institution generally continues to be a member during the pendency of the receivership (even if the stock previously owned by members of the consolidated group is cancelled). Treas. Reg. § 1.597-4(f)(1). The section 597 regulations specifically provide that they take precedence over conflicting provisions of the consolidated return rules. Treas. Reg. § 1.597-4(f)(2). An election is available (and in certain instances, deemed to be made) to deconsolidate the failed banking institution from the consolidated group if a subsidiary is placed in receivership. In such instance, the institution (post-deconsolidation) is treated as a new corporation created in a section 351 transaction. Treas. Reg. § 1.597-4(g).

The section 597 regulations disregard certain transactions engaged in by a failed banking institution for section 382 ownership change purposes. These transactions include (i) the imposition of a receivership by the FDIC, (ii) the cancellation of the stock of the failed banking institution by the FDIC, (iii) a transaction in which a failed banking institution transfers deposit liabilities to an interim banking institution (a “bridge bank”), and (iv) the election (described above) to deconsolidate the failed banking institution from a consolidated group. Treas. Reg. § 1.597-4(c).

The regulations generally treat a transaction in which a failed banking institution is taken over by a successor banking institution as a taxable asset transfer. Treas. Reg. § 1.597-5. The regulations also provide guidance on loss guarantees and loss sharing agreements. Treas. Reg. § 1.597-5(f) Ex. 4, 5.

If a banking institution emerges from the FDIC receivership (which is rare), it appears that any ownership change resulting from the emergence can qualify for special treatment under paragraphs (l)(5) or (l)(6) of section 382. An FDIC receivership is included in the definition of a bankruptcy case. IRC § 368(a)(3)(D).

VIII. Consolidated Groups

Rules that differ from the above-described section 382 rules apply if a loss corporation is a member of a consolidated group. These rules are very far-reaching and cover both the determination as to whether an ownership change has occurred, as well as the computation of the limitation. Generally, both the ownership change and the section 382 limitation are determined on a consolidated group (or subgroup) basis and not on a single entity basis. Treas. Reg. § 1.1502-91(a)(1).

On September 28, 2020, the Large Business and International Division (LB&I) of the IRS announced an active campaign to increase compliance regarding limitations on consolidated NOL carryforwards. Included in the campaign is a focus on noncompliance with the consolidated section 382 regulations by issue-based examinations. [LB&I Active Campaigns | Internal Revenue Service \(irs.gov\)](#), (last updated on Mar. 12, 2021).

In order to help the reader better understand the consolidated section 382 rules, a brief overview of the consolidated return treatment of NOLs and other tax attributes follows. It should be noted that many of the provisions of the consolidated return regulations do not reflect the current versions of the Code. A priority regulation project is ongoing to remove obsolete provisions and update the consolidated return regulation to reflect statutory changes. Office of Tax Policy and the IRS, “2021-2022 Priority Guidance Plan, 2nd Quarter Update p. 3 (Feb. 22, 2022).

A consolidated group determines the NOL for a taxable year on a consolidated basis. The consolidated NOL generally equals the excess of the deductions over the gross income of the members of the group (determined on consolidated basis). In other words, the consolidated NOL equals any negative amount of consolidated taxable income (within the meaning of section 1.1502-11(a) of the Treasury regulations and without regard to any NOL deduction). Treas. Reg. § 1.1502-21(e).

A consolidated NOL can be carried forward to subsequent taxable years (or back to prior taxable years) under the general principles that apply to separate returns. The amount of the consolidated NOL that is absorbed is determined on a consolidated basis. Treas. Reg. § 1.1502-21(b)(1).

The deduction of post-2017 NOLs are generally limited to 80% of taxable income in taxable years beginning after December 31, 2020. The 80% limitation on consolidated NOLs is determined on a consolidated basis. Special rules apply to consolidated groups that include nonlife insurance companies. Treas. Reg. § 1.1502-21(a)(2)(ii). These rules apply to taxable years beginning after December 31, 2020. Treas. Reg. § 1.1502-21(h)(10).

If a member of a consolidated group departs from the group, the member’s share of any unused consolidated NOL carryforwards are apportioned to the member. The apportioned amount is carried forward to the member’s separate return and cannot be carried forward to a consolidated return year of the former group that begins after the member leaves the group. The amount of the consolidated NOL that is apportioned to the member is based on the separate NOL of each member that has a separate NOL. Treas. Reg. § 1.1502-21(b)(2).

If a member joins a consolidated group, any NOL carryforward of the member is deductible by the consolidated group as part of the consolidated NOL deduction and generally subject to the same rules and

limitations. Treas. Reg. § 1.1502-21(a)(2), (b)(1). As a result, a separate NOL of a new member can freely offset the separate taxable income of other members unless a limitation rule prevents this. However, the NOLs can be subject to the SRLY limitation and other limitation rules (e.g., sections 382 and 384). (The SRLY limitation rules are discussed in more detail in Section X below.)

Where the SRLY limitation applies, the NOL deduction is limited to the member's contribution to consolidated taxable income (generally, the member's excess of gross income over deductions) in the aggregate for all years in which such member was part of the consolidated group. Treas. Reg. § 1.1502-21(c)(1)(i). The SRLY limitation does not apply if the member undergoes an ownership change within six months of the date that the member joined the consolidated group and the ownership change gave rise to a section 382 limitation. Treas. Reg. § 1.1502-21(g)(1), (2)(ii)(A).

Similar concepts apply with respect to the tax attributes that are limited by section 383 and to charitable contribution deductions. Treas. Reg. §§ 1.163(j)-5(b)(3) (business interest expense), 1.1502-3 (consolidated investment tax credits), -4 (consolidated foreign tax credit), -22 (consolidated net capital loss), -24 (consolidated charitable contributions), -55(h)(4)(iii) (consolidated minimum tax credit); -79 (separate return year rules); Prop. Reg. §§ 1.1502-55(h) (consolidated minimum tax credit). However, the SRLY limitation rules do not apply to the carryforward of unused foreign tax credits. Treas. Reg. § 1.1502-4(f)(3).

It should be noted that many portions of the consolidated regulations that apply to credits under section 38 potentially only apply to investment tax credits (which were repealed in 1983). Treas. Reg. § 1.1502-3, -79(c). The portion of these regulations regarding SRLY clearly apply to all general business credits, Treas. Reg. § 1.1502-3(d). But the provisions that apply to determining the consolidated credit and the separate return rules are limited, on their face, to investment tax credits. In any case, regulations regarding the research credit require that a consolidated group determine the credit as if the group were a single taxpayer. Treas. Reg. § 1.41-6(d), (e) Ex. 2

If a member joins a consolidated group, the acquiring group can irrevocably elect to waive some or all of a loss carryforward from a SRLY. In such case, the loss is treated as expiring immediately before the member joined the acquiring group. For purposes of any predecessor consolidated group, the expiration is treated as occurring immediately after the member ceased to be a member of the predecessor group. Treas. Reg. § 1.1502-32(b)(4)(i). The election is made by attaching a statement to the tax return for the taxable year in which the member joined the acquiring consolidated group. Treas. Reg. § 1.1502-32(b)(4)(iv). The election to waive loss carryforwards applies to NOLs and capital losses, Treas. Reg. § 1.1502-32(b)(3)(iii)(A), and may also apply to other tax attributes with expiration dates (e.g., charitable contributions). Taxpayers generally make the election to avoid reducing the stock basis of the acquired subsidiary when the loss carryforward expires. See Treas. Reg. § 1.1502-32(b)(3)(iii)(A), (4)(ii). The election may no longer be as necessary in the future since post-2017 NOLs no longer expire.

If a member of a consolidated group joins a different consolidated group, the acquiring group can irrevocably elect to relinquish the portion of the carryback period for which the member was a member of another group (the "split waiver election"). Such an election, if made, applies to all members that were affiliated with the member that is the subject of the election immediately before it joined the acquiring group. The split waiver election applies to consolidated NOLs attributable to such members and for all taxable years of the acquiring group. The election is made by attaching a statement to the tax return for the taxable year in which the members joined the acquiring consolidated group. Treas. Reg. § 1.1502-21(b)(3)(ii)(B); Prop. Reg. § 1.1502-21(b)(3)(ii)(B)(1), (3). An acquiring group might wish to make the split waiver election (i) to retain the benefit of its consolidated NOL, and/or (ii) to avoid the administrative difficulty of carrying back a consolidated NOL to a different taxpayer's return. (It should be noted that there is no similar election to relinquish the carryback for other tax attributes.)

Proposed regulations would also allow a member that departs from a consolidated group to elect to forego any carryback to a taxable year of the former group (and any prior taxable year) (the “departing member election”). (The election is binding on the departing consolidated group.) If the member joins a new consolidated group, then the election is made by the common parent of the new group. Such an election by an acquiring consolidated group, if made, applies to all members that were affiliated with the member that is the subject of the election immediately before it joined the acquiring group. The election applies to consolidated NOLs attributable to such members and for all taxable years of the acquiring group. Prop. Reg. § 1.1502-72(e). The proposed effective date for the departing member election is for deconsolidations that occur on or after the proposed regulations are finalized (unless the deconsolidation is pursuant to a written agreement that is binding on such date). Prop. Reg. § 1.1502-72(h)(2).

In 2020, the IRS and the Treasury Department issued temporary regulations that expanded the split-waiver election. These regulations allow an acquiring group (a consolidated group that acquires a member from another consolidated group) to make an “amended statute split-waiver election” or an “extended split-waiver election,” but not both. Temp. Reg. § 1.1502-21T(b)(3)(ii)(C)(1), (2)(ii). These regulations apply to consolidated NOLs arising in taxable year ending after July 2, 2020. However, taxpayers can apply the rule to any consolidated NOL arising in a taxable year beginning after December 31, 2017. Temp. Reg. § 1.1502-21T(h)(9)(i). These temporary regulations were also issued in proposed form and will expire on July 3, 2023 (unless finalized). Temp. Reg. § 1.1502-21T(h)(9)(ii).

The amended statute and extended split-waiver elections only apply if the Code is amended to change the carryback period after the date of acquisition of an acquired member. A separate election is available for each taxable year to which amended carryback rules apply. Temp. Reg. § 1.1502-21T(b)(3)(ii)(C)(1), (2)(iv). For example, these elections can apply to members that were acquired before the CARES Act allowed for a five-year NOL carryback (i.e., where no carryback was previously allowed).

Under the amended statute split-waiver election, the group elects to forego both (i) the default carryback period (the carryback period that was allowed by statute at the time of acquisition), and (ii) the extended carryback period (the additional carryback period that were added by the amendment to the statute). Under the extended split-waiver election, only the extended carryback period is waived. Both elections, if made, are irrevocable. If an election is made for one member it must be made for all members that joined the acquiring group contemporaneously. Temp. Reg. § 1.1502-21T(b)(3)(ii)(C)(1), (2)(v), (vii-ix), (3)(iii).

The elections can only be made if the acquiring group had not made a valid split-waiver or general waiver election. In addition, an election cannot be made if a former group (i.e., a group that the acquired member previously belonged to) had previously made a carryback claim with respect to the acquired member that is inconsistent with the election being made by the acquiring group. Temp. Reg. § 1.1502-21T(b)(3)(ii)(C)(2)(iii), (xi), (3), (4).

The amended statute and extended split-waiver elections are made by attaching an appropriate statement to consolidated return for the year in which the consolidated NOL was incurred. The election is generally made on a timely-filed original return (taking into account extensions). The election can also be filed on an amended return within 150 days after there is a statutory amendment to the carryback period. The temporary regulations also extended the date for making certain elections on an amended return until November 30, 2020. Temp. Reg. § 1.1502-21T(b)(3)(ii)(C)(1), (5), (6).

A. Definitions and Special Rules

For a proper understanding of the consolidated section 382 rules, there is a need to understand the definition of several key terms.

Definitions

An “affiliated group” is defined as one or more chains of includible corporations connected through stock ownership with a common parent corporation (that is an includible corporation) if the common parent corporation directly owns 80% or more of the stock (by vote and value) of at least one other includible corporation. The members of the affiliated group include (i) the common parent corporation, and (ii) each includible corporation (other than the common parent) the stock of which is directly owned 80% or more (by vote and value) by a member (or members) of the group. IRC § 1504(a)(1), (2). For purposes of determining stock ownership, pure preferred stock is not taken into account. IRC § 1504(a)(4). An includible corporation includes most domestic C corporations (with some exceptions). IRC § 1504(b).

A “consolidated group” is an affiliated group that files (or is required to file) a consolidated return. Treas. Reg. § 1.1502-1(h). A reference to a “group” in the consolidated return regulations is generally a reference to a consolidated group. However, if the context otherwise requires, a reference to a group can be a reference to an affiliated group. Treas. Reg. § 1.1502-1(a).

A “member” is a corporation (including the common parent) that is included in the consolidated group (or a subgroup). Treas. Reg. § 1.1502-1(b). A “subsidiary” is a member (other than the common parent). Treas. Reg. § 1.1502-1(c). Two members are considered “affiliated” with each other if they are both members of the same group. Treas. Reg. § 1.1502-1(j).

A “consolidated return year” is a taxable year for which a consolidated return is filed (or required to be filed) by the consolidated group. Treas. Reg. § 1.1502-1(d). A “separate return year” is a taxable year of a corporation that files a separate return (or that joins in the filing of a consolidated return with a different consolidated group). Treas. Reg. § 1.1502-1(e).

A “SRLY” is generally defined as a separate return year of a member (or a predecessor of a member). Treas. Reg. § 1.1502-1(f)(1). A separate return year of a member (or predecessor) is not a SRLY if the corporation was a member of the affiliated group for each day of such taxable year. Treas. Reg. § 1.1502-1(f)(2)(ii), (iii). A separate return year of a member that is the common parent for the consolidated return year to which the tax attribute is carried is generally not a SRLY. Treas. Reg. § 1.1502-1(f)(2)(i). Special rules apply to determine which taxable years are SRLYs where the consolidated group is treated as continuing under either the downstream transaction rule or the reverse acquisition rule. Treas. Reg. §§ 1.1502-1(f)(3), -75(d)(2)(ii).

A “loss group” is a consolidated group that is entitled to use an NOL carryforward. The definition of a loss group also includes a consolidated group that generates a consolidated NOL in a taxable year that includes a testing date. Additionally, a consolidated group that has a NUBIL on a testing date is considered a loss group. Treas. Reg. § 1.1502-91(c)(1). The definition of loss group is generally the consolidated group equivalent of the definition of loss corporation.

The definition of loss group includes a consolidated group in which any member is entitled to use a disallowed business interest expense carryforward. Treas. Reg. §§ 1.1502-91(e)(2)(iii), 98(b)(1). This rule applies to ownership changes occurring on or after November 13, 2020. However, a taxpayer can choose (or can be required) to apply these rules to earlier ownership changes if the taxpayer (and all related parties) consistently applies the section 163(j) regulations to earlier periods in their entirety. Treas. Reg. § 1.1502-98(d)(2).

For purposes of determining whether a consolidated group is a loss group, an NOL (or RBIL) carryforward that arose in a SRLY generally is not taken into account. Similarly, an NOL carryforward that is treated as

arising in a SRLY under section 1.1502-21(c) of the Treasury regulations is not taken into account. Treas. Reg. § 1.1502-91(c)(1)(i), (3). The reference to an NOL that is treated as arising in a SRLY relates to the treatment of built-in losses that are limited (and can therefore be carried forward) under the SRLY rules. Treas. Reg. § 1.1502-21(c)(1)(ii).

The rules ignoring SRLY NOLs for loss group purposes do not apply if the member (or subgroup) undergoes an ownership change within six months (before or after) of becoming a member of the group. Treas. Reg. § 1.1502-91(c)(2), (f)(2)(ii)(b). As a result, in many cases SRLY NOLs will be taken into account for purposes of determining whether a consolidated group is a loss group.

A “pre-change consolidated attribute” is an NOL carryforward that is taken into account for purposes of determining whether a consolidated group is a loss group. In addition, any RBIL of the loss group is considered a pre-change consolidated attribute. Treas. Reg. § 1.1502-91(e). The definition of pre-change consolidated attribute is generally the consolidated group equivalent of the definition of pre-change loss.

An “NOL subgroup” is a subgroup of two or more corporations that become members of a consolidated group (the “current group”) if (i) they were affiliated with each other in another affiliated group (the “former group”) whether or not the group was a consolidated group, (ii) at least one member carries over an NOL that did not arise (and is not deemed to arise) in a SRLY (with respect to the former group), and (iii), immediately after they become members of the current group, the subgroup parent requirement (described below) is met. Treas. Reg. § 1.1502-91(d)(1), (7) Ex. 1.

For purposes of determining whether an NOL subgroup exists, NOLs that arose in a SRLY are not taken into account. If a fold-in event occurs (as described below), then the NOL is not treated as having arisen in a SRLY and the such NOLs are treated as NOL subgroup attributes. Treas. Reg. § 1.1502-21(g)(5)(vii)(D), -96(a)(3)(i), (5). A fold-in event occurs (i) if an ownership change occurs within six months (before or after) of the member joining the consolidated group, or (ii) at the end of a five-year period in which the member does not experience an ownership change and is a member of the consolidated group. Treas. Reg. § 1.1502-96(a)(1).

A “NUBIL subgroup” is a subgroup of two or more corporations that become members of a consolidated group (the “current group”) if (i) they had been continuously affiliated with each other for the five consecutive year period ending immediately before they became members of the current group, and (ii) immediately after they become members of the current group, the subgroup parent requirement (described below) is met. Treas. Reg. § 1.1502-91(d)(2), (f)(2), (g)(2)(iv). In addition, the corporations will only be treated as a NUBIL subgroup if the subgroup has a NUBIL (computed on a consolidated subgroup basis) on the day the corporations that make up the subgroup become members of the current group (by treating that day as a change date). Treas. Reg. § 1.1502-91(d)(2)(iii).

For purposes of determining whether the NUBIL subgroup continuous affiliation requirement is met, any successor corporation and predecessor corporation are treated as a single corporation. Treas. Reg. § 1.1502-91(j). In addition, certain members are deemed to meet the five-year affiliation requirement if the member had an ownership change within six months (before or after) of becoming a member of the prior consolidated group. This rule applies if the member was the member of a NUBIL subgroup upon joining the prior consolidated group. This rule also applies if the member was not a member of a NUBIL subgroup but had a separately-computed NUBIL upon joining the prior consolidated group. Treas. Reg. § 1.1502-96(a)(1)(i), (2)(ii), (3)(i). For example, if Sub joins the M consolidated group and has an ownership change and a NUBIL upon joining the M consolidated group, Sub will be treated as affiliated with M for five years for NUBIL subgroup purposes if M and Sub become members of a new consolidated group three years later. *See* Treas. Reg. § 1.1502-96(a)(3)(ii).

The subgroup parent requirement is met if the members of the NOL subgroup or NUBIL subgroup would meet the definition of an “affiliated group” by (i) treating one corporation as a common parent (the “subgroup parent”), and (ii) ignoring the stock ownership of the subgroup parent by members of the current group that are not members of the subgroup. Treas. Reg. § 1.1502-91(d)(1)(ii), (2)(ii), (3), (7) Ex. 2-3.

The common parent of the current group can elect to treat the subgroup parent requirement as deemed to be met. In such case, all of the corporations that become members of the current group at the same time are treated as meeting the loss subgroup parent requirement but only if they were affiliated with each other immediately before they became members of the current group. Each such corporation that becomes a member of the subgroup is treated as a loss subgroup parent. Treas. Reg. § 1.1502-91(d)(4), (7) Ex. 4. The election is made by attaching the appropriate statement to the consolidated return for the taxable year in which the members of the subgroup joined the current group. The election must be filed on or before the extended due date of the return. Treas. Reg. § 1.1502-96(e).

An NOL subgroup or NUBIL subgroup is deemed not to exist if any one of the purported members is “formed, acquired, or availed of with a principal purpose of avoiding the application of, or increasing any limitation, under section 382.” Treas. Reg. § 1.1502-91(d)(5). This rule does not apply solely because members of a group (or subgroup) are rearranged to meet the loss subgroup parent requirement. *Id.*

If an attempt is made to exclude a member from a subgroup “with a principal purpose” of avoiding the application of, or increasing any limitation under section 382, then the member is included in the subgroup. Treas. Reg. § 1.1502-91(d)(5). This rule does not apply solely because members of a group (or subgroup) are not rearranged to meet the loss subgroup parent requirement. *Id.*

A “pre-change subgroup attribute” is an NOL carryforward that is taken into account for purposes of determining whether a subgroup is an NOL subgroup. In addition, any RBIL of a NUBIL subgroup is considered a pre-change subgroup attribute. Treas. Reg. § 1.1502-91(f). The definition of pre-change subgroup attribute is generally the subgroup equivalent of the definition of pre-change loss.

Predecessors and Successors

The consolidated section 382 regulations provide for special rules for predecessor and successor corporations. Any reference to a “corporation,” “member,” “common parent,” “loss subgroup parent,” or “subsidiary” in the consolidated section 382 regulations includes, depending on the context, a reference to a predecessor or successor corporation. Treas. Reg. § 1.1502-91(j).

For purposes of the consolidated section 382 regulations, a predecessor corporation includes (i) a transferor in an acquisitive asset reorganization, (ii) a distributor in a section 332 liquidation, and (iii) a transferor or distributor of assets if the successor receives a transferred basis in the assets. Treas. Reg. §§ 1.1502-1(f)(4), -91(j).

Information Reporting

A common parent is required to attach a section 382 information statement to its tax return for any consolidated return year to report any owner shift, equity structure shift, or other transaction with respect to its stock. In addition, to reporting transactions with respect to stock of the common parent, the common parent must also report (i) any transactions with respect to a subsidiary for which the subsidiary supplemental approach applies (described below in subsection E), and (ii) any ownership change pursuant to the separate subsidiary approach (described below in subsection E). Treas. Reg. § 1.1502-92(e)(1).

In addition, the common parent is required to attach a separate section 382 information statement to its tax return for any consolidated return year to report any owner shift, equity structure shift, or other transaction with respect to the stock of each subgroup parent (and with respect to each deemed subgroup parent). However, the common parent can choose to file a single consolidated section 382 information statement instead of separate statements for each subgroup parent. The single consolidated statement must include (i) the information described in the previous paragraph, (ii) the identity of each subgroup parent, and (iii) a statement of which subgroups, if any, had ownership changes during the consolidated return year. Treas. Reg. § 1.1502-92(e)(2).

The obligation to separately report information with respect to subgroup parents (and deemed subgroup parents) generally terminates when the separate tracking exception (described in section 1.1502-96(a) of the Treasury regulations and subsection F below) begins to apply. After the separate tracking exception applies, the attributes of the subgroup parents are reported on the general section 382 statement filed by the common parent. Treas. Reg. § 1.1502-92(e)(2).

B. Ownership Change Rules

The section 382 regulations provide rules for determining whether a loss group undergoes an ownership change. Generally, the determination is made on a consolidated basis. Accordingly, an ownership change occurs if the common parent has an ownership change. However, in certain cases, share issuances at the subsidiary level can affect the determination of whether the common parent has an ownership change.

If a loss group undergoes an ownership change, then the testing period for determining a subsequent ownership change begins no earlier than the day after the ownership change. Treas. Reg. § 1.1502-92(d).

Parent Change Approach

A loss group generally undergoes an ownership change if the common parent undergoes an ownership change. Treas. Reg. § 1.1502-92(b)(1)(i), (2) Ex. 4(iv). As a result, there generally is no need to perform separate ownership change analysis for subsidiaries. Treas. Reg. § 1.1502-92(b)(2) Ex. 2. However, there are exceptions which may result in the need to perform an analysis.

For purposes of determining whether the common parent undergoes an ownership change, some modifications to the normal ownership change rules apply. In determining when the testing period begins, certain tax attributes attributable to subsidiaries are taken into account. Treas. Reg. § 1.1502-92(b)(1)(i)(B). For this purpose, any NOL that is a pre-change consolidated attribute is treated as an NOL of the common parent. If the loss group has a consolidated NUBIL, the common parent is treated as having a NUBIL. Treas. Reg. § 1.1502-92(b)(1)(i)(A). (The regulations do not state whether other consolidated tax attributes (credits, capital losses, and disallowed business interest expense) are treated as being attributes of the common parent.) These modifications are made to (i) allow for the determination of the beginning of the testing period to be made on a consolidated basis, and (ii) treat the common parent as a loss corporation even if it has no tax attributes on a stand-alone basis. Treas. Reg. § 1.1502-92(b)(2) Ex. 1.

The common parent of a consolidated group can change without affecting the status of the consolidated group (i.e., the group remains in existence). This can occur (i) if there is a recapitalization of the common parent, (ii) if the common parent transfers substantially all of its assets to subsidiaries (i.e., a downstream transaction), (iii) if the common parent changes in a transaction in which the stock of the new common parent is worth less than the stock of the old common parent (i.e., a reverse acquisition), and (iv) if a subsidiary becomes the common parent by merger. Treas. Reg. § 1.1502-75(d)(2), (3); Rev. Rul. 82-152, 1982-2 CB 205.

For ownership change purposes, if an existing common parent is succeeded by a new common parent (as described in the previous paragraph) the new common parent is treated as a continuation of the old common parent. Appropriate adjustments need to be made to take into account owner shifts during the testing period (including owner shifts that occur in conjunction with the change in common parent). A new common parent is treated as a continuation of the old common parent even if the separate NUBIG or NUBIL of the new common parent is not taken into account for purposes of determining the consolidated NUBIL. Treas. Reg. § 1.1502-92(b)(3)(i), (iii) Ex. 1-2.

Supplemental Subsidiary Approach

In determining whether a loss group has an ownership change, the supplemental subsidiary approach must be considered in certain circumstances. This approach consists of supplemental rules with respect to the application of the parent change approach. These rules represent an alternative approach to determining whether an ownership change occurs. An ownership change occurs, if at all, on the earliest change date under either approach. Treas. Reg. § 1.1502-92(c)(1).

The supplemental subsidiary approach applies to a loss group if any 5% shareholder increases its percentage ownership interest in the stock of both the common parent and any subsidiary of the loss group within a three-year period ending on any day of a consolidated return year (or beginning on the day after the most recent ownership change if shorter). A “5% shareholder” for this purpose is an individual or entity that is a 5% shareholder with respect to the common parent. Treas. Reg. § 1.1502-92(c)(2)(i), (ii).

In determining whether the 5% shareholder has increased its ownership interest in a subsidiary, constructive ownership through a direct (or indirect) acquisition of stock of the common parent is ignored. Treas. Reg. § 1.1502-92(c)(2)(i). However, the other constructive ownership rules apply by treating the subsidiary stock as stock of a loss corporation. In addition, other rules described in section 382(l)(3) (i.e., the step-into-the-shoes and fluctuation in value rules) appear to apply. Treas. Reg. § 1.1502-92(c)(3)(ii).

Generally, the supplemental subsidiary approach only applies if the common parent has actual knowledge of the 5% shareholder’s increase in ownership of the subsidiary and the actual knowledge was acquired before the loss group’s income tax return is filed for the taxable year that includes the date of the increase. Treas. Reg. § 1.1502-92(c)(2)(iii)(A). However, actual knowledge of the ownership is not required if the 5% shareholder would also have been a 5% shareholder with respect to the subsidiary (determined as if the subsidiary were a loss corporation and taking into account the duty of inquiry rules). Treas. Reg. § 1.1502-92(c)(2)(iii)(B), (5) Ex. 1.

A 5% shareholder of the common parent is treated as increasing its ownership interest in a subsidiary if there is a plan or arrangement under which the 5% shareholder increases the percentage ownership interest in the common parent and another person (or persons) increases its percentage ownership in the subsidiary. Treas. Reg. § 1.1502-92(c)(3)(i), (5) Ex. 2 (purchase of 49% of common parent by shareholder and IPO of 20% of subsidiary). This provision only applies if the common parent has actual knowledge of the increase in ownership of the subsidiary pursuant to a plan or arrangement and the actual knowledge was acquired before the loss group’s income tax return is filed for the taxable year that includes the date of the increase. Treas. Reg. § 1.1502-92(c)(2)(iii)(A). The actual knowledge requirement applies even if the other person (or persons) acquires 5% or more of the subsidiary. Treas. Reg. § 1.1502-92(c)(2)(iii)(B).

The supplemental subsidiary approach does not apply if the application of the approach does not cause an ownership change before the day on which the subsidiary ceases to be a member of the loss group. Treas. Reg. § 1.1502-92(c)(4)(iv).

Where the supplemental subsidiary approach applies, the determination as to whether an ownership change occurs with respect to the loss group is made under a modified version of the parent change approach. Treas. Reg. § 1.1502-92(c)(4). The supplemental subsidiary approach provides for additional testing dates. Each day in which there is an increase in the percentage ownership interest in the stock of the subsidiary is a testing date. Treas. Reg. § 1.1502-92(c)(4)(i)(A). In addition, the first day of the first consolidated return year for which the consolidated group is a loss group is a testing date. Treas. Reg. § 1.1502-92(c)(4)(i)(B).

Under the supplemental subsidiary approach, the common parent is treated as issuing its own stock to the person (or persons) that increased their ownership in the subsidiary. The amount of stock deemed issued is an amount with the same value as the value of the subsidiary stock represented by the percentage increase in that person's ownership interest in the subsidiary (determined on a separate entity basis). Treas. Reg. § 1.1502-92(c)(4)(ii). For example, if a person who previously did not own any stock of any member of a consolidated group purchases 50% of the stock of the common parent and 20% of the stock of a subsidiary on the same day, the shareholder would be treated as acquiring additional shares of common parent stock resulting in an ownership change. Treas. Reg. § 1.1502-92(c)(5) Ex. 1.

The regulations state that similar principles apply to an increase in the percentage ownership interest in a subsidiary caused by a redemption or similar transaction. Treas. Reg. § 1.1502-92(c)(4)(ii). There is uncertainty as to whether the common parent is treated as issuing additional shares to the shareholder of the subsidiary or is treated as redeeming shares held by others.

Special rules apply if the increase in ownership of the subsidiary stock occurs before the increase in ownership of the common parent stock (and on a different day). In such case, the additional shares of common parent stock are treated as deemed to be issued on the later date. However, the value of the subsidiary stock is determined on the former date. Treas. Reg. § 1.1502-92(c)(4)(v).

Stock that is deemed issued by the common parent under the supplemental subsidiary approach is not taken into account if the relevant testing period does not include the date of the deemed stock issuance. Treas. Reg. § 1.1502-92(c)(4)(iii). As a result, if a deemed issuance causes an ownership change then the stock that was deemed to be issued is not treated as outstanding in subsequent testing periods.

Where the supplemental subsidiary approach applies as a result of a plan or arrangement by which two or more 5% shareholders increase their ownership in the common parent (and another person increases their ownership in the subsidiary), then appropriate adjustments must be made to prevent duplication of stock that is deemed to be issued to the 5% shareholders. Treas. Reg. § 1.1502-92(c)(4)(vi).

C. Base Annual Section 382 Limitation

The base annual section 382 limitation for a loss group is generally determined on a consolidated basis taking into account the equity of all of the members of the loss group. All of the components and adjustments that go into determining the base annual section 382 limitation are generally determined on a consolidated basis. Treas. Reg. § 1.1502-93(a)(1).

For purposes of determining the consolidated base annual section 382 limitation, the value of the loss group equals the value of the stock of each member of the consolidated group (not just the common parent) (the "equity approach"). For this purpose, stock of a member includes pure preferred stock, as well as financial obligations that are subject to either the stock recharacterization rule or the non-stock recharacterization rule. Treas. Reg. § 1.1502-93(b)(1)(iii).

Under the equity approach of the regulations, the stock of subsidiaries owned by non-members is taken into account for limitation purposes. This is the case, even though stock of a subsidiary generally would not have been taken into account for ownership change purposes under the common parent approach.

Stock that is directly or indirectly owned by a member is not taken into account. Treas. Reg. § 1.1502-93(b)(1), (3) Ex. 1. For purposes of determining whether stock of a member is owned by another member, the ownership rules described in section 1.382-2T of the temporary Treasury regulations (definition of ownership change) apply. Treas. Reg. § 1.1502-93(b)(1)(i). As a result, it is possible that rules that are not described in section 1.382-2T do not apply in determining ownership. One example of an ownership rule that appears elsewhere is the option attribution rule, which appears in section 1.382-4(d) of the Treasury regulations.

In determining whether stock is indirectly owned by another member, a member is considered to own stock through a non-member by attribution. However, such indirect interests are only taken into account if the member has a 5% or greater interest in the non-member. Treas. Reg. § 1.1502-93(b)(1)(ii), (3) Ex. 2.

The value of the loss group is adjusted under all of the rules that adjust value for purposes of determining the base annual section 382 limitation. However, modifications are to be made to take into account the differences between a loss corporation and a loss group. As a result, the redemption and corporate contraction adjustment does not apply to transactions that do not affect a transfer of value outside the loss group. Similarly, capital contributions between members of the loss group are ignored. Treas. Reg. § 1.1502-93(b)(2)(i).

The substantial nonbusiness asset and COBE rules are applied on a consolidated basis and are not applied separately to any member. Treas. Reg. § 1.1502-93(b)(2)(i), (d)(1). For example, the termination of the business by a member does not cause a base annual section 382 limitation of zero for that member unless the termination is large enough on a consolidated basis to cause a failure to meet the COBE requirement for the loss group. Treas. Reg. § 1.1502-93(d)(2) Ex.

Other section 382 limit rules are applied on a consolidated basis. If the consolidated section 382 limitation exceeds the tax attributes applied in a consolidated return year, the excess increases the consolidated section 382 limitation in future taxable years. Treas. Reg. § 1.1502-93(e). Similarly, if the loss group undergoes an ownership change in the middle of the taxable year, the consolidated taxable income or consolidated NOL is allocated between the two periods on a consolidated basis. Treas. Reg. § 1.1502-91(a)(2).

The regulations require an adjustment to be made to the value of the stock of a member to the extent necessary to prevent “any” duplication of the value of the stock of a member. These adjustments are required even though corporations that do not file consolidated returns may not be required to make such an adjustment. Treas. Reg. § 1.1502-93(b)(2)(ii).

The regulations give no indication as to what situations the anti-duplication rule applies to. However, the reference to “any duplication” indicates intent for the rule to be expansive. Below are some potential situations where the provision may apply.

- A loss group has an ownership change and a subsidiary has a contemporaneous ownership change under the separate subsidiary approach (but the two ownership changes do not occur on the same day). *See* Treas. Reg. § 1.1502-96(b)(3).
- A loss group has an ownership change and a new member of the consolidated group (or NOL subgroup or NUBIG subgroup) has a contemporaneous ownership change.

The regulations specifically state that anti-duplication can be required even where no such adjustment is necessary where a consolidated return is not filed. As a result, it is possible that an adjustment may be necessary where there are valuation anomalies. This can happen where a corporation's net assets are worth less than the liquidation price of the outstanding preferred stock (issued by the common parent or a subsidiary). In such case, the common stock might still have a positive fair market value based on the possibility of future appreciation (i.e., an option valuation). For example, if the loss group has net assets with a value of \$140 million and preferred stock with a liquidation preference of \$150 million, it is possible that the value of the common stock and the preferred stock equals \$10 million (based on the possibility of future appreciation in the value of the assets) and \$140 million, respectively. If a loss corporation did not file a consolidated return, it would appear that the section 382 stock value equals \$150 million. If the same corporation files a consolidated return, there is uncertainty as to whether the stock value equals \$140 million or \$150 million.

The regulations are unclear as to the proper approach for adjustments where the anti-duplication rule applies. The regulations only state that the adjustment must be "appropriate." Two approaches are discussed (the controlled group approach and the successive ownership change approach). These two approaches do not appear to be the only approaches available.

Under the controlled group approach, the loss group applies the principles of section 1.382-8 of the Treasury regulations. These regulations apply rules to avoid duplication of value where two or more members of a controlled group have an ownership change. The controlled group approach can be applied even if section 1.382-8 would not have applied if the members of the loss group filed separate tax returns. Treas. Reg. § 1.1502-93(b)(2).

Under the successive ownership change approach, the loss group applies the principles of section 1.382-5(d) of the Treasury regulations. These regulations apply rules for the absorption of section 382 limitations with respect to successive ownership changes. The successive ownership change approach is applied as if section 1.382-5(d) applied to simultaneous (rather than successive) ownership changes. Treas. Reg. § 1.1502-93(b)(2).

D. Consolidated NUBIG/NUBIL Rules

The NUBIG, NUBIL, and RBIG for a loss group is generally determined on a consolidated basis. Presumably, an RBIL is determined under the same approach, but the regulations have been reserved.

Consolidated NUBIG/NUBIL

The amount of a NUBIG or NUBIL for a loss group is generally determined on a consolidated basis. The amount of the consolidated NUBIG or NUBIL is determined by adding the total amount of separately-computed NUBIGs or NUBILs for each member of the group that is taken into account. The threshold requirement (i.e., lesser of \$10 million or 15% of gross assets) applies on a consolidated basis and not separately to each member. Treas. Reg. § 1.1502-91(g)(1); Prop. Reg. § 1.1502-91(g)(1), (8) Ex. 1.

A member's separately computed NUBIG or NUBIL is generally computed without reference to UBIGs or UBILs with respect to stock or debt obligations issued by another member of the group. For this purpose, stock includes pure preferred stock, as well as financial obligations that are subject to either the stock recharacterization rule or the non-stock recharacterization rule. Treas. Reg. § 1.1502-91(g)(1); Prop. Reg. § 1.1502-91(g)(1)(ii)(A), (B), (8) Ex. 1.

A member's separate NUBIG or NUBIL is adjusted, as necessary, to prevent duplication of unrealized gain or loss attributable to a member's indirect ownership interest in another member through a nonmember. This could occur, for example, if a member had an interest in a partnership and the partnership owned pure preferred stock in another member. An adjustment is only made if the member has a 5% or greater ownership interest in the nonmember. Treas. Reg. § 1.1502-91(g)(5). A further adjustment is required to a member's separate NUBIG or NUBIL to exclude an UBIG or UBIL with respect to assets acquired with a principal purpose to affect the amount of the separate NUBIG or NUBIL. Treas. Reg. § 1.1502-91(g)(4).

There is some uncertainty as to how to treat gains or losses that are deferred under the intercompany transaction rules. For example, if B sells an asset with a basis of zero to S for \$100 million, B's gain of \$100 million is deferred. *See* Treas. Reg. § 1.1502-13(c). If the consolidated group subsequently undergoes an ownership change, it would appear that S would take into account its basis of \$100 million in determining its separate NUBIG or NUBIL. There is less certainty as to how to treat B's deferred gain. Many taxpayers would take the position that the deferred gain is a built-in income items that adjusts the amount of NUBIG or NUBIL. This position is supported by the regulation. Treas. Reg. § 1.1502-91(g)(1); Prop. Reg. § 1.1502-91(g)(1)(ii)(C). However, the technical basis for the position may be strained where the taxpayer determines NUBIG or NUBIL under either the section 338 or 1374 approaches. Neither approach generally provides for an adjustment for built-in income items.

For purposes of determining whether a loss group has a NUBIG, generally all of the members of the consolidated group on the change date are taken into account. Treas. Reg. § 1.1502-91(g)(2)(i). However, for purposes of determining whether a loss group has a NUBIL, not all of the members of the consolidated group on the determination date are taken into account. Generally, members that joined the group within the five-year period ending on the NUBIL determination date (i.e., a testing date, change date, or the beginning of a testing period, as the case may be) are not taken into account for NUBIL purposes. Treas. Reg. § 1.1502-91(g)(2)(ii).

As a result of differences in the members that are taken into account for NUBIG and NUBIL purposes, it is possible for a loss group to have a consolidated NUBIG and a consolidated NUBIL. In such case, both the NUBIG and NUBIL rules can apply to the same loss group. Treas. Reg. § 1.1502-91(g)(2)(v).

A separate NUBIG or NUBIL of a member that is excluded in determining whether the group has a consolidated NUBIL is not taken into account. Instead, the basis and value of stock of such a member is taken into account for purposes of determining the separate NUBIG or NUBIL of the member owning the stock. However, a debt obligation of such an excluded member is never taken into account in determining separate NUBIG or NUBIL. Treas. Reg. § 1.1502-91(g)(1); Prop. Reg. § 1.1502-91(g)(i).

Five-Year Affiliation. Generally, members are taken into account for purposes of computing the amount of the consolidated NUBIL if they were affiliated with the common parent for the five-year period ending on the NUBIL determination date. Treas. Reg. § 1.1502-91(g)(2)(i). In determining whether the five-year affiliation requirement is met, the affiliation period of predecessor members are taken into account. Treas. Reg. § 1.1502-91(j). The common parent is generally included in the group regardless of the five-year requirement. Treas. Reg. § 1.1502-91(g)(2)(i). It appears that the five-year requirement is met where the common parent and the affiliated subsidiaries were previously members of a different consolidated group (e.g., members that were spun-off from an old group and afterwards joined a new group).

Special rules apply where the consolidated group is treated as continuing under either the downstream transaction rule or the reverse acquisition rule during the five-year affiliation period. In such case, adjustments are made in determining which members have been affiliated with the common parent for five years. The former common parent is treated as a predecessor of the new common parent. To meet the five-

year affiliation requirement, a member must have been affiliated with both the former common parent (from the beginning of the five-year period until the change in the common parent) and the new common parent (from the change in the common parent until the NUBIL determination date). The new common parent must also meet this revised five-year affiliation requirement to be taken into account. Treas. Reg. § 1.1502-91(g)(6).

For purposes of ascertaining the members that should be taken into account when determining the amount of a NUBIL, certain members are deemed to meet the five-year affiliation requirement if the member had an ownership change within six months (before or after) of becoming a member of the consolidated group. This rule applies if a member was the member of a NUBIL subgroup upon joining the consolidated group. This rule also applies if the member was not a member of a NUBIL subgroup but had a separately-computed NUBIL upon joining the consolidated group. The rule applies to NUBIL determination dates of the loss group that occur at least one day after the member or NUBIL subgroup's change date (but not before the day it joined the group). Treas. Reg. § 1.1502-96(a)(1)(i), (2)(ii). Where this rule applies, the separately computed NUBIG or NUBIL of the member (or members of the NUBIL subgroup) are taken into account in determining the amount of a consolidated NUBIL.

A similar deemed affiliation rule applies if a member (or NUBIL subgroup) has been a member of the consolidated group for an uninterrupted five-year period and has not had an ownership change (during this period). This rule applies to NUBIL determination dates of the loss group that occur at least one day after the end of the five-year period. Treas. Reg. § 1.1502-96(a)(1)(ii), (2)(ii). This rule appears to only apply where the consolidated group is treating as continuing under either the downstream transaction rule or the reverse acquisition rule during the five-year affiliation period.

The five-year affiliation requirement does not generally apply to subsidiaries that have changed their NUBIG or NUBIL status between the day they joined the consolidated group and the NUBIL determination date. As described in more details below, this exception applies to members that had a NUBIL when they joined the group and have a NUBIG on the NUBIL determination date (or had a NUBIG when they joined the group and have a NUBIL on the NUBIL determination date.) Where this exception applies, the separately computed NUBIG or NUBIL of the member (or members of the NUBIL subgroup) are taken into account in determining the amount of a consolidated NUBIL. A member is included (without regard to the five-year affiliation requirement) if:

- the member has a NUBIL (on a separately-computed basis) on the NUBIL determination date and did not have a NUBIL when it joined the consolidated group (and was not a member of a NUBIL subgroup), Treas. Reg. § 1.1502-91(g)(2)(ii)(B),
- the member has a NUBIG (on a separately-computed basis) on the NUBIL determination date and had a NUBIL when it joined the consolidated group, Treas. Reg. § 1.1502-91(g)(2)(ii)(C), or
- the member is a member of a NUBIL subgroup and the subgroup has a NUBIG (on a subgroup basis) on the NUBIL determination date. Treas. Reg. § 1.1502-91(g)(2)(ii)(D).

In determining whether a member has a NUBIG or NUBIL on the NUBIL determination date, there is uncertainty as to whether the basis and value of stock of lower tier subsidiaries (i.e., a UBIG or UBIL with respect to stock) are taken into account. A UBIG or UBIL with respect to intercompany debt is never taken into account. *See* Treas. Reg. § 1.1502-91(g)(1).

Any member that was acquired with a principal purpose to affect the amount of NUBIG or NUBIL is excluded in determining whether the group has a NUBIG or NUBIL. Treas. Reg. § 1.1502-91(g)(4). This appears to be the only situation in which a member is not taken into account for NUBIG purposes.

Proposed regulations would expand existing anti-abuse rules to cover situations in which a person acts with a principal purpose that is contrary to the purposes of the consolidated NUBIG/NUBIL rules to (i) avoid the effect of the consolidated NUBIG/NUBIL rules, or (ii) apply the consolidated NUBIG/NUBIL rules to avoid the effect of any of the other provisions of the consolidated return regulations. In such case, appropriate adjustments must be made to carry out the purposes of the consolidated NUBIG/NUBIL rules. Prop. Reg. § 1.1502-91(g)(7)(iv). This proposed amendment to the existing regulations is proposed to be effective for ownership changes occurring after October 24, 2011 (but only after the regulations are finalized). Prop. Reg. § 1.1502-91(k). This effective date may be revisited if the proposed regulations are finalized. Nathan J. Richman, “Final Built-in Gain or Loss Regs Likely to Revise Effective Date,” 2017 TNT 30-6.

Consolidated NUBIG/NUBIL Example. Corp P is the common parent of a consolidated group. On January 1, 2006, Corp P acquired 100% of the stock of Target for \$500 million. At the time of the acquisition, Target had an aggregate adjusted basis in its assets of \$100 million (and no liabilities). On January 1, 2008, Corp P had an ownership change. On the change date, the members of the consolidated group (other than Target) had a NUBIL of \$150 million. The value of the Target stock and assets have dropped to \$300 million and the basis of the stock and assets have remained unchanged. As a result, Target has a separately computed NUBIG of \$200 million. Since Target has a NUBIG on both the date it joined the group and the change date (and has not been affiliated with Corp P for five years), Target’s NUBIG is not taken into account for purposes of determining the amount of the consolidated NUBIL. The consolidated NUBIL equals \$350 million (NUBIL of other members of \$150 million, plus UBIL with respect to Target stock of \$200 million (basis of \$500 million, less value of \$300 million). The group also has a consolidated NUBIG of \$50 million (NUBIL of other members of \$150 million, offset by Target NUBIG of \$200 million).

If the value of the Target stock and assets had dropped to \$75 million, Target would have had a separately computed NUBIL of \$25 million. Since Target has a NUBIG on the date it joined the group and a NUBIL on the change date, Target’s NUBIL is taken into account for purposes of determining the amount of the consolidated NUBIL. The group has a consolidated NUBIL of \$175 million (NUBIL of other members of \$150 million, plus Target NUBIL of \$25 million) and does not have a consolidated NUBIG.

Proposed Regulations. The IRS and Treasury Department have proposed amendments to the existing regulations that would require a redetermination of the consolidated NUBIG or NUBIL (on a prospective basis) to the extent gain or loss with respect to stock of an “included subsidiary” is taken into account during the recognition period. These proposed regulations are proposed to be effective for ownership changes occurring after October 24, 2011 (but only if the gain or loss with respect to the subsidiary’s stock is taken into account after the regulations are finalized). Prop. Reg. § 1.1502-91(k). This effective date may be revisited if the proposed regulations are finalized. *Final Built-in Gain or Loss Regs Likely to Revise Effective Date*, 2017 TNT 30-6.

Under the proposed amendments to the rules, the consolidated NUBIG or NUBIL is redetermined if any member of the consolidated group takes into account, directly or indirectly, gain or loss during the recognition period with respect to stock of an included subsidiary. For this purpose, an included subsidiary is a subsidiary that was a member of the loss group immediately before the change date.

A loss with respect to subsidiary stock requires a redetermination even if the loss is not absorbed. Prop. Reg. § 1.1502-91(g)(7)(i). As a result, a loss that is recognized but becomes part of a capital loss or NOL carryforward appears to result in a redetermination. It is possible that a redetermination may be required if the loss is disallowed by the unified loss rules (i.e., section 1.1502-36 of the Treasury regulations).

Where a redetermination is required, the consolidated NUBIG or NUBIL is redetermined to include any “unduplicated built-in gain or loss” with respect to the shares of the included subsidiary. The redetermination is given effect immediately before the time the gain or loss with respect to the share is taken into account.

The redetermined NUBIG or NUBIL is effective for all purposes immediately before the gain or loss on the stock of the included subsidiary is taken into account (and at all times thereafter). The redetermination does not affect the treatment of prior transactions (i.e., transactions for which gain or loss was taken into account before the gain or loss with respect to the subsidiary stock).

The redetermination can cause the group to switch from having a NUBIG to a NUBIL (or vice versa) or to a situation in which the NUBIG or NUBIL is zero due to the de minimis rule (or vice versa). Prop. Reg. § 1.1502-91(g)(7)(i). There is some uncertainty as to whether taxpayers will be allowed to change approaches in the event of a switch in regimes. For instance, in a switch from NUBIL to NUBIG, would a group be allowed to change from the section 1374 approach to the section 338 approach (and would such a change be allowed only on a prospective basis or retroactive to the change date)?

The unduplicated built-in gain or loss with respect to a share of stock is determined by tentatively adjusting the basis of the share immediately before the change date. If the gain or loss with respect to the share is deferred as of the change date (e.g., under section 267 or under section 1.1502-13 of the Treasury regulations), the tentative adjustment to basis takes place as of the date of the transaction that gives rise to the amount. Prop. Reg. § 1.1502-91(g)(7)(ii). For example, if a member of the group sold a subsidiary to another member in 1996 and recognized a gain that was deferred, it appears that the unduplicated built-in gain or loss is determined as of the 1996 transfer. It should be noted that the current intercompany transaction rules are generally effective for transactions occurring in taxable years beginning on or after July 12, 1995, but predecessor versions exist that can still result in the recognition of deferred gain or loss today. Treas. Reg. § 1.1502-13(l)(1). It may be very difficult to determine the amount of unduplicated gain or loss for transactions that occurred decades ago (and may have occurred while the subsidiary was a member of a predecessor consolidated group).

The first step in determining the tentative adjustment to basis is to treat the separate NUBIG or NUBIL of the included subsidiary as having been recognized, taken into account, and absorbed immediately before the change date (or in the case of a deferred gain or loss, immediately before the transaction that gave rise to the deferred amount). A similar tentative adjustment is made with respect to the separate NUBIG or NUBIL of any included subsidiary that is lower tier to the subsidiary for which unduplicated built-in gain or loss is being computed. Prop. Reg. § 1.1502-91(g)(7)(ii)(A).

The second step is to adjust the basis in the shares of the subsidiary for which gain or loss was taken into account for the amounts that were deemed recognized, taken into account, and absorbed in the prior step. This is done by tiering up the adjustments under the principles of the investment adjustment rules (i.e., section 1.1502-32 of the Treasury regulations) to tentatively adjust the basis of the shares. Prop. Reg. § 1.1502-91(g)(7)(ii)(B).

The aggregate unduplicated gain or loss with respect to a share of stock for which gain or loss was taken into account equals the difference between the aggregate fair market value of the shares and the aggregate tentatively adjusted basis in the shares. The unduplicated gain or loss is determined immediately before the change date (or in the case of a deferred amount, on the date of the transaction that gave rise to the item). Prop. Reg. § 1.1502-91(g)(7)(ii)(C).

The redetermined NUBIG or NUBIL of the loss group (or loss subgroup) equals the sum of (i) the originally determined NUBIG or NUBIL (i.e., determined without regard to stock of any included subsidiary), (ii) any unduplicated gain or loss with respect to share of stock of an included subsidiary that was the subject of a previous redetermination, and (iii) the unduplicated gain or loss computed above. Prop. Reg. § 1.1502-91(g)(7)(iii).

If stock of an included subsidiary is transferred to another member of the consolidated group and the stock of the subsidiary is subsequently sold to a non-member during the recognition period, the proposed rules for redetermining NUBIG or NUBIL apply even if the selling member was not a member of the loss group (or loss subgroup). For example, if stock of an included subsidiary is transferred to a newly-formed member of the consolidated group three years after an ownership change and the new member sells the stock of the included subsidiary during the recognition period, the consolidated NUBIG or NUBIL is redetermined (even though the member selling the stock was not a member of the loss group at the time of the ownership change). Prop. Reg. § 1.1502-91(g)(8) Ex. 2(ii).

Redetermination Example. P, the common parent of a consolidated group, owns 100% of the stock of S, the only other member of the group (and a member for more than five years). P has an ownership change and the loss group has a consolidated NUBIL of \$10 million. S had a separate NUBIL of \$10 million (basis of \$100 million less fair market value of \$90 million) and P had a separate NUBIG/NUBIL of zero. P's basis in the S stock was \$120 million. (The basis in the stock is not taken into account in determining the consolidated NUBIL.) P has a UBIL of \$30 million (basis of \$120 million less value of \$90 million) with respect to the S stock.

P sells 100% of the stock of S within the recognition period at a loss of \$55 million (basis of \$120 million less amount realized of \$65 million). (The loss is fully allowed by the unified loss rules.) As a result of the sale, the consolidated NUBIL must be redetermined.

The first step is to treat S's separate NUBIL of \$10 million as having been recognized, taken into account, and absorbed immediately before the ownership change. The second step is to adjust P's basis in the S stock for this amount. As a result, the basis immediately before the change date would be tentatively reduced to \$110 million (actual of \$120 million less tentative adjustment of \$10 million). The fair market value of the S stock immediately before the ownership change was \$90 million. Thus, the unduplicated loss with respect to the S stock equals \$20 million (tentative basis of \$110 million less fair market value of \$90 million).

Immediately before P takes into account the \$55 million loss with respect to the sale of S stock, the consolidated NUBIL is recomputed. The recomputed NUBIL equals \$30 million (original NUBIL of \$10 million plus unduplicated loss with respect to S stock of \$20 million). Since the recomputed NUBIL and UBIL with respect to S stock are both \$30 million, \$30 million of the recognized loss is treated as an RBIL. The remaining loss of \$25 million is not an RBIL and is not subject to section 382. It should be noted that under current law, only \$10 million of the loss would be treated as an RBIL. Prop. Reg. § 1.1502-91(g)(8) Ex. 2(i).

If the basis of the S stock had been \$60 million instead of \$120 million, P would have recognized a gain of \$5 million on the sale. (The originally computed consolidated NUBIL of \$10 million would be unaffected by the change in basis.) The tentatively adjusted basis would equal \$50 million (actual of \$60 million less tentative adjustment of \$10 million) and the unduplicated gain with respect to the S stock would equal \$40 million (fair market value of \$90 million less tentative basis of \$50 million). The originally computed consolidated NUBIL of \$10 million would become a

redetermined consolidated NUBIG of \$30 million. The \$5 million gain with respect to the sale of the S stock would be treated as an RBIG. Prop. Reg. § 1.1502-91(g)(8) Ex. 5(i).

Examples in the proposed regulations describe how NUBIG or NUBIL is redetermined where the loss group has taken into account RBIGs or RBILs before gain or loss is taken into account with respect to an included subsidiary. It appears that the prior RBIG or RBIL adjusts the NUBIG or NUBIL balance (before redetermination) but only if the amount would have been an RBIG or RBIL if the unduplicated gain or loss were taken into account in the original NUBIG or NUBIL calculation. For example, assume that a consolidated group has a consolidated NUBIL of \$10 million and sells an asset at a \$30 million loss (\$10 million of which is treated as an RBIL) before selling the stock of an included subsidiary. In such case, the remaining balance of the consolidated NUBIL would be reduced to zero. If group subsequently sells the stock of an included subsidiary with an unduplicated loss of \$8 million, the redetermined consolidated NUBIL would have equaled \$18 million (if there had been no prior RBILs). The \$30 million loss previously taken into account reduces the consolidated NUBIL balance to zero since it would have been an RBIL if the redetermined NUBIL balance had been applied retroactively. As a result, the redetermined consolidated NUBIL balance equals \$8 million (NUBIL balance of zero plus unduplicated loss of \$8 million). Prop. Reg. § 1.1502-91(g)(8) Ex. 3.

If, in the prior example, there had been an unduplicated gain of \$100 million, the consolidated NUBIL would be redetermined to be a consolidated NUBIG of \$90 million (unduplicated gain of \$100 million less original NUBIL of \$10 million). The earlier \$30 million loss would not have any effect on the computation of redetermined consolidated NUBIG since losses are not treated as an RBIL if there is a NUBIG. Prop. Reg. § 1.1502-91(g)(8) Ex. 5(ii).

Application of Notice 2003-65. There is currently uncertainty about how to apply Notice 2003-65, 2003-2 CB 747, in determining consolidated NUBIG or NUBIL. The consolidated regulations (which were promulgated before the issuance of Notice 2003-65) require that consolidated NUBIG or NUBIL be determined by taking into account the aggregate of the separate NUBIGs and NUBILs of each member of the consolidated group that is included in the group or subgroup. Treas. Reg. § 1.1502-91(g)(1).

Some practitioners worry that the application of Notice 2003-65 to each member separately could produce anomalies, such as with respect to (i) one or more insolvent members, (ii) intercompany debt obligations, or (iii) holding companies. There would appear to be similar concerns with respect to the proposed section 382(h) regulations.

To alleviate some of the concerns regarding the application of Notice 2003-65 on a consolidated basis, one taxpayer requested permission to apply section 338 aggregate deemed sale price (ADSP) principles in determining the consolidated NUBIG or NUBIL. In Private Letter Ruling 201051019 (Sept. 14, 2010), the IRS allowed the taxpayer to utilize this approach (the “ADSP approach”) in applying Notice 2003-65.

Under the ADSP approach, the taxpayer determines NUBIG or NUBIL by applying the principles for computing and allocating ADSP under sections 1.338-4 and -6 of the Treasury regulations. These principles are used to determine the amount realized on the Notice 2003-65 hypothetical sale of assets by a member of the group. The aggregate amount realized is then allocated to all of the assets of the member (including stock and obligations of other members of the group). The amount realized is allocated to intercompany stock and obligations notwithstanding that gain or loss might not be taken into account in determining NUBIG or NUBIL pursuant to section 1.1502-91 of the Treasury regulations. PLR 201051019.

Under section 1.338-4, ADSP is the sales price for which a target corporation is deemed to sell all of its assets in a deemed asset sale pursuant to a section 338 election. Under section 1.338-6, ADSP is allocated

among the target corporation's assets to determine the amount for which each asset is deemed to be sold. ADSP is allocated among the assets based upon the fair market value of each asset and by applying ordering rules and residual concepts. Treas. Reg. § 1.338-6(b).

In applying sections 1.338-4 and -6 to target corporations with subsidiaries, stock and debt obligations of subsidiaries and affiliates are treated as just another asset that receives an allocation of ADSP. Treas. Reg. § 1.338-6(d) Ex. 1. In the case of parent-subsidiary chains of corporations, the ADSP rules are applied to the parent corporation first and then down the chain of subsidiary corporations. Treas. Reg. §§ 1.338-3(b)(4)(i), -6(d) Ex. 1, 1.338(h)(10)-1(d)(3)(ii).

ADSP Example. P owns 100% of the stock of S and P and S are the only members of the consolidated group. S holds assets with a fair market value of \$900 thousand (and zero basis) and owes P \$400 thousand (S' only liability). P has outstanding liabilities of \$1 million and its only assets are stock and debt of S.

Under the ADSP approach, it appears that P would determine its amount realized on a hypothetical sale of assets with reference to the amount of liabilities (\$1 million) since the liabilities exceed the fair market value of its assets. Of the amount realized of \$1 million, \$500 thousand would be allocated to S stock and \$400 thousand would be allocated to S debt. The remaining \$100 thousand would be allocated to goodwill. Since the gain or loss on the S stock and debt is ignored, P would have a separate NUBIG of \$100 thousand (the value allocated to the goodwill).

S would then determine its amount realized on a hypothetical sale of assets based upon the sum of the amount allocated by P to S stock (\$500 thousand) plus the amount of S' liabilities (\$400 thousand). As a result, it appears that S would have a separate NUBIG of \$900 thousand.

Based on the above analysis, it appears that the consolidated NUBIG would equal \$1 million (P's NUBIG of \$100 thousand plus S' NUBIG of \$900 thousand).

Many taxpayers apply Notice 2003-65 by determining consolidated NUBIG or NUBIL using a single entity approach. (Adjustments need to be made under this approach in computing NUBIL in situations where certain members of the consolidated group are excluded from the calculation.) Under this single entity approach, it appears that the consolidated NUBIG in the prior example would also equal \$1 million based upon the excess of the amount of third party liabilities (\$1 million) (which exceed the actual fair market value of the group's assets of \$900 thousand) over the basis of the group's assets (zero).

Consolidated RBIG/RBIL

The amount of the RBIGs for a loss group is generally determined on a consolidated basis. This would appear to equal the aggregate RBIGs of all of the members of the consolidated group. The consolidated RBIG increases the consolidated section 382 limitation for the loss group. Treas. Reg. § 1.1502-93(c)(1).

The regulations with respect to determining the amount of an RBIL have been reserved. *See* Treas. Reg. § 1.1502-91(h)(1). Since an RBIL of a loss group is included in the definition of a pre-change consolidated attribute, Treas. Reg. § 1.1502-91(e)(1)(ii), it would appear that an RBIL is computed on a consolidated basis.

The separate NUBILs and NUBIGs of certain members of a loss group are not taken into account in computing a group's consolidated NUBIL. The regulations state that such members are not included in the

loss group. Treas. Reg. § 1.1502-91(g)(1). This would appear to indicate that RBILs of such members are not taken account.

Recognized gain or loss on the disposition of stock of another member is generally treated as an RBIG or RBIL (as the case may be and to the extent the other requirements are met). This rule applies to pure preferred stock, as well as financial obligations that are subject to either the stock recharacterization rule or the non-stock recharacterization rule. Gain or loss is treated as an RBIG or RBIL even though UBIG or UBIL with respect to the stock was not taken into account in determining consolidated NUBIG or NUBIL. Treas. Reg. § 1.1502-91(h)(2); Prop. Reg. § 1.1502-91(h)(2).

It is possible that a member may be able to offset gains and losses with respect to the disposition of multiple blocks of stock of another member in determining the amount of RBIG or RBIL. In an example in proposed regulations, a member sold two shares of stock of another member of the group. The member recognized a gain of \$3.50 on one share and a loss of \$7.50 on the other share. The example concludes that the RBIL is \$4 (and not \$7.50). Prop. Reg. § 1.1502-91(g)(8) Ex. 4(ii)(C). Since this example is only in proposed regulations, there is uncertainty as to whether taxpayers can rely upon this result.

Recognized gain or loss on the disposition of an intercompany obligation (a debt or other financial obligation of another member of the group) is not generally treated as an RBIG or RBIL. However, it is treated as an RBIG or RBIL to the extent the transaction results in aggregate income or loss (on a consolidated basis). Treas. Reg. § 1.1502-91(h)(2); Prop. Reg. § 1.1502-91(h)(2).

If gain or loss is deferred (for example under section 267 or section 1.1502-13 of the Treasury regulations), the gain or loss is not treated as RBIG or RBIL except to the extent taken into account by the consolidated group during the recognition period. Treas. Reg. § 1.1502-91(h)(3). It appears that the net amount of gain or loss that is treated as an RBIG or RBIL (after an intercompany transaction) is generally determined on a consolidated basis. The general rule is that the separate entity attributes are generally redetermined to the extent necessary to produce the same effect on consolidated taxable income as a transaction between divisions. *See* Treas. Reg. § 1.1502-13(c)(1)(i). For example, if a loss corporation joins a consolidated group and subsequently sells UBIG assets at \$30 million gain to another member of the group, the gain is deferred and is not treated as an RBIG. If the member that purchased the property subsequently sells the property to a non-member in the recognition period at a \$10 million loss, the net gain of \$20 million (\$30 million deferred gain less \$10 million loss) is treated as an RBIG. Treas. Reg. § 1.1502-13(c)(7)(ii)(J)(2). A similar result would apply if the loss corporation sold the asset to the other member for an amount equal to the basis and the purchasing member subsequently sold the asset at a \$20 million gain. Treas. Reg. § 1.1502-13(c)(7)(ii)(J)(3).

The regulations require an adjustment to be made so that an RBIG of a member that increases more than one section 382 limitation does not result in a duplication of the amount of pre-change NOLs that can be utilized. These adjustments are required regardless of whether the section 382 limitation are applied on a consolidated, subgroup, or separate basis. Treas. Reg. § 1.1502-93(h)(2).

The regulations cite as example of the application of the anti-duplication rule, a situation where an RBIG would otherwise increase the section 382 limitation for both a loss group and an NOL subgroup. In such case, the RBIG increases the section 382 limitation of the subgroup but not the loss group. Treas. Reg. § 1.1502-93(h)(2). It appears that the principles of section 1.382-5(d) of the Treasury regulations were applied as if section 1.382-5(d) applied to simultaneous (rather than successive) ownership changes.

Another example of the application of the anti-duplication rule is a situation where a loss group has both a consolidated NUBIG and a consolidated NUBIL. In such case, an RBIG cannot be used to increase the section 382 limitation with respect to any RBILs. Treas. Reg. § 1.1502-93(h)(2).

E. Separate Subsidiary Rules

The section 382 regulations provide rules for determining whether a subsidiary undergoes an ownership change (and the effects thereof) on a separate corporation basis. A subsidiary can have a separately-determined ownership change if certain described conditions are met. These rules are designed to prevent perceived abuses.

Separate Subsidiary Approach

Generally, as indicated previously, the determination as to whether the members of a loss group undergo an ownership change is made on a consolidated basis. In certain instances, a subsidiary can be required to determine whether an ownership change has occurred on a separate company basis.

A subsidiary is required to determine whether an ownership change occurred under the separate subsidiary approach in one of two circumstances. The separate subsidiary approach applies generally if there is either (i) a deemed exercise of an option to acquire subsidiary stock, or (ii) there is an acquisition of stock of both the subsidiary and one or more higher tier members. Treas. Reg. § 1.1502-96(b)(1).

The separate subsidiary approach applies as a result of an option if there is a deemed exercise of an option to acquire more than 20% of the stock of the subsidiary by applying the option attribution rules. The more than 20% option must be held by a single person (or multiple persons acting pursuant to a plan or arrangement). Any option with respect to the stock of the common parent is not taken into account for this purpose. Treas. Reg. § 1.1502-96(b)(1)(i).

The separate subsidiary approach applies as a result of an acquisition of stock of both the subsidiary and one or more higher tier members, if there is an increase in ownership by one or more 5% shareholders in their percentage ownership interest in the subsidiary through the acquisition (or deemed acquisition under the option attribution rule) of ownership interests in both the subsidiary and in higher tier members (with respect to the subsidiary). This rule only applies if (i) the aggregate increase in the ownership of the subsidiary by the participants is greater than 50 percentage points, and (ii) the participants are acting pursuant to a plan or arrangement to avoid an ownership change of the subsidiary. Treas. Reg. § 1.1502-96(b)(1)(ii).

The regulations cite as an example of an acquisition of stock of both the subsidiary and higher tier members, an acquisition pursuant to a plan of 20% of the stock of a first, second, third, and fourth-tier subsidiary. The owners of the stock of the fourth-tier subsidiary and the three higher tier members would indirectly own 59% of the fourth-tier subsidiary (by attribution). Treas. Reg. § 1.1502-96(b)(4).

Where the separate subsidiary approach is applied, an ownership change is determined for the subsidiary under the general principles of section 382. Whether an ownership change occurs is determined on a separate entity basis by treating the subsidiary as not being a member of the consolidated group. Treas. Reg. § 1.1502-96(b)(1). For purposes of determining when the testing period begins, any consolidated NOL that is apportioned to the subsidiary is taken into account. Treas. Reg. §§ 1.1502-95(b)(1)(i), -96(b)(1).

A special rule applies if both a loss group and a subsidiary have an ownership change on the same day. In such case, the ownership change is considered to occur only at the loss group. Treas. Reg. § 1.1502-96(b)(3).

The regulations are silent as to the treatment of subsidiaries of a member that has an ownership change under the separate subsidiary approach. The rules that require the application of the separate subsidiary approach by their words appear to only apply to the member and not to lower tier members. However, there is a sentence in the regulations that cross-references the anti-duplication rules of section 1.1502-94. Treas. Reg. § 1.1502-96(b)(3). The cross-reference appears to have no connection with the prior sentence and may represent a drafting error that was originally intended to deal with lower tier subsidiaries.

Section 382(g)(4)(D)

The regulations are silent as to the application of section 382(g)(4)(D) with respect to the stock of a subsidiary. Outside of a consolidated group, if a 50% shareholder reports a worthless stock deduction with respect to a loss corporation's stock, section 382(g)(4)(D) creates a deemed owner shift with respect to the stock owned by the 50% shareholder at the end of the taxable year.

The most obvious circumstance in which section 382(g)(4)(D) could apply is with respect to a worthless stock deduction reported by one member of the consolidated group with respect to the stock of another member. However, issues can also arise with respect to minority shares of a subsidiary. For example, section 382(g)(4)(D) potentially could apply if a person sells 80% of the stock of a corporation to a member of a consolidated group and later reports the 20% retained as worthless.

Both the supplemental subsidiary and separate subsidiary approaches identify specific subsidiary stock transactions that require either approach to be used. Since a worthless stock deduction is not one of those stock transactions, it appears that a worthless stock deduction does not result in the application of either approach (absent the existence of other transactions).

Where either the supplemental subsidiary or separate subsidiary approaches apply because of other transactions (e.g., a subsidiary issues an option to acquire more than 20% of its stock), the normal section 382 rules apply to determine the cumulative owner shifts with respect to the subsidiary stock. In such case, section 382(g)(4)(D) appears to apply. For example, if the supplemental subsidiary approach applies, a worthless stock deduction with respect to the subsidiary stock could result in an owner shift at the common parent level if section 382(g)(4)(D) applied.

It should be noted that several consolidated return regulations have been promulgated which severely narrow the circumstances in which section 382(g)(4)(D) can apply to stock of a subsidiary that is owned by another member of the consolidated group. First, subsidiary stock generally cannot be treated as worthless under section 165 until the earlier of (i) the day substantially all of the assets of the subsidiary are abandoned, destroyed, or disposed of (other than in complete liquidation or in exchange for consideration other than relief from debt), or (ii) the subsidiary ceases to be a member of the consolidated group. Treas. Reg. § 1.1502-80(c)(1). Second, if a member of a consolidated group treats subsidiary stock as worthless under section 165 and the subsidiary (or successor) remains a member of the group on the first day of the next consolidated return year, then any losses attributable to the subsidiary expire on the beginning of the first day of the next consolidated return year. Treas. Reg. §§ 1.1502-35(f), -36(d)(7).

Subsidiary Ownership Change

Where a subsidiary undergoes an ownership change pursuant to the separate subsidiary approach, the base annual section 382 limitation is determined on a separate corporation basis. The value is determined with reference only to the value of the subsidiary's stock. Treas. Reg. § 1.1502-96(b)(2)(i).

A pre-change loss of a subsidiary includes (i) the subsidiary's allocable share of the consolidated NOL, and (ii) any NOL carryforward (and any carryforward of a disallowed RBIL) that arose in a SRLY. The allocable share of the consolidated NOL is determined on the last day of the consolidated return year that includes the change date. The consolidated NOL is also determined after taking into account NOL carry backs to prior taxable years. In addition, any RBIL of the subsidiary is considered a pre-change consolidated attribute. Treas. Reg. § 1.1502-96(b)(2)(ii).

The regulations require an adjustment to be made to the value of the stock of a subsidiary to the extent necessary to prevent "any" duplication of the value of the stock. These adjustments are required even though corporations that do not file consolidated returns may not be required to make such an adjustment. The regulations indicate the principles of the anti-duplication rules described above with respect to ownership changes of loss groups apply in determining the value of the subsidiary. Treas. Reg. §§ 1.1502-94(b)(2), - 96(b)(3).

The regulations do not prescribe rules for determining NUBIG, NUBIL, RBIG, or RBIL where an ownership change occurs pursuant to the separate subsidiary approach. Presumably, the rules with respect to separate ownership changes of new members apply. *See* Treas. Reg. § 1.1502-94(c).

F. New Members Rules

The regulations provide elaborate rules for determining whether a member that joins a consolidated group has an ownership change as a result of (or after) joining the group (and the consequences of an ownership change). The rules regarding the treatment for new members are different for members of either an NOL subgroup or NUBIL subgroup and for members that do not belong to a subgroup.

When the common parent of a consolidated group becomes a member of a new consolidated group, there is a potential overlap between the above-described rules for loss groups and the new member rules. For example, if a member of a consolidated group acquires 100% of the stock of the common parent of a different consolidated group, the members of the target group would join the acquiring group. Ordinarily, the common parent of the target group would undergo an ownership change. Many practitioners apply the loss group rules, described above, to this type of an ownership change since the ownership change occurs on the last day of the target group's final taxable year. The regulations (ignoring examples) are ambiguous as to whether the loss group rules or new member rules apply. However, the example in section 1.1502-96(a)(3)(ii) of the Treasury regulations applies the new member rules (and not the loss group rules) to two different situations in which a common parent (and subsidiaries) joins a new consolidated group and has a contemporaneous ownership change upon joining. Since the results of the new member rules differ materially from the loss group rules with respect to the determination of NUBILs, the potential application of the new member rules represents a significant trap for the unwary tax practitioner.

General Rules

If a new member has had an ownership change before it became a member of the consolidated group, any limitation under section 382 continues to apply. Treas. Reg. § 1.1502-96(c).

In a typical situation, the new member will have an ownership change as a result of the transaction that brings the member into the consolidated group. For example, if a member of an existing consolidated group purchases 100% of the stock of an unrelated corporation, the target corporation joins the consolidated group and undergoes an ownership change.

Generally, the new member joins the consolidated group at the end of the day in which the consolidated group acquires 80% control. Treas. Reg. § 1.1502-76(b)(1)(ii)(A)(1); Prop. Reg. § 1.1502-76(b)(1)(ii)(A)(1). As a result, activity on the change date is not included on the consolidated return for the group. Treas. Reg. § 1.1502-76(b)(2)(i). It appears that one consequence of this rule is that any elections with respect to the ownership change (e.g., an election under section 1.382-8 of the Treasury regulations to attribute value) are to be made on either the new member's final tax return or, if the new member was a member of a different consolidated group, the selling consolidated group's tax return. In the case of a selling consolidated group, this can cause significant problems for a consolidated group that acquires a new member with tax attributes, if the purchase agreement does not require the selling consolidated group to make the desired elections.

A different rule from the one described in the previous paragraph applies if the new member was an S corporation immediately before joining the consolidated group. In such situation, the new member joins the consolidated group at the beginning of the day in which the consolidated group acquires 80% control. Treas. Reg. § 1.1502-76(b)(1)(ii)(A)(2); Prop. Reg. § 1.1502-76(b)(1)(ii)(B)(1). As a result, the activity on the change date is reported by the consolidated group.

The consolidated return regulations provide rules for determining the amount of taxable income to be reported by the consolidated group with respect to the new member. These rules override the general section 382 rules for situations where an ownership change occurs in the middle of the taxable year. Treas. Reg. § 1.382-6(d). Generally, the new member's short taxable year is treated as a separate taxable year for all US federal income tax purposes (subject to any rule that applies to short periods). Treas. Reg. § 1.1502-76(b)(2)(i). However, elections are available in certain circumstances to allocate a full year's activity (or activity in the month that includes the change date) between the two (or more) short periods ratably based on the number of days in each period. Treas. Reg. § 1.1502-76(b)(2)(ii), (iii).

The current regulations do not describe how to apply the end of the day and next day rules (and the beginning of the day rule, with respect to S corporations) in the context of an ownership change. Conceptual problems arise in determining NUBIG and NUBIL since the day of the ownership change is included in the recognition period, even though the activity on that day would not generally be reported on the short year tax return for the acquired loss corporation.

The IRS and the Treasury Department have proposed regulations to modify the rules for allocating items between the two short years, as well as clarify how the revised rules apply in the context of an ownership change. The proposed rules would apply where a member joins a group and on the same day undergoes an ownership change. In such instance, the determination of NUBIG and NUBIL would reflect the application of the end of the day and next day rules (and the beginning of the day and proposed previous day rules, with respect to S corporations). As a result, income, gain, deductions, and losses that are properly reported on the separate short taxable year return under the end of the day rule, would not be taken into account in determining NUBIG or NUBIL, and would not be treated as RBIGs or RBILs. Prop. Reg. § 1.1502-76(b)(1)(ii)(D); REG-100400-14, 2015-12 IRB 779, 782-83. The proposed effective date of this rule is for members joining or departing a group on or after the date that final regulations are published in the Federal Register.

Subgroup Rules

The regulations provide rules for determining whether an NOL subgroup or NUBIL subgroup that joins a consolidated group has an ownership change upon joining the group (or subsequently) and the consequences of an ownership change.

In determining whether a subgroup has an ownership change, the parent change approach and the supplemental subsidiary approach generally apply. Treas. Reg. § 1.1502-92(b)(1)(ii), (c)(1). Both of these approaches are described in detail above with respect to determining whether a loss group has an ownership change. The parent change and supplemental subsidiary approaches apply to a subgroup by treating the subgroup parent as the common parent of a loss group. Treas. Reg. § 1.1502-92(b)(1)(ii), (c)(4). As a result, the subgroup will have an ownership change if the subgroup parent has an ownership change (under either approach). Treas. Reg. § 1.1502-92(b)(2) Ex. 3, 4.

In determining whether a subgroup has an ownership change, the testing period may include the period before the subgroup joined the new consolidated group. Treas. Reg. §§ 1.1502-92(b)(1)(ii), -95(b)(1)(ii). However, the testing period may not begin before the day after the most recent ownership change of the subgroup (including ownership changes with respect to the consolidated group the subgroup members previously were members of). Treas. Reg. §§ 1.1502-92(b)(1)(ii), (d), -95(b)(2)(iii).

For purposes of determining whether a subgroup has an ownership change, the day that the members of the subgroup become members of the consolidated group is treated as a testing date. Similarly, the day the members of the subgroup become members of the subgroup is treated as a testing date. Treas. Reg. § 1.1502-92(b)(1)(ii)(B).

If the subgroup parent has not been the subgroup parent for at least three years as of the testing date, adjustments must be made to the parent change and supplemental subsidiary approaches. The adjustments must be appropriate to take into account owner shifts of other members of the subgroup so that the structure does not have the effect of avoiding an ownership change. Treas. Reg. § 1.1502-92(b)(3)(ii). For example, if members of a consolidated group are transferred to a new holding corporation and the holding corporation is spun-off to shareholders of the common parent, the new subgroup parent succeeds to the owner shifts of its subsidiaries. Treas. Reg. § 1.1502-92(b)(3)(iii) Ex. 3.

Special rules apply if an election is made to waive the subgroup parent requirement for subgroup treatment. In such case, the parent change and supplemental subsidiary approaches do not apply. Treas. Reg. § 1.1502-92(b)(1)(iii)(A). (c)(1). Instead, each member of the subgroup determines whether it has an ownership change on a separate-member basis. Treas. Reg. § 1.1502-92(b)(1)(iii)(A). Any ownership change of any member of the subgroup causes an ownership change for all of the members of the subgroup. Treas. Reg. § 1.1502-92(b)(2) Ex. 5(iii). This special rule does not apply if a member of a subgroup has an ownership change upon (or after) ceasing to be a member of the current consolidated group. Treas. Reg. § 1.1502-92(b)(1)(iii)(B). As a result, a sale of all of the stock of a member of a subgroup will generally not cause an ownership change for the members of the subgroup that remain (assuming that the departing member undergoes an ownership change upon departure). Treas. Reg. § 1.1502-92(b)(2) Ex. 5(ii).

The above rules for determining ownership changes of NOL and NUBIL subgroups are mitigated by the separate tracking rules described below. The rules for determining ownership changes of subgroups generally do not apply if the new member has an ownership change within six months (before or after) of joining the group. As a result, these ownership change rules will, in many cases, apply to cause an ownership change upon the subgroup joining the consolidated group and then will cease to apply thereafter. Treas. Reg. §§ 1.1502-92(b)(4), -96(a).

If an NOL subgroup has an ownership change upon (or after) joining a consolidated group, the section 382 limitation for the subgroup is determined by applying the rules that apply to a loss group, described in detail above. Treas. Reg. § 1.1502-93. As a result, the base annual section 382 limitation for the subgroup is generally determined on a subgroup basis taking into account the equity of all of the members of the subgroup. Treas. Reg. § 1.1502-93(a), (b). In addition, COBE, NUBIG, and RBIG are generally determined on a subgroup basis. Treas. Reg. §§ 1.1502-91(g)(1), (2)(iii), -93(c), (d).

If a NUBIL subgroup has an ownership change upon (or after) joining a consolidated group, the section 382 limitation for the subgroup is determined generally by applying the rules that apply to an NOL subgroup described above. Treas. Reg. § 1.1502-93. While the rules for determining the section 382 limitation are generally the same, the application can be very different based upon differences in the composition of the NOL and NUBIL subgroups.

In many cases, the base annual section 382 limitation for an NOL subgroup can be determined based upon the value of the stock of the subgroup parent (frequently the former common parent of the old consolidated group). The calculation of the section 382 limitation for a NUBIL subgroup can be more complicated since the subgroup does not always include all of the members of the NOL subgroup since the rules for inclusion are more restrictive. The regulations require that appropriate adjustments be made to the section 382 limitation to avoid duplication of value and the effects of indirect ownership. Treas. Reg. § 1.1502-93(b)(1), (2)(ii), (3) Ex. 2.

As an example of some of the complexities of applying the rules to a NUBIL subgroup, assume that P owns 100% of S1 and S1 owns 100% of S2. If P, S1, and S2 compose an NOL subgroup, the base section 382 limitation with respect to the subgroup would be determined based upon the equity of P. If only P and S2 compose a NUBIL subgroup (because S1 has not been affiliated for five years and a subgroup parent election was made), the base annual section 382 limitation would be determined based upon the combined equity of P and S2 (after eliminating the value of P's indirect ownership of S2 through S1). In determining the amount of the NUBIL, P's UBIG or UBIL with respect to S1 stock would be taken into account, but an adjustment is necessary to prevent duplication of S2's UBIGs or UBILs. Treas. Reg. § 1.1502-91(g)(5). Removing the duplication from the amount of the base annual section 382 limitation, in this simple example, does not seem complicated. However, removing the duplication from the NUBIL computation could very well be complicated in other situations. For example, what if there is a UBIG with respect to the stock of S1 but S2 has a NUBIL in its assets?

The NUBIG or NUBIL of an NOL subgroup or NUBIL subgroup is determined based upon the rules that apply to determining the consolidated NUBIG or NUBIL of a loss group. Treas. Reg. § 1.1502-91(g); Prop. Reg. § 1.1502-91(g). As with respect to a loss group, the NUBIL of a NUBIL subgroup is generally determined by taking into account some (but not all) of the members of the subgroup. Treas. Reg. § 1.1502-91(g)(2)(iv). The makeup of the members of the NUBIL subgroup differ from the members that are taken into account for purposes of determining whether a loss group has a NUBIL. First, common parents are not included in a NUBIL subgroup unless they have been affiliated with other members for five years (and meet other requirements). Second, the five-year members must be affiliated with each other immediately after joining the new consolidated group (unless a subgroup parent election is made). Third, there is no exception to the five-year affiliation rule for members that had a NUBIG upon joining the prior group and have a NUBIL upon joining the new group.

Similar to the rules that apply with respect to loss groups, it is possible for an NOL subgroup to have a NUBIG in conjunction with a NUBIL subgroup that has a NUBIL. Treas. Reg. § 1.1502-91(g)(2)(v). As a result, any RBIG of an NOL subgroup cannot be used to offset RBILs of a NUBIL subgroup. Treas. Reg. § 1.1502-94(c)(2).

New Loss Member Rules

The regulations provide rules for determining whether a member (that is not a member of a subgroup) that joins a consolidated group (the “current group”) has an ownership change upon (or after) joining the group (and the consequences of an ownership change). A corporation that is not a member of an NOL subgroup is a new loss member if it carries over an NOL (or deferred built-in loss) that arose in a SRLY (or is a successor to such a corporation pursuant to a section 332 liquidation or acquisitive asset reorganization) to a consolidated return year of the current group. Treas. Reg. § 1.1502-94(a)(1)(i), (2). Presumably, a corporation will also be a new loss member if it carries over other attributes (e.g., capital losses, disallowed business interest expense, and credits) that arose in a SRLY.

A corporation is also a new loss member if it has a NUBIL (determined on a separate member basis) immediately before it became a member of the current group if the separate NUBIL is not taken into account in determining whether two or more members compose a NUBIL subgroup. Treas. Reg. § 1.1502-94(a)(1)(ii). A corporation will generally be taken into account in determining whether a NUBIL subgroup exists if the corporation (i) has been continuously affiliated with the other members of the subgroup for a five consecutive year period ending on the date the corporation joined the current group, and (ii) is affiliated with a subgroup parent immediately after becoming a member of the current group (unless a deemed subgroup parent election was made). Treas. Reg. §§ 1.1502-91(d)(2), (g)(2)(iv), -94(a)(1)(ii).

An ownership change of a new loss member is determined on a separate entity basis. Treas. Reg. § 1.1502-94(b)(1). For example, if the common parent increases the equity ownership of a loss corporation with no subsidiaries from 75% to 100%, the loss corporation would be a new loss member. If an ownership change did not occur on the day the loss corporation joined the group, determinations of later ownership changes would be made by examining owner shifts at the common parent level (pursuant to section 382 attribution rules) and taking into account the common parents increase from 75% to 100%. Treas. Reg. § 1.1502-94(b)(4) Ex. 1.

The above rules for determining ownership changes of new loss members are mitigated by the separate tracking rules described below. The rules for determining ownership changes of new loss members generally do not apply if the new member has an ownership within six months (before or after) of joining the group. As a result, these ownership change rules will, in many cases, apply to cause an ownership change upon the new loss member joining the consolidated group and then will cease to apply thereafter. Treas. Reg. §§ 1.1502-94(a)(4), -96(a).

Separate Tracking Rules

As described above, owner shifts with respect to a new member or members of an NOL or NUBIL subgroup are required to be determined after the member or members of a subgroup join a consolidated group. This is referred to as separate tracking of owner shifts.

An exception to separate tracking of owner shifts applies if the member or subgroup undergoes an ownership change within six months before, on, or after becoming a member of the consolidated group. Treas. Reg. § 1.1502-96(a)(1)(i). In such case, separate tracking is not required starting on the later of (i) the day after the change date, or (ii) the day the member or subgroup becomes a member of the consolidated group. Treas. Reg. § 1.1502-96(a)(2)(i)(A), (ii)(A). As a result, there is an ownership change after the end of separate tracking with respect to the tax attributes of the member or subgroup only if the consolidated group has an ownership change. Treas. Reg. § 1.1502-96(a)(2)(i)(C), (ii)(C).

A special rule applies in determining when the testing period begins for a loss group where separate tracking has ended under the six-month rule described in the previous paragraph. In such case, the NOLs or NUBILs of the member or subgroup are considered to arise in a taxable year that begins not earlier than the day following the change date or the day the member or subgroup joined the group. Treas. Reg. § 1.1502-96(a)(4)(i).

If the exception to separate tracking described above does not apply, separate tracking ends on the fifth anniversary of the date the member or subgroup joined the consolidated group. This exception only applies if the member or subgroup has not undergone an ownership change during the five-year period. Treas. Reg. § 1.1502-96(a)(1)(ii). In such case, the separate tracking is not required starting on the date of the fifth anniversary. Treas. Reg. § 1.1502-96(a)(2)(i)(A), (ii)(A).

If the member or subgroup undergoes an ownership change during the first five years after joining the group (but not in the first six months), separate tracking ends when there is a five-year period without an ownership change. Treas. Reg. § 1.1502-96(a)(1)(ii). In such case, the separate tracking is not required starting on the date of the fifth anniversary of the ownership change. Treas. Reg. § 1.1502-96(a)(2)(i)(A), (ii)(A).

A special rule applies in determining when the testing period begins for a loss group where separate tracking has ended under the five-year rule described above. In such case, the NOLs or NUBILs of the member or subgroup are considered to arise in a taxable year that begins three years before the end of the five-year period. Treas. Reg. § 1.1502-96(a)(4)(ii).

As an illustration of how the separate tracking rules apply, assume that a corporation with NOLs joins a group on January 1, 2005 as a result of an increase in ownership from 75% to 100%. If the corporation had an ownership change on the day it joined the group (or within the previous six months), separate tracking ends upon joining the group. If the corporation has an ownership change within the first six months of joining the group, separate tracking ends on the day of the ownership change. If the corporation does not have an ownership change in the first five years, separate tracking ends on the fifth anniversary of joining the group. If the corporation has an ownership change during the first five years after joining the group, separate tracking does not end until there is a five-year period without an ownership change.

A SRLY NOL of the member or NOL subgroup is treated as an NOL of the consolidated group after the end of separate tracking for purposes of determining whether the consolidated group is a loss group. Treas. Reg. § 1.1502-96(a)(2)(i)(B). If the consolidated group undergoes an ownership change, the SRLY NOL is treated as a pre-change consolidated attribute that is subject to the consolidated section 382 limitation. Treas. Reg. § 1.1502-96(a)(2)(i)(D).

A separate or subgroup NUBIL of a member or NUBIL subgroup is taken into account after the end of separate tracking in determining whether the consolidated group is a loss group. Treas. Reg. § 1.1502-96(a)(2)(ii)(B). If the consolidated group undergoes an ownership change, the separate or subgroup NUBIL is taken into account in determining the group's pre-change consolidated attributes. Treas. Reg. § 1.1502-96(a)(2)(ii)(D).

G. Departing Member Rules

The regulations provide for rules for applying section 382 on or after the date a member ceases to be a member of a consolidated group or an NOL or NUBIL subgroup.

General Rules

If a departing member of a consolidated group has had an ownership change (either before it became a member or during the period it was a member), any limitation under section 382 continues to apply. Treas. Reg. § 1.1502-96(c).

In a typical situation, the departing member will have an ownership change as a result of the transaction that causes the member to depart from the consolidated group. For example, if an unrelated corporation purchases 100% of the stock of a member of an existing consolidated group, the target corporation leaves the consolidated group and undergoes an ownership change.

Generally, the departing member leaves the consolidated group at the end of the day in which the consolidated group loses 80% control. Treas. Reg. § 1.1502-76(b)(1)(ii)(A)(1); Prop. Reg. § 1.1502-76(b)(1)(ii)(A)(1). As a result, activity on the change date is included on the consolidated return for the group. Treas. Reg. § 1.1502-76(b)(2)(i). It appears that one consequence of this rule is that any elections with respect to the ownership change (e.g., an election under section 1.382-8 of the Treasury regulations to attribute value) are to be made on the selling consolidated group's tax return.

The consolidated return regulations provide rules for determining the amount of taxable income to be reported by the consolidated group with respect to the departing loss member. These rules override the general section 382 rules for situations where an ownership change occurs in the middle of the taxable year. Treas. Reg. § 1.382-6(d). Generally, the departing member's short taxable year is treated as a separate taxable year for all federal income tax purposes (subject to any rule that applies to short periods). Treas. Reg. § 1.1502-76(b)(2)(i). However, elections are available in certain circumstances to allocate a full year's activity (or activity in the month that includes the change date) between the two (or more) short periods ratably based on the number of days in each period. Treas. Reg. § 1.1502-76(b)(2)(ii), (iii).

The current regulations do not describe how to apply the end of the day and next day rules (and the beginning of the day rule, with respect to S corporations) in the context of an ownership change. Conceptual problems arise in determining NUBIG and NUBIL since the day of the ownership change is included in the recognition period, even though the activity on that day would not generally be reported on the consolidated tax return for the group.

The IRS and the Treasury Department have proposed regulations to modify the rules for allocating items between the two short years, as well as clarify how the revised rules apply in the context of an ownership change. The proposed rules would apply where a member departs a group and on the same day undergoes an ownership change. In such instance, the determination of NUBIG and NUBIL would reflect the application of the end of the day and next day rules (and the beginning of the day and proposed previous day rules, with respect to S corporations). As a result, income, gain, deductions, and losses that are properly reported on the consolidated group return under the end of the day rule, would not be taken into account in determining NUBIG or NUBIL, and would not be treated as RBIGs or RBILs. Prop. Reg. § 1.1502-76(b)(1)(ii)(D); REG-100400-14, 2015-12 IRB 779, 782-83. The proposed effective date of this rule is for members joining or departing a group on or after the date that final regulations are published in the Federal Register.

Group Departure Rules

The regulations provide rules for determining whether a member that departs from a consolidated group (the "former group") has an ownership change after departing from the group (and how section 382 applies to the ownership change).

An ownership change of a departing member is determined on a separate entity basis after it ceases to be member of a consolidated group. Treas. Reg. § 1.1502-95(b)(1). For example, if the common parent decreases the equity ownership of a subsidiary from 100% to 75%, the subsidiary would be a departing member. If an ownership change did not occur on the day the subsidiary left the group, determinations of later ownership changes would be made by examining owner shifts at the common parent level (pursuant to section 382 attribution rules) and taking into account the common parents decrease from 100% to 75%. Treas. Reg. § 1.1502-95(b)(4)(i) Ex. 1.

For purposes of determining whether a departing member has an ownership change, the day the member departs from the former group is treated as a testing date. Treas. Reg. § 1.1502-95(b)(1)(iii).

The testing period can include the period during which (or before) the member was included in the former group. Treas. Reg. § 1.1502-95(b)(1)(ii). In determining when the testing period begins, a consolidated NOL that is apportioned to the member is taken into account. Treas. Reg. § 1.1502-95(b)(1)(i). However, the testing period cannot begin any earlier than the former group's most recent ownership change. Treas. Reg. § 1.1502-95(b)(2)(iii).

If the departing member has an ownership change on or after the date it departs from the former group, the section 382 limitation rules are generally applied on a separate entity basis. Treas. Reg. § 1.1502-95(b)(1), (4) Ex. 2. If the member was subject to one or more prior ownership changes (either separately or as a member of the former group), the new limitation may result in a reduced limitation amount. Treas. Reg. § 1.1502-95(b)(2)(iv).

If two or more members of an NOL or NUBIL subgroup depart from a consolidated group, special rules apply if the members are members of the same subgroup immediately after the departure from the former group. In such case, the determination as to whether an ownership change occurs after the departure from the group is made on a subgroup basis. Additionally, the amount of any section 382 limitation is determined on a subgroup basis. Treas. Reg. § 1.1502-95(b)(3).

Subgroup Departure Rules

The regulations provide rules for determining whether a member that departs from an NOL or NUBIL subgroup (the "former subgroup") has an ownership change after departing from the subgroup (and how section 382 applies to the ownership change). A corporation generally ceases to be a member of an NOL or NUBIL subgroup on the first day for which it files a separate return. Treas. Reg. § 1.1502-95(d)(1)(i), (3) Ex. 1, 2.

A corporation also ceases to be a member of an NOL or NUBIL subgroup on the first day that the subgroup parent requirement ceases to be met with respect to the member. Treas. Reg. § 1.1502-95(d)(1)(ii). This rule will generally apply when the structure of a consolidated group changes so that the member is no longer affiliated with the subgroup parent. Treas. Reg. § 1.1502-95(d)(3) Ex. 4. However, this rule will rarely apply due to generous exceptions. First, a corporation does not lose its status as a member of a subgroup if it remains a member of the current consolidated group and an election to deem the subgroup requirement as being met had been made. Treas. Reg. § 1.1502-95(d)(2)(i). Second, a corporation does not lose its status as a member of a subgroup if it remains a member of the current consolidated group and the separate tracking rules no longer applies at the time. Treas. Reg. § 1.1502-95(d)(2)(ii), (iii). For example, if a subgroup has an ownership change within six months before, on, after joining the consolidated group, the members of the subgroup can be safely moved within the consolidated group without terminating membership in the subgroup. Treas. Reg. § 1.1502-95(d)(2)(ii), (3) Ex. 3. Similarly, the members of the subgroup can be safely moved within the consolidated group without terminating membership in the

subgroup after a five-year period has elapsed without an ownership change. Treas. Reg. § 1.1502-95(d)(2)(iii), (3) Ex. 4.

An ownership change of a departing member is determined on a separate entity basis after it ceases to be a member of a subgroup. Treas. Reg. § 1.1502-95(b)(1). The testing period can include the period during which (or before) the member was included in the former subgroup. Treas. Reg. § 1.1502-95(b)(1)(ii). In determining when the testing period begins, a consolidated NOL that is apportioned to the member is taken into account. Treas. Reg. § 1.1502-95(b)(1)(i). However, the testing period cannot begin any earlier than the former subgroup's most recent ownership change. Treas. Reg. § 1.1502-95(b)(2)(iii).

If the departing member has an ownership change on or after the date it departs from the former subgroup, the section 382 limitation rules are generally applied on a separate entity basis. Treas. Reg. § 1.1502-95(b)(1), (4) Ex. 2. If the member was subject to one or more prior ownership changes (either separately or as a member of the former subgroup), the new limitation may result in a reduced limitation amount. Treas. Reg. § 1.1502-95(b)(2)(iv).

Prior Consolidated Ownership Change

The regulations provide rules with respect to a member's departure from a consolidated group after the group has had an ownership change. These rules also apply to a member's departure from an NOL or NUBIL subgroup after the subgroup has had an ownership change. Treas. Reg. § 1.1502-95(a)(1).

When a member departs from a consolidated group, the member is apportioned its share of any consolidated NOL carryforwards. The apportioned loss can be carried to subsequent taxable years of the member. Treas. Reg. § 1.1502-21(b)(2)(i). The amount of the consolidated NOL that is apportioned to a member equals the total consolidated NOL for the taxable year multiplied by the ratio of the separate NOL for the member over the sum of the separate NOLs of all of the members having losses. The consolidated NOLs are apportioned separately for each taxable year. Treas. Reg. § 1.1502-21(b)(2)(iv). (Similar rules apply for capital losses and tax credits that are subject to limitation under section 383. Treas. Reg. §§ 1.1502-22(b)(3) (capital losses), -79(c) (investment tax credit), (d) (foreign tax credit); Prop. Reg. § 1.1502-55(h)(6) (minimum tax credit).)

The apportionment rule for disallowed business interest expense is different than for other tax attributes. Business interest expense (unlike other attributes limited by sections 382 and 383) is not a consolidated tax attribute. Instead, each member deducts its own business interest expense (based on the consolidated section 163(j) limitation) and carries forward the disallowed portion to future taxable years (including taxable years that end after the member departed from the group). Treas. Reg. § 1.163(j)-5(b)(3)(iii).

If a member departs from a consolidated group and does not have a subsequent taxable year (e.g., the member terminated its existence in a taxable dissolution), the NOLs, capital losses, disallowed business interest deductions, credits, and deferred deductions attributable to the member generally expire at the end of the taxable year. Treas. Reg. §§ 1.1502-19(b)(1)(iv), -36(d)(7).

A former member is also allocated its share of any remaining consolidated NUBIL balance. This is the consolidated NUBIL reduced by RBILs previously taken into account. Treas. Reg. § 1.1502-95(e)(1). The rules for allocating the remaining consolidated NUBIL balance are described in more detail below.

When a member departs from an NOL or NUBIL subgroup but remains a member of the consolidated group, there are generally no rules that require or permit an allocation of consolidated or subgroup NOLs.

If a departing member is apportioned a share of a consolidated NOL (or a remaining consolidated NUBIL balance) that is subject to a consolidated section 382 limitation, the apportioned NOL or NUBIL continues to be subject to limitation. Treas. Reg. § 1.1502-95(b)(2)(i). The section 382 limitation with respect to the departing member (absent an election to apportion) is zero. Treas. Reg. § 1.1502-95(b)(2)(ii).

Generally, when a member of a loss group departs from the group after an ownership change, the group retains the entire section 382 limitation. Treas. Reg. § 1.1502-95(c)(7) Ex. 2. The common parent can elect to apportion all (or part) of the limitation to the departing member. Treas. Reg. § 1.1502-95(c)(1).

If two or more former members are included in the same NOL or NUBIL subgroup after their departure from the consolidated group, any apportionment by the common parent is made to the new subgroup (and not to the individual members). If the common parent allocates amounts to individual members, the aggregate amounts apportioned to the members are treated as apportioned to the subgroup. Treas. Reg. § 1.1502-95(b)(3), (e)(6)(ii).

If two or more former members are not included in the same NOL or NUBIL subgroup after their departure from the consolidated group (but are members of the same consolidated group), an apportionment can be made to the members as if they were an NOL or NUBIL subgroup. Treas. Reg. § 1.1502-95(e)(6)(ii). This rule is generally relevant where the former members do not have an NOL or a NUBIL but are allocated a portion of a group's (or subgroup's) remaining NUBIL balance.

Generally, when a member of an NOL or NUBIL subgroup departs from the subgroup after an ownership change, the subgroup retains the entire section 382 limitation. The common parent can elect to apportion all (or part) of the limitation to the departing member. Treas. Reg. § 1.1502-95(c)(1). It should be noted that the election to apportion is made by the common parent and not the subgroup parent. Treas. Reg. § 1.1502-95(a)(2).

The regulations are very generous as to how the common parent can allocate the section 382 limitation. The common parent can allocate some or all of the specified individual elements. The elements are (i) value, (ii) adjustments, and (iii) NUBIG. Treas. Reg. § 1.1502-95(c)(2). Appropriate adjustments are necessary in the taxable year in which the member leaves the group to reflect the inclusion of the member for a part of a taxable year. Treas. Reg. § 1.1502-95(c)(6).

The value element is the value of the stock of the group or subgroup (before the ownership change and as adjusted for equity infusions, corporate contractions, etc.). Treas. Reg. § 1.1502-95(c)(2)(i)(A). The loss group reduces the value element retained on the departure date by the amount allocated to the former member or members. Treas. Reg. § 1.1502-95(c)(3)(i). Appropriate adjustments are made to the value element after the departure for short taxable years, etc. Treas. Reg. § 1.1502-95(c)(4)(i), (7) Ex. 1.

The adjustment element is the unused carryforward of section 382 limitation (including unused adjustments for RBIGs). Treas. Reg. § 1.1502-95(c)(2)(i)(B). The loss group reduces the adjustment element retained on the departure date by the amount allocated to the former member or members. Treas. Reg. § 1.1502-95(c)(3)(i), (4)(i), (7) Ex. 3.

The NUBIG element is the loss group's remaining consolidated NUBIG balance (i.e., consolidated NUBIG less RBIGs previously taken into account during the recognition period). Treas. Reg. § 1.1502-95(c)(2)(ii). The loss group reduces the NUBIG element retained on the departure date by the amount allocated to the former member or members. Treas. Reg. § 1.1502-95(c)(3)(ii), (4)(ii).

If a loss group terminates, the unapportioned elements are apportioned to the NOL or NUBIL subgroup that includes the common parent. If there is no such subgroup, the elements are apportioned to the common parent. Treas. Reg. § 1.1502-95(c)(5).

An election to allocate some or all of an element of a section 382 limitation to a former member must be made by the common parent by attaching the appropriate statement to the tax return for the taxable year in which the former member leaves the group. Treas. Reg. § 1.1502-95(f)(3)(i). The former member must attach an identical statement on the return for the first taxable year after leaving the group. Treas. Reg. § 1.1502-95(f)(3)(ii). A valid election can only be revoked with the permission of the IRS. Treas. Reg. § 1.1502-95(f)(4). A description of the election statement and the necessary signatures can be found in section 1.1502-95(f) of the Treasury regulations.

NUBIL Allocation Rules

As previously stated, a former member is allocated its share of any remaining consolidated (or subgroup) NUBIL balance. After the allocation, the remaining consolidated (or subgroup) NUBIL balance is reduced by the amount that is allocated to the former member. The reduction first applies to the first taxable year beginning after the consolidated return year in which the former member departed from the group or subgroup. Treas. Reg. § 1.1502-95(e)(3), (7) Ex. 1(vi). These rules also appear to apply in the situation where the departing member does not have a subsequent taxable year (i.e., the member's existence terminated in a taxable dissolution).

For purposes of applying the NUBIL rules to the former member in taxable years beginning after the member left the group or subgroup, the amount allocated is treated as the member's NUBIL. The threshold requirement is not applied to the amount allocated. In addition, the recognition period begins on the change date. Treas. Reg. § 1.1502-95(e)(4).

The amount of the remaining NUBIL balance allocated to the former member equals the remaining consolidated (or subgroup) NUBIL balance multiplied by a fraction. Treas. Reg. § 1.1502-95(e)(2)(i). The remaining consolidated (or subgroup) NUBIL balance is computed immediately after the close of the consolidated return year in which the former member leaves the group (or subgroup). Treas. Reg. § 1.1502-95(e)(1)(ii).

The numerator of the fraction equals the member's remaining UBIL balance. The remaining UBIL balance equals the member's UBILs in assets held by the former member immediately after departing from the group (or subgroup). For this purpose, an asset is only taken into account in determining the remaining UBIL balance if it was taken into account in computing the consolidated (or subgroup) NUBIL. Treas. Reg. § 1.1502-95(e)(2)(i).

The denominator of the fraction equals the sum of the former member's and the loss group's (or NUBIL subgroup's) remaining UBIL balance. The loss group's (or NUBIL subgroup's) remaining UBIL balance equals the UBILs in assets held by the group (or subgroup) immediately after the close of the taxable year in which the former member departed from the group (or subgroup). For this purpose, an asset is only taken into account in determining the remaining UBIL balance if it was taken into account in computing the consolidated or subgroup NUBIL. Treas. Reg. § 1.1502-95(e)(2)(i).

Anyone preparing this calculation should note the difference in the dates for computing the former member's and loss group's (or NUBIL subgroup's) remaining UBIL balance. The former member's balance is computed immediately after departing from the group. The loss group's (or NUBIL subgroup's) is computed after the end of the taxable year in which the former member left the group (or subgroup).

In determining the amount of the remaining UBIL balance, fluctuations in value between the change date and the determination date are not taken into account. Treas. Reg. § 1.1502-95(e)(2)(i), (7) Ex. 1(iv). For example, if land held by a former member had a UBIL of \$10 million on the change date, the remaining UBIL balance would be \$10 million. This conclusion would not change if the value of the land increased to put it in a gain position by the time the former member departed from the group. While fluctuations in value are ignored, changes in basis are not. As a result, it appears the remaining UBIL balance takes into account changes in basis due to depreciation and capital improvements.

If built-in deduction items are taken into account in computing consolidated (or subgroup) NUBIL, the amounts taken into account are treated as if they were assets in determining the numerator and denominator. Treas. Reg. § 1.1502-95(e)(2)(i). It would appear that amounts taken into account as deductible liabilities where either the section 338 or 1374 approaches are applied would be treated as assets under this rule.

For purposes of both the numerator and the denominator, assets held by a member, group, or subgroup include transferred basis property that was held by any member of the loss group (or NUBIL subgroup) on the change date. Treas. Reg. § 1.1502-95(e)(2)(ii)(A). A similar rule applies to exchanged basis property whose basis is determined with respect to an asset (other than stock of a member) that was held by the member, group, or subgroup on the change date. Treas. Reg. §§ 1.1502-91(h)(4), -95(e)(2)(iv).

For purposes of both the numerator and the denominator, deferred gain or loss under the intercompany transaction regulations (to the extent not previously taken into account) is to be considered. Treas. Reg. § 1.1502-95(e)(2)(ii)(B). There is a great deal of uncertainty as to how to apply this rule.

For purposes of both the numerator and the denominator, assets held by a member, group, or subgroup do not include assets for which gain or loss has previously been recognized (and taken into account) during the recognition period. This exclusion also applies to assets for which the gain or loss was deferred under the intercompany transaction regulations if the gain or loss is taken into account immediately before the former member departs from the consolidated group. If the gain or loss on an asset was only partially recognized and taken into account, appropriate adjustments are needed to determine the amount of the remaining UBIL balance with respect to the asset. Treas. Reg. § 1.1502-95(e)(2)(iii).

The NUBIL allocation rules contain an anti-abuse provision. This provision potentially applies if (i) assets are transferred between members, or (ii) a member departs from the group or subgroup. For the anti-abuse provision to apply the transfer or departure must have been for a principal purpose of “causing or affecting” the allocation of amounts under the NUBIL allocation rule. If the anti-abuse provision applies, appropriate adjustments are made to eliminate any benefit of the transaction. Treas. Reg. § 1.1502-95(e)(2)(vi).

Special rules apply if two or more members depart from a loss group (or NUBIL subgroup) during the same consolidated return year. In such case, the allocation calculation is generally prepared separately for each former member. The numerator includes only a single former member. The denominator takes into account the assets held by the other former members immediately after they depart from the group or subgroup. Treas. Reg. § 1.1502-95(e)(2)(v), (7) Ex. 2. It should be noted that the denominator with respect to members (other than former members) takes into account assets held after the end of the taxable year.

The NUBIL allocation rules are not applied separately to two or more former members to the extent that they are members of the same consolidated group (the “second group”) immediately after they depart from the existing group. In such case, the NUBIL allocation rules are applied to the former members on an aggregate basis (i.e., a subgroup basis). If one of the former members that is aggregated subsequently departs from the second group, the NUBIL allocation rules are applied to allocate any remaining NUBIL balance that was allocated from the existing group. Treas. Reg. § 1.1502-95(e)(5).

Since the amount of the remaining NUBIL balance that is allocated to a former member is based on the consolidated or subgroup NUBIL, the amount allocated can exceed the separate NUBIL for the member. In addition, a former member that had a separate NUBIG can be allocated an amount of the remaining NUBIL balance. Treas. Reg. § 1.1502-95(e)(2).

If the NUBIL allocation rules apply, the common parent must attach a statement describing the allocation to the tax return for the consolidated return year in which the former member leaves the group (or subgroup). The common parent is required to represent that it has delivered a copy of the statement to the former member before filing the return. Treas. Reg. § 1.1502-95(e)(8)(i). The former member must attach a similar statement on the return for the first taxable year after leaving the group. The former member is required to represent that it has received (and will retain as part of its records) a copy of the statement from the common parent. Treas. Reg. § 1.1502-95(e)(8)(ii). A description of the required statements can be found in section 1.1502-95(e)(8) of the Treasury regulations. If the common parent elects to allocate some or all of the elements of a section 382 limitation to the former member, the common parent can choose to attach information relating to the NUBIL allocation to the election statement in lieu of attaching a separate NUBIL allocation statement. Treas. Reg. § 1.1502-95(e)(8)(iii).

Allocation of RBILs

There are currently no specific rules regarding whether and how an RBIL carryforward is to be allocated to a departing member. It is possible that no specific rule was drafted because the authors of the regulations thought the rule was already covered.

RBILs are carried forward under rules that are similar to the rules for carrying forward NOLs and capital losses, as the case may be. IRC § 382(h)(4)(A). There are existing rules that require an allocation of NOL and capital loss carryforwards to departing members. Treas. Reg. § 1.1502-21(b)(2) (NOLs), -22(b)(3) (capital losses). It is possible that these apportionment rules could be considered carryforward rules since they apply to determine which attributes are carried forward to the consolidated group and the departing member.

If a member departs from a consolidated group and does not have a subsequent taxable year (e.g., the member terminated its existence in a taxable dissolution), the NOLs, capital losses, credits, and deferred deductions attributable to the member generally expire at the end of the taxable year. Treas. Reg. §§ 1.1502-19(b)(1)(iv), -36(d)(7); *see also* Treas. Reg. § 1.1502-35(f) (more limited provision applicable to transactions on or after March 10, 2006). It appears that these provisions apply to RBIL carryforwards. The definition of “deferred deduction” is very broad and includes a member’s share of consolidated tax attributes (such as consolidated charitable contribution carryforwards and disallowed business interest expense under section 163(j)). Treas. Reg. § 1.1502-36(f)(2).

H. Bankruptcy Rules

The IRS has not issued any guidance as to how paragraphs (l)(5) and (l)(6) of section 382 apply to a consolidated group. Treas. Reg. § 1.1502-97 [Reserved]. In addition, until the last few years, no case or ruling has been found on point. Some taxpayers have applied the provisions by using a consolidated approach and others have applied them by using a separate company approach.

United Dominion Indus. v. United States, 532 US 822 (2001), involved a similar consolidated versus separate approach issue. The case involved the application of the ten-year NOL carryback rules. There were outstanding consolidated return regulations that required NOL carrybacks to be determined generally on a consolidated basis. However, the regulations with respect to the ten-year carryback provisions had not been

issued. The IRS argued that the amount eligible for ten-year carryback should be determined on a separate company basis. The Supreme Court held that the amount should be determined on a consolidated basis.

There is a parallel between the situation in *United Dominion* and the treatment of bankrupt loss corporation. As in *United Dominion*, there are comprehensive consolidated regulations generally requiring consolidated treatment (e.g., section 382 herein and section 172 in the instant case). However, no guidance had been issued for the specific provision in question. While not definitive, it appears that the Supreme Court's analysis in *United Dominion* lends some support to applying paragraphs (l)(5) and (l)(6) on a consolidated basis.

In Private Letter Ruling 201051019 (Sept. 14, 2010), the IRS ruled on the application of the bankruptcy rules of section 382 where the common parent was the only member of the consolidated group to have filed for bankruptcy (other than an LLC that was a disregarded entity that was owned by a subsidiary member). The IRS ruled that paragraphs (l)(5) and (l)(6) of section 382, whichever alternative applied, was to be applied on a consolidated basis. *Id.*; see PLR 201435003 (May 21, 2014) (same where substantially all of the members were in bankruptcy); PLR 201306003 (Oct. 25, 2012) (section 382(l)(5) and section 1.269-3(d) of the Treasury regulations applied on a consolidated basis).

Section 382(l)(5)

A key issue for many taxpayers in bankruptcy is how to determine which members of a consolidated group qualify for the benefits of section 382(l)(5). Many taxpayers take the position that where the parent change method applies, all of the members of the group qualify for section 382(l)(5) if the common parent is in bankruptcy and meets requirements on a separate company basis. In many cases, taxpayers take this position even if some members are not in bankruptcy. The IRS permitted the taxpayer to take this position in Private Letter Rulings 201051019 and 201435003.

It is possible that qualification for the benefits of section 382(l)(5) is determined on a separate company basis. In many cases, each of the bankrupt subsidiaries will independently meet the qualification requirements since a pre-change shareholder (i.e., a member of the consolidated group) will own at least 50% of the stock of the subsidiary after the ownership change. See IRC § 382(l)(5)(A)(ii); Treas. Reg. § 1.382-9(b)(2). A separate approach would necessarily result in exclusion from section 382(l)(5) for members that are not in bankruptcy.

For members that do not qualify for section 382(l)(5) under a separate company approach (because they were not in bankruptcy), it would appear that the section 382 limitation rules could be applied either on a subgroup basis or on a separate basis. In many cases, the subsidiaries will not have followed the common parent into bankruptcy because they were solvent and/or profitable. As a result, applying section 382 to the non-bankrupt subsidiaries could result in a reasonably high limit due to positive stock value and/or a NUBIG. If section 382 applies to the non-bankrupt subsidiaries on a separate company basis, it appears that the value of the stock of the various subsidiaries cannot be counted more than once for base annual section 382 limitation purposes pursuant to the principles of section 1.382-8 of the Treasury regulations.

There is some uncertainty as to how to apply the section 382(l)(5) interest haircut rule in the consolidated context. It may be possible to apply the interest haircut rule on a consolidated basis. Alternatively, a separate company approach could also be applied by analogy to the consolidated COD income regulations. See Treas. Reg. § 1.1502-28.

Section 382(l)(6)

The issues under section 382(l)(6) in the consolidated context are similar to those under section 382(l)(5). However, there seems to more comfort that section 382(l)(6) can be applied on a consolidated basis than there is for section 382(l)(5). Section 382(l)(6) only adjusts the amount of the base annual section 382 limitation and does not provide an exemption from section 382. Applying section 382(l)(6) to non-bankrupt subsidiaries is simpler than trying to use one base limitation for the bankrupt members and a different one for the non-bankrupt members.

In Private Letter Ruling 201051019, the IRS permitted the taxpayer to apply section 382(l)(6) on a consolidated basis if the consolidated group elected to apply section 382(l)(6). In the ruling, the taxpayer was permitted to take into account increases in value of the common parent's stock (which was the only member in bankruptcy) resulting from the surrender or cancellation of creditor claims against the parent in the bankruptcy case. The ruling instructed the taxpayer to apply the rules of section 1.382-9 of the Treasury regulations in determining the base annual section 382 limitation. PLR 201051019; *see also* PLR 201435003 (stock of subsidiary members taken into account unless the stock is owned by another member).

Where section 382(l)(6) is applied on a consolidated basis, there is uncertainty as to how to determine the fair market value of the pre-change gross assets. It is possible that only the gross assets of the common parent corporation are taken into account. Under this scenario, the stock of first tier subsidiary corporations would be included in the parent's gross assets. Alternatively, the gross assets would be determined on a consolidated basis (and intercompany stock and debt would not be taken into account).

Various IRS personnel have stated in public forums that they believe that pre-change gross assets are determined on a consolidated basis if all of the members are in bankruptcy. However, if one or more subsidiaries are not in bankruptcy, then (depending upon the facts and circumstances) determining the gross assets on the basis of the holdings of only the common parent (or only the members in bankruptcy) may be more appropriate. This approach was applied by the IRS in Private Letter Ruling 201435003.

I. Consolidated Rules – Other Tax Attributes

Section 1.1502-98 of the Treasury regulations contain consolidated rules that coordinate sections 163(j) and 383 with section 382.

Section 163(j)

The consolidated rules that coordinate section 163(j) with section 383 are relatively brief and generally instruct taxpayers to apply the consolidated section 382 regulations with respect to disallowed business interest expense carryforwards. As a result, a reference to an NOL carryforward in the main body of the consolidated section 382 regulations is treated as a reference to a disallowed business interest expense carryforward. References in the main body of the regulations to “loss” or “losses” include references to disallowed business interest expense carryforwards or section 382 disallowed business interest carryforwards, as appropriate. Treas. Reg. § 1.1502-98(b)(1).

The regulations state that in applying the main body of the consolidated section 382 regulations to current-year business interest expense, disallowed business interest expense carryforward, and section 382 disallowed business interest carryforwards, appropriate adjustments are required. Treas. Reg. § 1.1502-98(b)(2). However, the regulations do not provide examples as to the types of adjustments that should be made or the circumstances in which they apply.

The applicability date of the rules that coordinate section 163(j) with the consolidated section 382 regulations depend on which underlying section 382 regulation are being effectuated. If sections 1.382-2 (ownership change determinations) or 1.382-5 (section 382 limitation) are being effectuated, then these regulations apply to ownership changes that occur on or after November 13, 2020. If sections 1.382-6 (allocation between periods) or 1.383-1 (ordering rules) are being effectuated, then these regulations apply to ownership changes that occur during a taxable year beginning on or after November 13, 2020. In either case, a taxpayer can choose (or can be required) to apply these rules to earlier ownership changes if the taxpayer (and all related parties) consistently applies the section 163(j) regulations to earlier periods in their entirety. Treas. Reg. § 1.1502-98(d).

Section 383

The consolidated section 383 regulation is a single paragraph long and generally instructs taxpayers to apply the consolidated section 382 regulations to section 383 situations. For most situations, the lack of detailed section 383 rules will not cause a hardship.

The consolidated section 383 rules states that the consolidated section 382 rules also apply for purposes of section 383. Appropriate adjustments to the section 382 rules are to be made to reflect that section 383 applies to capital losses and credits. Treas. Reg. § 1.1502-98(a). The regulation also gives illustrations of those appropriate adjustments.

The rules for determining the members of an NOL subgroup are described above. The principles of these rules apply for purposes of pre-change capital losses and pre-change credits. Treas. Reg. § 1.1502-98(a). Since the only attribute requirement to form an NOL subgroup is that at least one member has an NOL carryforward, Treas. Reg. § 1.1502-91(d)(1)(iii), the members of any section 383 subgroup will generally be the same as the members of any NOL subgroup.

If a loss group has an ownership change, the regulations state that the section 383 credit limitation is computed on a consolidated basis (i.e., the consolidated section 383 credit limitation). Treas. Reg. § 1.1502-98(a).

J. Unified Loss Rules

In 2008, the IRS and the Treasury Department issued unified loss rules regarding losses with respect to the sale or disposition of stock of a member of a consolidated group. These regulations provide rules relating to adjustments to subsidiary stock basis and tax attributes when a member transfers a loss share of subsidiary stock. A loss share is a share of stock with a basis that exceeds its value. Treas. Reg. § 1.1502-36(f)(7).

The duplicated loss portion of the unified loss rules prevent both the consolidated group and a subsidiary from benefiting from the same economic loss. In general, if a transferred share is a loss share (after taking into account all other rules), the subsidiary is generally required to reduce the amount of its tax attributes immediately before the transfer. As a result, unless an election is made, the consolidated group retains the ability to deduct the loss on the stock and the subsidiary generally loses an amount of tax attributes equal to the loss.

The amount of attribute reduction is limited to the “attribute reduction amount.” Treas. Reg. § 1.1502-36(d)(2)(i). The attribute reduction amount is the lesser of (i) the net stock loss (i.e., the excess of the basis over value of all of shares transferred by members in the transaction), or (ii) the aggregate inside loss. Treas. Reg. § 1.1502-36(d)(3)(i), (ii). Generally, the aggregate inside loss equals the excess, if any, of (i) the sum of NOL carryforwards, capital loss carryforwards, deferred deductions, cash, and basis in assets, over (ii)

the sum of the amount of liabilities and the value of the subsidiaries' outstanding shares of stock. Treas. Reg. § 1.1502-36(c)(5), (d)(3)(iii). The above formula generally results in the aggregate inside loss equaling the sum of the amount of any NUBIL and any loss carryforward (reduced by any NUBIG). Special rules apply in determining the net inside attribute amount and the attribute reduction amount where the subsidiary holds shares of stock of another subsidiary. *See* Treas. Reg. § 1.1502-36(d)(5).

Under the duplicated loss rules, the subsidiary is generally required to reduce the amount of its tax attributes immediately before the transfer by the attribute reduction amount. The attributes available for reduction are (i) capital loss carryforwards, (ii) NOL carryforwards, (iii) deferred deductions, and (iv) basis of assets (other than cash and similar assets). Treas. Reg. § 1.1502-36(d)(4)(i). To the extent the attribute reduction amount exceeds all of the available attributes, the excess is suspended and taken into account as certain liabilities are taken into account for tax purposes. Treas. Reg. § 1.1502-36(d)(4)(ii)(C)(1).

The common parent may reduce the potential for loss duplication (and attribute reduction) by electing to (i) reattribute to itself some or all of the tax attributes (other than basis of assets) of the subsidiary, (ii) reduce some or all of the basis in the transferred loss shares of the subsidiary, or (iii) any combination thereof. The amount elected is limited to the attribute reduction amount (computed without regard to the election). Treas. Reg. § 1.1502-36(d)(6)(i). An election to reattribute the tax attributes of the subsidiary can only be made if the subsidiary becomes a nonmember of the consolidated group and does not become a member of a consolidated group that includes the common parent. Treas. Reg. § 1.1502-36(d)(6)(iv)(A). Further limitations apply if the subsidiary (or higher tier subsidiary) is insolvent and to prevent circular computations. *See* Treas. Reg. § 1.1502-36(d)(6)(iv)(B), (C). An election to reattribute the attributes of a subsidiary is made by the common parent and is irrevocable. Treas. Reg. § 1.1502-36(e)(5).

All of the above discussion is introductory to the discussion of the application of section 382. Where a reattribution election is made, special rules apply in determining the proper application of section 382.

If an election is made to reattribute the tax attributes of a subsidiary to the common parent, the common parent is treated as if it succeeds to the losses pursuant to section 381(a). Treas. Reg. § 1.1502-36(d)(6)(iv)(A). For purposes of applying the consolidated section 382 regulations, the common parent is treated as a successor entity with respect to the subsidiary. As a result, if the reattributed losses were subject to section 382 (before reattribution) they remain subject to limitation in the hands of the common parent. Treas. Reg. § 1.1502-96(d)(2).

Special rules apply in determining which owner shifts are taken into account for ownership change purposes with respect to the reattributed losses. In general, any owner shift with respect to the disposed of subsidiary is ignored if the shift is in connection with the disposition of the stock. Owner shifts that are ignored include deemed owner shifts pursuant to section 382(g)(4)(D) (worthless stock deduction) and section 382(l)(3) (e.g., an owner shift at a higher tier level). If the owner shift is ignored, it is not taken into account in determining whether there is an ownership change with respect to the reattributed losses. Treas. Reg. §§ 1.1502-36(d)(6)(iv)(A), -96(d)(3)(i). Conversely, the owner shift with respect to the disposition of the stock of the subsidiary is taken into account with respect to the tax attributes that are not reattributed. For example, if 100% of the stock of a subsidiary is sold to an unrelated third party and an election is made to reattribute \$10 of \$100 NOL, the owner shift with respect to the subsidiary stock is not taken into account for purposes of determining whether there is an ownership change with respect to the reattributed \$10 NOL. But the subsidiary would have an ownership change with regard to the retained \$90 NOL. Treas. Reg. § 1.1502-96(d)(3)(ii) Ex. 1.

Owner shifts with respect to the subsidiary that take place before (and not in connection with) the disposition of the subsidiary are taken into account. For example, if the common parent owns 60% of a

subsidiary, later acquires the remaining 40% of the stock, and then sells the entire 100%, the 40% increase by the shareholders of the common parent is treated as an owner shift that is taken into account with respect to any reattributed losses. Treas. Reg. § 1.1502-96(d)(3)(ii) Ex. 1.

Owner shifts with respect to subsidiary stock not held by members of the group that take place in connection with the disposition of the subsidiary are taken into account. Treas. Reg. § 1.1502-36(d)(3)(i). For example, if the common parent owns 60% of a subsidiary, later acquires an additional 30% of the stock, and then sells the 90% owned, the 10% increase by the shareholders of the common parent represented by the holdings of the minority is treated as an owner shift that is taken into account with respect to any reattributed losses. In such case, the cumulative owner shift would be 40% (30% caused by the direct purchase of stock by the common parent and 10% caused by the common parent becoming a successor of the subsidiary.) Treas. Reg. § 1.1502-96(d)(3)(ii) Ex. 2.

If an ownership change occurs with respect to a reattributed tax attribute at the time of, or after, the reattribution event (i.e., the disposition of the subsidiary), the base annual section 382 limitation is generally determined based upon the value of the stock of the common parent (and not the disposed of subsidiary). Treas. Reg. § 1.1502-96(d)(4)(iii). However, appropriate adjustments to stock value must be made to avoid an improper omission or duplication of value as a result of the reattribution of subsidiary tax attributes. For example, if both the subsidiary and common parent have an ownership change upon the departure of the subsidiary from the consolidated group, an adjustment must be made so that the value of the subsidiary's stock is not duplicated (i.e., the value cannot be counted for base annual section limit purposes with respect to both the tax attributes retained by the subsidiary and the reattributed tax attributes). Treas. Reg. § 1.1502-96(d)(4)(iv).

If an ownership change occurs with respect to a pre-change separate attribute of a departing subsidiary at the time of, or after, the reattribution event, then then the deemed section 381(a) transaction is treated as a capital contribution to the departing subsidiary for section 382 purposes. As a result, it is possible that the value of the stock of the common parent for base section 382 limitation purposes may need to be adjusted downward for the effects of the deemed capital contribution (if the transaction was part of a plan a principal purpose of which was to avoid or increase any section 382 limitation). If an adjustment to value is required, the value is ordinarily reduced by the value of the subsidiary stock. A similar deemed capital contribution is treated as occurring if the reattributed tax attribute is a pre-change subgroup attribute. Treas. Reg. § 1.1502-96(d)(4)(iii).

Special rules apply if a reattributed loss is subject to an ownership change prior to the disposition of the subsidiary. If the reattributed loss is subject to a separate-company section 382 limitation (i.e., is a pre-change separate attribute of a new loss member) before the disposition, the common parent's section 382 limitation is zero (except if the common parent apportions to itself all or part of the limitation.) Treas. Reg. § 1.1502-96(d)(4)(i). If no election is made, the subsidiary retains the entire section 382 limitation. *See* Treas. Reg. §§ 1.1502-95(b)(1), -96(d)(5)(ii) Ex. 1(ii)(B).

If the reattributed loss is subject to a subgroup section 382 limitation (i.e., is a pre-change subgroup attribute of a member of an NOL or NUBIL subgroup) before the disposition, the common parent's section 382 limitation is zero if the common parent is not a member of the subgroup immediately after the reattribution (except if the common parent apportions to itself all or part of the limitation.) Treas. Reg. § 1.1502-96(d)(4)(ii). There is some uncertainty as to when the rule described in the previous sentence will apply since as a general rule the common parent becomes a successor member of the subgroup as a result of the deemed section 381 treatment. *See* Treas. Reg. § 1.1502-95(d)(3) Ex. 6. If the common parent is not a member of the subgroup immediately after the reattribution and no election is made, the subgroup retains

the entire section 382 limitation (unless an election is made to apportion some of the limit to the subsidiary). *See* Treas. Reg. § 1.1502-95(b)(2)(ii), (d)(3) Ex. 1.

If the reattributed loss is subject to a consolidated section 382 limitation (i.e., is a pre-change consolidated attribute of a member of a loss group), the consolidated group retains the entire section 382 limitation (except if the common parent elects to apportion some or all of an element of the section 382 limitation to the subsidiary under section 1.1502-5(c) of the Treasury regulations). Treas. Reg. § 1.1502-96(d)(5)(ii) Ex. 2.

As described above, the common parent generally inherits a limitation of zero with regard to any separate or subgroup section 382 limitation (but not a consolidated section 382 limitation) with respect to an ownership change that occurred prior to the disposition of the subsidiary. The common parent is permitted to elect to apportion to itself all (or part) any separate or subgroup section 382 limitation (and away from the subsidiary or subgroup, as the case may be). The principles of section 1.1502-95(c) of the Treasury regulations (election to apportion consolidated section 382 limitation after member leaves the group) apply to the apportionment election. References in section 1.1502-95(c) to the “former member” are treated as references to the “common parent” and references to “consolidated section 382 limitation” are treated as references to the “separate or subgroup section 382 limitation,” as the case may be. As a result, the common parent can attribute to itself the all or part of the value or adjustment element of the separate or subgroup section 382 limitation. However, the common parent is not permitted to attribute to itself any of the NUBIG element. Treas. Reg. § 1.1502-95(d)(5)(i), (ii) Ex. 1.

The election to apportion some of the separate or subgroup section 382 limitation to the common parent is made by the common parent as part of the election by the common parent to reattribute the loss. Treas. Reg. § 1.1502-95(d)(5)(i). The election is made by attaching the statement described in section 1.1502-36(e)(5)(x) of the Treasury regulations to the election to reattribute the loss. The election to reattribute some or all of the loss (and the related election to apportion some or all of the separate or subgroup section 382 limitation) must be made by the common parent on a timely filed return for the taxable year of the transfer of the subsidiary and is irrevocable. Treas. Reg. § 1.1502-36(e)(5).

Special rules apply to the application of the section 382 COBE rules with respect to a pre-change separate attribute of a departing subsidiary that is attributed to the common parent. In such case, the COBE requirement is determined by reference to the business enterprise of the common parent starting immediately after the reattribution event. As a result, the section 382 limit could be zero if the common parent does not continue the departing subsidiary’s business enterprise for two years after an ownership change. Similar principles apply with respect to COBE to a pre-change subgroup attribute if the common parent is not a member of the subgroup on the day after the reattribution event. Treas. Reg. § 1.1502-96(d)(4)(v).

IX. Section 384

Section 384 limits the use of NOLs (and certain other tax attributes) by corporations. These provisions apply after an acquisition of assets or stock of one corporation (the “target corporation”) by another corporation (the “acquiring corporation”). Section 384 only applies if one of the two (or both) corporations is a “gain” corporation (i.e., has a NUBIG) and the other corporation has pre-acquisition attributes (i.e., NOLs, NUBIL, etc.).

Section 384 shares many concepts and definitions with section 382 and the SRLY limitation rules. However, unlike section 382, the limitation under section 384 is not a fixed-dollar cap on the amount of attributes that can be used in a taxable year. Instead, section 384 merely prohibits the tax attributes of one

corporation (either the target corporation or the acquiring corporation) from offsetting RBIGs of the other corporation.

Section 384 applies independently and, potentially, in addition to section 382. H. Rep. 100-795 (1988); S. Rep. 100-445, p. 436 (1988). As a result, where both section 382 and 384 limit the deduction of NOLs in a particular taxable year, the amount allowed as a deduction is the lower of the two limits.

Section 384 was enacted in 1987 (one year after the enactment of section 382) as part of the Revenue Act of 1987, PL 100-203. Congress was concerned that section 269 might not be sufficient to prevent taxpayers from avoiding tax on built-in gains and burnt-out tax shelters. H. Rep. 100-391 (1987). The language of section 384 was revised significantly in technical corrections legislation that was enacted the following year under the Technical and Miscellaneous Revenue Act of 1988, PL 100-647.

Since 1988, Congress has not revised the language of section 384 (except to correct a typo in 1989). Despite the amount of time section 384 has been law (over thirty years), no overall guidance with respect to section 384 has been issued by either the Treasury Department or the IRS. In addition, there is only a smattering of rulings (and no cases).

The Treasury Department and the IRS are currently working on a new set of proposed regulations to supersede the proposed section 382(h) regulations. We understand that the forthcoming guidance will provide rules on the application of section 384. We also understand that a position is being considered to treat items under the built-in gain or loss rules of sections 382 and 384 consistently.

A. Section 384 Acquisitions

In general, section 384 applies if an acquiring corporation acquires assets (pursuant to a corporate reorganization) or stock (that constitutes “control”) of a target corporation and either (or both) of the corporations is a gain corporation. IRC § 384(a). A corporation is a gain corporation if it has a NUBIG. IRC § 384(c)(4). A NUBIG for section 384 purposes generally has the same meaning as with respect to section 382, except that it is determined on the acquisition date. IRC § 384(c)(8). Additionally, section 384 will not have any effect unless one of the corporations has pre-acquisition attributes. IRC § 384(a).

The acquisitions for which section 384 can apply include both stock and asset acquisitions. For a stock acquisition, the acquisition date is the date on which there is an acquisition of “control” (see below) of the target corporation. IRC § 384(c)(2)(A). For an asset acquisition, the acquisition date is the date of the transfer in the reorganization. IRC § 384(c)(2)(B).

Section 384 applies to a stock acquisition if the acquiring corporation acquires “control” of the target corporation. IRC § 384(a)(1)(A). Control is defined as the ownership of 80% of the stock of the target corporation (by vote and value). IRC §§ 384(c)(5), 1504(a)(2). Pure preferred stock is not treated as stock in determining whether control is acquired. IRC § 1504(a)(4).

A stock acquisition can be an acquisition of control for section 384 purposes either by a direct acquisition of stock by a single corporation or indirectly through one or more corporations. IRC § 384(a)(1)(A). The legislative history is silent as to the types of indirect stock acquisitions that are taken into account in determining control. (Acquisitions by other members of an affiliated group are taken into account under different provisions.) It is possible that acquisitions of stock by other corporations are taken into account as indirect acquisitions only if there is a tax-avoidance motivation. The IRS in FSA 200125007 (Mar. 9, 2001) suggested it might apply where a corporation has control of a subsidiary corporation that acquires the stock.

For purposes of determining whether control is acquired, all members of a consolidated group (or an affiliated group that does not file a consolidated return) are treated as a single corporation. IRC § 384(c)(6). As a result, if two members of a consolidated group each acquire 40% of the stock of a target corporation, the consolidated group has acquired control and section 384 applies. Future regulations can expand the corporations that are included in the group to include foreign corporations and special-types of corporations (e.g., REITs). IRC § 384(c)(6).

The legislative history is silent as to whether the acquiring corporation must acquire 80% of the stock in one or more related transactions or only has to increase the ownership to 80%. In other words, does the preexisting ownership count towards the 80%. For example, if a corporation owns 50% of the stock of a target corporation, is the acquisition of an additional 30% sufficient to be an acquisition of control. It would appear that this is an acquisition of control since before the transaction, the target corporation could not consolidate with the parent and afterwards it can. It should be noted that preexisting stock ownership counts for determining control for section 269 purposes. Tax Mgmt. (BNA) 780-4th, VII-B.1(b) (increase from 49% to 50% meets control requirement); *see also* Treas. Reg. § 1.269-1(c) (application of transition rule). This is relevant since the expressed Congressional intent for section 384 was to deal with situations that section 269 might not capture.

Section 384 applies to an asset acquisition if the acquiring corporation acquires assets of the target corporation in a type A, C, or D reorganization. IRC § 384(a)(1)(A). The statutory language refers to reorganizations that are described in subparagraphs (A), (C), or (D) of section 368(a)(1). As a result, section 384 could apply to a type G reorganization that would have otherwise qualified as a type A, C, or D reorganization absent section 368(a)(3)(C) (type G reorganization prevail over other types).

Section 384 does not generally appear to apply to a contribution to capital or a section 351 transaction. However, Section 384 could apply if the transfer also qualifies as a reorganization. *See, e.g.*, Rev. Rul. 76-188, 1976-1 CB 99 (transaction qualified as type C reorganization and section 351 transaction), *obsoleted by*, Rev. Rul. 2007-8, 2007-1 CB 469. In addition, a transfer of assets to a newly-formed corporation or a conversion of a partnership into a corporation could be treated as an acquisition of control. *See* Treas. Reg. § 1.269-3(b)(3) (transfer to newly-organized corporation was acquisition of control for section 269 purposes).

The Treasury Department and the IRS have the regulatory authority to ensure that the “purposes” of section 384 are not circumvented through contributions of assets to a corporation. IRC § 384(f)(2). No such regulations have been proposed or promulgated. It should be noted that regulations were issued in the section 382 context to apply those rule to section 351 transactions by expansion of the section 382 successor rules. *See* Treas. Reg. § 1.382-2(a)(1)(v), (5), (6).

There is an exception to the application of section 384 if both the acquiring and target corporations were under common control before the transaction. The exception applies if both corporations were members of the same controlled group at all times during the five-year period ending on the acquisition date. IRC § 384(b)(1).

The five-year period is shortened if one or both of the corporations were not in existence throughout the five-year period. In such case, the applicable period is the period during which the recently-formed corporation was in existence. If both corporations were not in existence for five years, then the applicable period is the shorter of the period for both corporations. IRC § 384(b)(3). For purposes of determining the period of time the acquiring or target corporation was in existence, it appears that the period of time of existence of predecessor entities are taken into account. IRC § 384(c)(7). Where a partnership converts into a corporation, it is possible that the partnership could be treated as a predecessor entity for this purpose.

For purposes of the common control exception, a “controlled group” is defined in section 1563(a), as modified. Under this definition, two corporations are generally treated as members of a controlled group if a corporation or group of individuals owns (directly, or indirectly by attribution) more than 50% of the stock (by vote and value) of both corporations. IRC § 384(b)(2). The rule that all members of an affiliated group are treated as a single corporation for section 384 purposes does not apply in determining the members of the controlled group. IRC § 384(c)(6).

B. Limited Attributes and Ordering Rules.

Section 384 limits the amount of pre-acquisition losses that offset RBIGs. The list of tax attributes that are limited by section 384 are as follows:

- NOLs under section 172,
- net capital losses under section 1212,
- general business credits under section 39,
- minimum tax credit under section 53, and
- RBILs.

IRC. § 384(c)(3), (d). Section 384 does not appear to limit the use of foreign tax credits, charitable contribution deductions, or disallowed business interest deductions.

Except with respect to RBILs, each of the above-limited tax attributes includes (i) amounts carried forward to a taxable year that includes the acquisition date, and (ii) amounts carried forward from the taxable year that includes the acquisition date to the extent attributable to the pre-change period. IRC § 384(c)(3).

Applicable provisions of the Code generally provide that each of the above attributes are applied in the order in which occurred (i.e., earliest year first) after applying the current year’s amount. IRC §§ 39(b) (general business credit), 172(b)(2) (NOLs), 1212(a) (net capital loss). (The minimum tax credit has no ordering rule. IRC § 53.) The rules of sections 384 generally do not appear to effect these ordering rules. *See* IRC § 384(e)(1).

One modification made to the ordering rules applies where a corporation carries tax attributes from the same taxable year and some are subject to section 384 and other are not. In such a case, an NOL carryforward that is subject to limitation is applied before an NOL or RBIL from the same taxable year that is not subject to limitation. IRC § 384(e)(2). This rule helps prevent the more valuable NOL (not subject to limit) from expiring before the less valuable.

A second modification relates to the ability to carryforward disallowed preacquisition losses. The provisions of section 384 modify the applicable carryforward rules to allow the amount that is in excess of the limitation to be carried forward. IRC § 384(e)(1).

If section 382 limits the deduction of an RBIL in a taxable year, the portion of the RBIL that cannot be currently deducted can be carried forward. IRC § 382(h)(4). There is no similar provision in section 384. As a result, there is some uncertainty as to whether an RBIL that cannot be currently deducted as a result of section 384 can be carried forward.

Where section 384 limits the use of pre-acquisition NOLs, post-acquisition NOLs can be used to offset RBIGs. In such case, the post-acquisition NOL are absorbed and cannot be carried forward to future years. PLR 9804013, (Oct. 22, 1997).

For section 382 purposes, business interest that is carried forward under section 163(j) is treated as a pre-change loss. IRC § 382(d)(3). The equivalent section 384 definition of “preacquisition loss” was not modified by TCJA to cover carryforwards of business interest under section 163(j). A first blush it would appear that section 163(j) carryforwards are not limited by section 384. However, it is possible that section 163(j) carryforwards are taken into account in computing RBIL and NUBIL for section 384 purposes. Both of these terms have the same respective meanings for section 382 and 384 purposes. IRC § 384(c)(8). The applicable regulations clarify that section 163(j) carryforwards are not treated as RBILs for section 382 purposes (and presumably not taken into account for NUBIL purposes). Treas. Reg. § 1.382-7(d)(5). This regulation potentially applies for section 384 purposes since RBIL has the same meaning for both section 382 and 384 purposes.

C. Application.

Section 384 only applies if either the acquiring or target corporation (or both) has a NUBIG on the acquisition date. Where section 384 applies, income for any “recognition period taxable year” cannot be offset by any preacquisition loss to the extent the income is attributable to an RBIG. However, an RBIG can offset a preacquisition loss of the gain corporation (i.e., the corporation with the RBIG). IRC § 384(a). Although, section 384 can technically apply if neither corporation has any preacquisition tax attributes, there would not be anything that is subject to limitation.

In applying the section 384 limitation rule, the terms “NUBIG”, “NUBIL”, “RBIL”, “recognition period”, and “recognition period taxable year” all have the same meaning as with respect to the section 382 built-in gain or loss rules. However, the terms are applied with respect to the “acquisition date” instead of the “change date.” IRC § 384(c)(8).

The rule of section 384 stated simply prohibits the offset of RBIGs of one corporation against pre-acquisition NOLs (and other pre-acquisition tax attributes) of the other corporation. While this rule seems simple to state, it generally is complicated to apply in practice. The lack of guidance from the IRS and the failure to include any examples in the committee reports that are part of the legislative history compounds the difficulties of applying section 384.

The statute refers to “income for any recognition period taxable year (to the extent attributable to recognized built-in gains).” IRC § 384(a). This is the item that cannot be offset by preacquisition losses. There is uncertainty as to how to determine this amount. In many instances, it will be the lesser of taxable income for the year for the gain corporation or the sum of the RBIGs for the taxable year.

Section 384 Example. Parent is the common parent of a consolidated group. On January 1, 2008, Parent acquired 100% of the stock of Target. After the acquisition, Target joins Parent’s consolidated group. Parent and Target each have NOL carryforwards of \$200 million (both from equivalent taxable years). The Parent NOLs are not subject to any section 382 limitations. The Target NOLs are subject to section 382, but the limitation is so large that it will not affect the anticipated NOL usage described below. Both Parent and Target each have a NUBIG of \$500 million as of the acquisition date.

In 2008, Parent has separate taxable income of \$100 million. Target has separate taxable income of zero (RBIGs of \$70 million offset by an operating loss of \$70 million). Absent section 384, the consolidated group would be permitted to apply \$100 million of NOLs against income. It does not appear that section 384 would impact the NOL deduction in 2008 since Target does not have income attributable to an RBIG. That is, the RBIG is being offset by a current year operating loss

and not by NOLs. As a result, \$50 million each of the Parent and Target NOLs are applied in 2008 (and \$150 million each carry forward).

In 2009, Parent has separate taxable income of \$100 million. Target has separate taxable income of \$70 million (RBIGs of \$70 million and zero operating income or loss). Absent section 384, the consolidated group would be permitted to apply \$170 million of NOLs against income. Target's \$70 million of income appears to be fully attributable to RBIGs. Parent's NOL cannot offset Target income, but Target's NOLs can. As a result, \$50 million each of the Parent and Target NOLs are applied in 2009 against Parent's income and \$70 million of Target NOLs are applied against Target's income. Parent can carry forward to 2010 \$100 million of its NOL and Target can carryforward \$30 million.

In 2010, Parent has separate taxable income of \$60 million (RBIGs of \$60 million and zero operating income or loss). Target has separate taxable income of \$70 million (RBIGs of \$70 million and zero operating income or loss). Absent section 384, the consolidated group would be permitted to apply \$130 million of NOLs against income (i.e., the full amount of the NOL carryforward). Both Parent and Target's income appears to be fully attributable to RBIGs. Parent's NOL cannot offset Target income and Target's NOL cannot offset Parent income. As a result, \$60 million of Parent's NOLs are applied in 2010 against Parent's income and the remaining \$30 million of Target NOLs are applied against Target's income. It appears that section 384 limits the total NOL deductions to \$90 million, resulting in consolidated taxable income of \$40 million (i.e., Target's income that is in excess of Target's NOL). Target can carry forward to 2011 the \$40 million of its NOL that was limited by section 384.

In 2011, Parent has separate taxable income of negative \$100 million and Target has separate taxable income of zero. (There are no RBIGs in the taxable year.) Absent section 384, the consolidated group would be permitted to carry back to 2010 \$40 million of the consolidated NOL. Since the NOL is a post-acquisition NOL, it does not appear that section 384 would impact the carryback.

RBIG

The term RBIG has its own definition for section 384 purposes. However, the definition does not deviate significantly from the definition for section 382 purposes. RBIGs, for section 384 purposes, are generally income and gains that are "built-in" on the acquisition date and that are taken into account by the gain corporation during the recognition period. IRC § 384(c)(1). The recognition period is the five-year period beginning on the acquisition date. IRC §§ 382(h)(7)(A), 384(c)(8).

The amount of income and gain that is treated as an RBIG in any recognition period taxable year is limited to the excess of (i) the NUBIG, over (ii) the total RBIGs in prior taxable years which would have been offset been offset by preacquisition losses (but for the application of section 384) (the "remaining NUBIG balance" limitation). IRC § 384(c)(1)(C)(ii). Thus, the amount of the NUBIG is a limitation on the total amount of income and gains that can be treated as an RBIG.

An RBIG is a gain recognized during the recognition period on the disposition of any asset that was held by the gain corporation on the acquisition date. IRC § 384(c)(1)(A)(i). The amount of the RBIG with respect to the disposition is limited to the UBIG. The UBIG equals the excess of the fair market value of the asset over its adjusted basis. The UBIG is determined as of the acquisition date. IRC § 384(c)(1)(A)(ii). If the gain recognized is less than the amount of the UBIG, the entire gain is an RBIG. If the asset had an UBIL, then none of the gain is considered an RBIG.

Under section 384, a loss corporation that takes the position that some or all of a gain is not an RBIG has the burden of establishing (i) that the asset was not held on the acquisition date, or (ii) the amount of the UBIG. IRC § 384(c)(1)(A). It appears that any recognition period gain not meeting this substantiation requirement is treated as an RBIG.

The House Ways and Means Report for the Revenue Act of 1987 indicated that an RBIG would include income recognized after the acquisition if (i) the fair market value of the property acquired is less than, (ii) the present value of taxes that would be due on the income associated with the property. This was intended to apply to a “burnt-out” leasing subsidiary with built-in income that is transferred to a loss corporation. H. Rep. 100-391 (1987).

In Notice 90-27, 1990-1 CB 336, the IRS announced that it intends to issue regulations regarding the correct treatment of installment sales of assets with a UBIG. If the asset is sold either before the acquisition date or during the recognition period, forthcoming regulations will require taxpayers to treat the amount of gain taken into account after the end of the recognition period as an RBIG. The forthcoming regulations will apply to installment sales occurring on or after March 26, 1990. Notice 90-27.

The IRS announced that Notice 90-27 would be withdrawn and made obsolete effective on the day after the proposed section 382(h) regulations become final. REG-125710-18, 84 Fed. Reg. 47455, 47462 (2019). It is unclear as to whether such a withdrawal would apply for section 384 purposes.

The Treasury Department and the IRS have the regulatory authority to ensure that the “purposes” of section 384 are not circumvented through the rules of subchapter K (partnership rules) of the Code. IRC § 384(f)(1). No such regulations have been proposed or promulgated.

The Conference Committee Report for the Revenue Act of 1987 suggested that regulations should be considered that would prevent built-in gains of one partner to be allocated to another partner with pre-acquisition losses under the so-called “ceiling rule” of section 704(c). The regulations which expand section 384 were not intended to be effective prior to the issuance of guidance. H. Conf. Rep. 100-495, 1987-3 CB 193, 253-54. The section 704(c) regulations were amended in 1993 to provide for an anti-abuse rule to prevent the shifting of the tax consequences of built-in gain or loss property to reduce tax. *See* Treas. Reg. § 1.704-3(a)(10). As a result, there no longer appears to be a need for regulations under section 384 to avoid abuses of the ceiling rule.

In Technical Advice Memorandum 200447037 (Aug. 24, 2004), the taxpayer argued that a portion of operating expenses attributable to current year gain can be used to reduce the amount of an RBIG for section 384 purposes. The IRS held that there was no basis for such an offset. In the IRS’ view, the gross gain is taken into account.

Interaction with Section 382 NUBIG/NUBIL Rules

In 2003, the IRS issued interim guidance on the correct application of the section 382 NUBIG and NUBIL rules. Notice 2003-65, 2003-2 CB 747, generally allows loss corporations to adopt one of two approaches to applying the rules. The two approaches are (i) the section 338 approach, and (ii) the section 1374 approach. Taxpayers can apply either (or neither) of the approaches described in Notice 2003-65. Taxpayers are permitted to apply the notice retroactively to ownership changes that occurred before the issuance of the notice.

In Notice 2003-65, the IRS and the Treasury Department requested comments on the extent to which regulations under section 384 should differ from section 382 with respect to built-in items. No other mention of section 384 appears in the notice.

In 2019, the IRS and Treasury Department issued the proposed section 382(h) regulations on the correct application of the section 382 NUBIG and NUBIL rules. These rules propose a single approach (a variation on the section 1374 approach). Taxpayers are generally permitted to rely on the proposed section 382(h) regulations with respect to an ownership change that occurred during a taxable year in which the statute of limitations has not expired (with qualifications). Prop. Reg. § 1.382-7(g). The preamble to the proposed regulations do not offer any insight as to whether taxpayers can apply the proposed section 382(h) regulations for section 384 purposes.

Notice 2003-65 and the proposed section 382(h) regulations are both interpretive guidance of section 382(h). Section 384 shares many concepts and defined terms with section 382(h). As a result, the IRS may find it difficult to challenge the use of Notice 2003-65 or the proposed section 382(h) regulations by taxpayers for section 384 purposes.

There are circumstances where both sections 382 and 384 apply to the same transaction. For example, if a gain corporation purchases 100% of the stock of a loss corporation, the transaction would result in a section 382 ownership change with respect to the loss corporation and a section 384 stock acquisition. If the loss corporation adopts one of the two approaches of Notice 2003-65 or the approach under the proposed section 382(h) regulations, a question arises as to whether the two corporations must use the same approach for section 384 purposes.

A taxpayer could take the position that the guidance under section 382 has no application to section 384. In such instance, the statutory approach would be used and the positions (including the resulting uncertainty) that were available for section 382 purposes before Notice 2003-65 would apply. Under this position, a taxpayer could benefit from foregone amortization for section 382 purposes (using the section 338 approach), but ignore it for section 384 purposes.

It is possible that taxpayers are required to conform the approach used for section 384 purposes with the approach used for section 382 purposes. As a result, it is possible that a taxpayer that adopts the section 338 approach for section 382 purposes may be bound to also use the section 338 approach for section 384 purposes. My understanding is that several major CPA firms believe that this is the “more likely than not” position. Even among those that advocate conformity there is disagreement as to how far this goes. Some take the position that only the corporation that has had an ownership change must conform and others take the position that both do. For example, if an acquiring corporation purchases 100% of a target corporation and the transaction results in ownership change for the target corporation (but not the acquiring corporation), some people believe that the target corporation must conform the approaches for both section 382 and 384 and some people believe that conformity also applies to the acquiring corporation, as well.

Due to the current uncertainty in the law, where section 382 and 384 apply to the same acquisition, taxpayers should consider the effects of both provisions in tandem in determining which approach to use. There is a risk that the same approach applies for both provisions. The IRS has not stated a view on this topic publicly.

Interaction Example. Parent is the common parent of a consolidated group. On January 1, 2008, Parent acquired 100% of the stock of Target, a corporation with significant NOLs, for cash. At the time of the acquisition, both Parent and Target had a significant NUBIG. The base annual section 382 limitation for the ownership change was \$200 million. If Target chooses to apply the section 338 approach, it is anticipated that the RBIGs would be \$100 million per year (e.g., goodwill had

a value of \$1.5 billion and no basis). However, under the section 1374 approach, it is anticipated that there would not be any RBIGs during the recognition period.

Projections show that the consolidated group is anticipated to produce taxable income (before NOL deductions) for each of the first five years of \$400 million per year. Target is projected to break even each year. As a result, if section 384 were not a consideration, Target would apply the section 338 approach and Parent would be allowed to offset \$300 million of taxable income with Target NOLs for each of the first five years (base annual section 382 limitation of \$200 million, plus RBIGs of \$100 million per year).

Parent is a bigger company than Target and has goodwill with a value of \$6 billion (no basis). If the section 338 approach applies for section 384 purposes, the entire income of Parent of \$400 million per year would be attributable to RBIGs of \$400 million (\$6 billion over fifteen years). As a result, the section 384 limitation would be zero for the first five taxable years (2008 through 2013). Section 384 would not apply in 2014 and later. In 2014, the section 382 limitation would equal \$1.7 billion (six years of base annual section 382 limitation and five years of foregone amortization).

If the section 1374 approach applied for both section 382 and 384 purposes, the section 382 limitation would equal \$200 million every year. Section 384 would not limit the deduction since Parent would not have any RBIGs under the section 1374 approach.

It is possible that Parent might decide that the section 1374 approach is better than the section 338 approach (if the same approach must be applied to for purposes of both section 382 and 384). The deduction of \$200 million per year under the section 1374 approach may be preferable to \$1.7 billion in the sixth taxable year (and \$200 million per year thereafter) under the section 338 approach.

Parent might choose to take a return position giving it the best of both worlds (section 338 approach for section 382 purposes but not for section 384 purposes). Under this position, the section 382 limitation would be \$300 million for each of the first five taxable years (\$200 million per taxable year thereafter). Section 384 would not limit the deduction.

In the situation where the taxpayer applies the section 338 approach for section 382 purposes, it is possible that the IRS might require the application of the same approach for section 384 purposes at the time of an audit. The taxpayer might then try to change the section 382 approach to the section 1374 approach. As discussed above in Section VI.A, there is currently uncertainty as to whether a taxpayer can change approaches after applying an approach on a tax return based on the doctrine of elections.

Change Year Allocation

Special rules apply where the acquisition date occurs other than on the last day of the taxable year. In such case, the NOL is allocated between the pre-acquisition period (the period ending on the acquisition date) and the post-acquisition period (the period beginning on the date after the acquisition date). If there is an NOL in the pre-acquisition period, the pre-acquisition NOL is treated as a pre-acquisition loss that is subject to limit under section 384. IRC § 384(c)(3).

There appear to be two acceptable approaches to allocating the items. They are (i) the ratable allocation approach, and (ii) the closing-of-the-books approach. The ratable allocation approach is the approach required by statute. IRC § 384(c)(3). The IRS has allowed taxpayers to use the closing-of-the books

approach pursuant to letter rulings. *See* PLR 201806005 (Nov. 16, 2017); PLR 200238017 (June 11, 2002); PLR 9306013 (Nov. 13, 1992); PLR 9027008 (Mar. 30, 1990).

In Technical Advice Memorandum 200447037 (Aug. 24, 2004), the IRS discussed how to allocate taxable income or NOL between the pre- and post-acquisition period for section 384 purposes. They ruled the default position for a taxpayer is the ratable allocation approach. The closing-of-the books approach is available to taxpayers (but only if the taxpayer requests a private letter ruling). Since the taxpayer did not request a private letter ruling (and waited until the issue was raised on audit to request permission), the IRS held that closing-of-the-books approach was unavailable (even under section 9100 principles because no regulatory election existed).

For section 382 purposes, the allocation calculation is performed (under both approaches) by adjusting the amount of the NOL for RBIGs and RBILs. The amount of the RBIGs and RBILs are allocated entirely to the post-change period. Treas. Reg. § 1.382-6(c)(1)(ii)(A). The IRS applied similar concepts for section 384 purposes in Technical Advice Memorandum 200447037.

Technical Advice Memorandum 200447037 is discussed further below in the context of the consolidated return section (subsection D). A portion of the ruling is discussed there because the IRS treated certain of the issues related to the allocation between periods as consolidated regulation issues. There is some uncertainty as to how much of the analysis in the ruling is specific to consolidated returns. It is very possible that the analysis and conclusions could equally apply outside of a consolidated return context (e.g., a separate corporation acquired another corporation in a corporate reorganization).

Successor Rule

For section 384 purposes, any reference to a corporation in the statute also includes a reference to a predecessor or successor. IRC § 384(c)(7). The terms “predecessor” and “successor” are not defined for section 384 purposes. Presumably, the recipient of assets in a transaction described in section 381 (section 332 liquidations and certain corporate reorganizations) is a successor corporation of the corporation that is transferring the assets. *See* Treas. Reg. § 1.382-2(a)(5), (6); PLR 200709018 (target and acquirer in a type D reorganization treated as a single entity for section 382(l)(5) qualification purposes).

As an example of how these rules apply, assume that a corporation with NOLs acquires control of a gain corporation. Section 384 prevents the NOLs from offsetting RBIGs of the target corporation. If the target corporation merges upstream in a section 332 liquidation three years later, section 384 continues to apply (for two more years). The results are the same if the acquiring corporation merges downstream into the gain corporation. H. Rep. 100-795 (1988); S. Rep. 100-445, p. 435-36 (1988). After the NOL corporation and the gain corporation merge together, the application of section 384 may present some practical hurdles if the businesses of the two former companies are not accounted for separately.

There is currently uncertainty as to whether a corporate transferor in a section 351 transaction is a predecessor of the transferee for section 384 purposes. There is also uncertainty as to whether, and under what circumstances, a corporation can be a predecessor or successor of another type of entity (for example, a partnership).

D. Consolidated Returns.

For section 384 purposes, all members of a consolidated group are treated as a single corporation. IRC § 384(c)(6). As a result, many of the relevant section 384 computations (e.g., NUBIG and NUBIL) are prepared on a subgroup basis. For example, if a consolidated group (consisting of two members) acquires

a third member, the determination of whether the acquiring group has a NUBIG or NUBIL is determined on a subgroup basis. The subgroup would consist of the two original members of the consolidated group. H. Rep. 100-795 (1988); S. Rep. 100-445, p. 436 (1988).

If the target corporation was a member of a consolidated (or affiliated) group before the acquisition, NUBIG or NUBIL would also be determined on a subgroup basis. It would appear that the subgroup would consist of the members of the acquiring consolidated group that were previously members of the former group. TAM 200447037 (Aug. 24, 2004).

The IRS discussed the treatment of section 384 in the consolidated return context in Technical Advice Memorandum 200447037. In the ruling, the common parent of a consolidated group purchased all of the stock of a corporation, which itself was the common parent of a consolidated group.

At the time of the acquisition described in Technical Advice Memorandum 200447037, the target subgroup had a NUBIG (and thought that it had a capital loss carryforward). The acquiring subgroup had an NOL carryforward from a pre-acquisition taxable year. In the year that the target subgroup joined the consolidated group, the target subgroup recognized capital gains which were treated as RBIGs. The consolidated group took the position on the tax return that the target subgroup's capital loss carryforward was available to offset Target's RBIGs.

In the course of the audit, the IRS agent disallowed the target subgroup's capital loss carryforward. As a result of the disallowance, section 384 became an issue. The question then arose as to the extent that the current operating loss or the NOL carryforward of the acquiring subgroup could offset Target's RBIGs.

Since the taxpayer was still under audit (and issues unrelated to section 384 had still not been decided), it was not known whether the consolidated group would have taxable income or an NOL (before carryforward) in the year of acquisition. As a result, the IRS ruled on both possibilities. In both situations, the target subgroup had positive taxable income (in addition to the RBIG).

In Situation 1, the consolidated group had consolidated taxable income. The IRS ruled that since there was no consolidated NOL, no allocation was required. The acquiring subgroup's NOL was not permitted to offset the RBIG, but was allowed to offset other ordinary income and capital gains. Assuming the NOL was large enough, presumably, the consolidated taxable income (after application of section 384) equaled the amount of the RBIG.

As an example to illustrate Situation 1, assume that the acquiring subgroup has an NOL carryforward of \$200 million and operating loss of \$20 million and the target subgroup has operating income of \$150 million and a capital gain RBIG of \$50 million. Under the IRS view, the combined operating income of \$130 million would have been offset by the NOL deduction. This would result in consolidated taxable income of \$50 million (the amount of the RBIG). (The taxpayer wanted to allocate the acquiring subgroup's current year operating loss between the pre- and post-acquisition periods and offset some of the post-acquisition portion against the RBIG.)

In Situation 2, the consolidated group had a consolidated NOL. The consolidated NOL (increased by the amount of the RBIG) was allocated between the pre- and post-acquisition periods based upon the number of days in each period. The consolidated NOL subject to allocation included the operating income of the target subgroup. The pre-acquisition portion of the NOL could not offset the RBIG. The IRS ruled that this amount must be carried forward. The post-acquisition NOL can be offset by the RBIG.

As an example to illustrate Situation 2, assume that the acquiring subgroup has an NOL carryforward of \$200 million and operating loss of \$220 million and the target subgroup has operating income of \$150 million and a capital gain RBIG of \$50 million. Under the IRS view, the combined operating loss of \$70 million would be allocated between the pre- and post-acquisition period. If the acquisition occurred on June 30 for a calendar year taxpayer, \$35 million would be treated as pre-acquisition and \$35 million would be treated as post acquisition. The \$50 million RBIG could be offset by \$35 million of the current year NOL, resulting in consolidated taxable income of \$15 million. The remaining \$35 million of the current year operating loss (as well as the NOL carryforward of \$200 million from prior years) would carry forward.

The taxpayer unsuccessfully argued that a separate subgroup approach applies for section 384 purposes. Under this approach, the taxable income of the acquiring subgroup and the target subgroup would be separately computed. The acquiring subgroup's taxable income or NOL is then allocated between the pre- and post-acquisition periods. The target subgroup's taxable income or NOL would be allocated entirely to the post-acquisition period. The IRS rejected the separate company approach. TAM 200447037. Notwithstanding the IRS' conclusion, many taxpayers apply the separate company approach.

The dual consolidated loss regulations provide for the section 384 treatment of potential recapture amounts with respect to a dual consolidated loss. (This is the only regulation that provides for the consolidated treatment of section 384.) Such recapture amounts are treated as built-in gain item that is taken into account in determining whether a NUBIG exists. Treas. Reg. § 1.1503(d)-6(f)(2)(iii)(A)(3).

X. SRLY Limitation Rules.

The SRLY limitation rules limit the use of NOLs (and certain other tax attributes) by a consolidated group. These provisions apply if a new member joins (or an existing member departs) a consolidated group.

The SRLY limitation rules share many concepts and definitions with sections 382 and 384. However, unlike section 382, the limitation under the SRLY limitation rules is not a fixed-dollar cap on the amount of attributes that can be used in a taxable year. The limitation under the SRLY limitation rules bears some resemblance to the section 384 limitation except that, for SRLY limitation purposes, multiple taxable years are taken into account. In addition, the SRLY limitation rules apply to carrybacks, which neither section 382 nor 384 do. (The carryback rules are not discussed in this paper.)

The SRLY limitation rules apply independently and, potentially, in addition to sections 382 and 384. As a result, where both the SRLY limitation rules and section 382 or 384 limit the deduction of NOLs in a particular taxable year, the amount allowed as a deduction is the lower of the applicable limits. It should be noted that there is an exception to the application of the SRLY limitation rules in many cases, but not all, where there is an overlap with section 382. Treas. Reg. §§ 1.163(j)-5(f) (disallowed business interest), 1.1502-3(d)(2)(iv) (section 38 credits), -15(g) (built-in losses), -21(g) (NOLs), -22(g) (net capital losses), -55(h)(4)(iii)(B)(5) (minimum tax credits).

The SRLY limitation rules are not contained in a single section of the Treasury regulations. Each attribute has its own provision. Each of the provisions has similar concepts. The rules for NOLs can be found in section 1.1502-21(c) of the Treasury regulations. The other provisions can be found in sections 1.163-5(d) (disallowed business interest), 1.1502-1(f) (definition of SRLY), -3(d) (general business credits), -4(f)(3) (foreign tax credits), -15 (built-in losses), -22(c) (net capital losses), and -55(h)(4)(iii) (minimum tax credit) of the Treasury regulations.

A version of the SRLY limitation rules first appeared in the consolidated return regulations in 1966. Unlike the current rules, the original rule applied a limitation independently to each member and each taxable year. The current version of the rules was generally adopted in temporary form in 1996 and in final form in 1999.

Since 1999, the IRS and Treasury Department have not revised the language of the SRLY limitation rules (except with respect to section 163(j)). Despite the amount of time the current rules have been in place (over twenty years), there have only been a few rulings (and no cases) that interpret the rules.

On September 28, 2020, LB&I announced an active campaign to increase compliance regarding limitations on consolidated NOL carryforwards. Included in the campaign is a focus on noncompliance with the SRLY regulations by issue-based examinations. [LB&I Active Campaigns | Internal Revenue Service \(irs.gov\)](#), (last updated on May 27, 2022).

A. Circumstances in Which SRLY Limitation Rules Apply

In general, the SRLY limitation rules apply if a new member joins (or an existing member departs) a consolidated group. Where a new member joins a consolidated group, the rules limit the ability of the group to apply carryforwards of the new member against income and gain of the other members of the group. Where a member departs a consolidated group, the rules limit the ability of the group to apply carrybacks of the departing member against income and gain of the other members of the group.

The SRLY limitation rules can also apply to an asset acquisition if a member acquires assets of a non-member. For purposes of the SRLY limitation rules, a predecessor or successor to a member is also considered to be a member. Treas. Reg. §§ 1.1502-15(e), -21(f)(1), -22(f). Generally, for section 332 liquidations and acquisitive asset reorganizations, the corporation that received the assets in the transaction will be considered a successor to the corporation that transferred the assets. Treas. Reg. § 1.1502-1(f)(4)(i). In addition, a corporation that receives assets from another corporation in a section 351 transaction (or other transferred basis transaction) is considered a successor to the corporation that transferred the assets. Treas. Reg. § 1.1502-1(f)(4)(ii). As a result, it appears that the SRLY limitation rules generally apply to a section 351 transaction in which a non-member corporation transfers assets with a NUBIL to a member.

The SRLY limitation rules only apply with respect to a carryback or carryforward to a SRLY. A SRLY is generally defined (with exceptions) as a separate return year of a member or predecessor of a member. Treas. Reg. § 1.1502-1(f)(1). A separate return year is a taxable year of a corporation for which it files a separate return (i.e., a return separate from the consolidated group) or for which it joins in the filing of a consolidated return with a different consolidated group. Treas. Reg. § 1.1502-1(e).

The reverse acquisition rules generally apply if a corporation, or any member of a consolidated group of which the corporation is the common parent, (the “acquiring corporation”) acquires stock (or substantially all of the assets) of another corporation (the “target corporation”) in exchange for stock of the acquiring corporation and the stockholders of the target corporation own more than 50% of the stock of the acquiring corporation immediately after the acquisition. In such case, the consolidated group of which the acquiring corporation was a member terminates and any consolidated group of which the target corporation was a member is treated as remaining in existence. Treas. Reg. § 1.1502-75(d)(3)(i). Where the reverse acquisition rules apply, all taxable years of the acquiring corporation (and each corporation affiliated with the acquiring corporation) ending on or before the date of the acquisition are treated as SRLYs. The separate return years of the target corporation (and each corporation affiliated with the target corporation) are not treated as SRLYs unless they were so treated before the acquisition. Treas. Reg. § 1.1502-1(f)(3); PLR 201003012 (Sept. 25, 2009).

A SRLY does not generally include a separate return year of the common parent. This so-called “lonely parent” exception would apply, for example, if a corporation filed a separate return and, in a later taxable year, acquired a subsidiary and the two corporations then filed a consolidated return. The lonely parent exception only applies with respect to separate return year tax attributes of the common parent that are carried to a consolidated return year. Treas. Reg. § 1.1502-1(f)(2)(i). As a result, if a common parent becomes a successor of another member (e.g., due to a section 332 liquidation) the SRLY limitation rules can apply to the tax attributes inherited by the common parent from the predecessor. Rev. Rul. 75-378, 1975-2 CB 378.

The lonely parent exception does not apply if the member became the common parent in a reverse acquisition (as described in section 1.1502-75(d)(3) of the Treasury regulations) or a downstream asset acquisition (as described in section 1.1502-75(d)(2)(ii) of the Treasury regulations). In such case, the lonely parent exception applies to tax attributes of the former common parent (and not to tax attributes of the new common parent). Treas. Reg. §§ 1.1502-1(f)(2)(i), (3), -75(d)(2)(ii). For example, if P (the common parent) merges downstream into S (a member of the group), S would become the common parent of the group. However, the lonely parent exception applies to NOLs attributable to P and does not apply to NOLs attributable to S.

It is possible to change the common parent of the group without terminating the consolidated group through an inversion transaction. For example, if S2 (a second tier subsidiary) merges with P (the common parent) and as a result of the merger, P becomes a subsidiary of S1 (formerly a first tier subsidiary of P), S1 would replace P as the common parent of the group. Rev. Rul. 82-152, 1982-2 CB 205. In such case, the lonely parent exception appears to apply to the new common parent. CCA 200901031 (June 15, 2006).

A SRLY also does not include a separate return year of any corporation (or a predecessor corporation of any member) which was a member of the affiliated group for each day of such year. Treas. Reg. § 1.1502-1(f)(2)(ii), (iii). The exception generally applies to a taxable year of a subsidiary that was a member of an affiliated group before the group choose to file a consolidated return.

For purposes of determining whether a taxable year is a SRLY, a predecessor corporation is defined as a transferor or distributor in a section 332 liquidation or an acquisitive asset reorganizations. Treas. Reg. § 1.1502-1(f)(4)(i). In addition, a transferor in a section 351 transaction (or other transferred basis transaction) is considered a predecessor to the corporation that received the assets. Treas. Reg. § 1.1502-1(f)(4)(ii).

The SRLY rules are generally intended to allow a benefit of tax attributes to a member or subgroup that would be similar to the amount that could be achieved if the member or subgroup had not joined the consolidated group. While this may be the general intent, there are many circumstances in which the SRLY rules can give the taxpayer a different (better or worse) result than would be achieved with a separate filing.

For taxpayers that find the SRLY regime more burdensome than filing separately, deconsolidating the member (or members) appears to be an option. In PLR 201251003 (Sept. 25, 2012), the stock of a member that had NOLs subject to SRLY was transferred to a foreign subsidiary in order to deconsolidate the subsidiary. The IRS ruled that the subsidiary would not be subject to SRLY after the deconsolidation (unless it later joins a consolidated group again). Where this technique is used to avoid SRLY, the subsidiary would generally need to wait at least 60 months before it could again become a member of the same consolidated group. IRC § 1504(a)(3)(A). It should be noted that the benefits of avoiding SRLY could have been challenged by the IRS under section 269(a)(1) since the foreign subsidiary acquired a controlling interest in the NOL subsidiary. The IRS did not state in PLR 201251003 whether the taxpayer had (i) represented that the principal purpose of the transaction was something other than avoiding the SRLY rules, or (ii) established a non-tax business purpose for the transaction.

B. Limited Attributes and Ordering Rules.

The SRLY limitation rules limit the amount of tax attributes of a member that joined a new consolidated group or departed from an existing consolidated group. The list of tax attributes that are limited by the SRLY limitation rules are as follows:

- NOLs under section 172,
- net capital losses under section 1212,
- general business credits under section 38,
- minimum tax credits under section 53, and
- built-in losses (i.e., RBILs).

Treas. Reg. §§ 1.1502-3(d) (section 38 credits), -15 (built-in losses), -21(c) (NOLs), -22(c) (net capital losses), -55(h)(4)(iii) (minimum tax credit). The SRLY limitation rules do not apply to foreign tax credits or charitable contribution deductions. Treas. Reg. §§ 1.1502-4(f)(3), -24.

Regulations issued in 2020 expanded the SRLY limitation rules to cover disallowed business interest under section 163(j). Treas. Reg. § 1.163(j)-5(d). These regulations apply to taxable years beginning on or after November 13, 2020. However, a taxpayer can choose (or can be required) to apply these rules to earlier periods if the taxpayer (and all related parties) consistently applies the section 163(j) regulations to such earlier periods in their entirety. Treas. Reg. § 1.163(j)-5(h).

Section 168(k)(4) (as in effect for property acquired in taxable years beginning before January 1, 2018) permits taxpayers to elect to increase the general limitations on the use of research tax credits and minimum tax credits. The IRS has stated that these credits remain subject to section 383 (if there has been an ownership change) and any limitations under the consolidated return rules (such as the SRLY limitation rules). Rev. Proc. 2009-16, 2009-1 CB 449, § 2.09, *mod. by*, Rev. Proc. 2009-33, 2009-2 CB 150.

Applicable provisions of the Code (and consolidated regulations) generally provide that each of the above attributes are applied in the order in which occurred (i.e., earliest year first) after applying the current year's amount. IRC §§ 39(b) (general business credit), 172(b)(2) (NOLs), 1212(a) (net capital loss); *See* Treas. Reg. §§ 1.163(j)-5(b)(2) (disallowed business interest), 1.1502-21(b)(1) (NOLs), -22(b)(2) (net capital losses); Prop. Reg. § 1.1502-55(h)(7) (minimum tax credit). The SRLY limitation rules generally do not effect these ordering rules.

Sections 382 and 384 have explicit rules that allow deductions and credits that are in excess of the limitation to be carried forward. IRC §§ 382(l)(2), 384(e)(1). The SRLY limitation rules do not state explicitly that the disallowed deductions and credits can be carried forward. However, such a carryforward appears to be allowed. Treas. Reg. § 1.1502-21(c)(1)(iii)(B)(6) (NOLs).

Sections 382 and 384 have rules that absorb limited deductions and credits before deductions and credits from the same taxable year that are not subject to limit. IRC §§ 382(l)(2)(B), 384(e)(2). This convention is not applicable for purposes of the SRLY limitation rules. Tax attributes that are carried from the same taxable year are generally taken into account on an equivalent basis even if one is subject to limit and the other is not. If the attributes from the same taxable year exceed the aggregate limitation (e.g., taxable income in the case of regular tax NOLs), the attributes are absorbed on a pro-rata basis. Treas. Reg. §§ 1.1502-3(b)(2)(ii) (investment tax credit), -21(b)(1) (NOLs), -22(b)(2) (capital losses); Prop. Reg. § 1.1502-55(h)(7) (minimum tax credit).

Where tax attributes from the same taxable year are carried forward and absorbed on a pro rata basis, the amount subject to absorption is the amount that would be available (taking into account limitations, such as section 382 and SRLY). For example, if a group is entitled to an NOL of \$120 million (that is not subject to any limitation) and an NOL of \$60 million (but subject to a SRLY limitation of \$20 million) from the same taxable year, only \$20 million of the NOL subject to the SRLY limitation is taken into account in determining the amount absorbed. If consolidated taxable income (before NOL deductions) of the group is \$70 million, then \$60 million of the NOL that is not subject to limitation is absorbed and \$10 million of the NOL that is subject to the SRLY limitation is absorbed. As a result, the group would carry forward \$50 million of the NOL that is subject to the SRLY limitation (and the unused amount of the SRLY limitation of \$10 million). Treas. Reg. § 1.1502-21(c)(1)(iii)(B).

There is some uncertainty as to how to apply the limitation rules when a tax attribute is subject to the SRLY limitation and another limitation (such as limitations under section 382, 383, or 384). Applicable regulations state that all rules that apply to limit use of a tax attribute (other than sections 382 and 383) are applied before section 382 or 383. Treas. Reg. § 1.383-1(d)(3)(i), (ii) (application of limitation on use of business credits). Notwithstanding this statement in the regulations, there are circumstances where the application of section 382 after the application of the SRLY limitation rules could lead to absurd results.

The SRLY limitation rules do not have detailed ordering rules where multiple tax attributes are subject to the limitation. The SRLY limitation is generally computed separately for each type of attribute. For example, the SRLY limitations for capital loss and NOL carryforwards would generally be computed independently of each other. Treas. Reg. § 1.1502-21(c)(1)(iii)(E).

Notwithstanding the lack of detailed ordering rules, the SRLY limitation rules do have some ordering rules. The regulations state that built-in losses are taken into account before NOL and capital loss carryforwards. Treas. Reg. § 1.1502-15(a). In addition, the limitation on net capital losses is applied before limitations on NOLs. Treas. Reg. § 1.1502-21(c)(1)(iii)(E).

C. Overlap Exception

An exception to the SRLY limitation rules applies if the member (or subgroup of members) undergoes an ownership change within six months before, on, or after becoming a member of the consolidated group. Treas. Reg. §§ 1.163(j)-5(f) (disallowed business interest), 1.1502-15(g)(1), (2)(ii)(A) (built-in losses), -21(g)(1), (2)(ii)(A) (NOLs), -22(g)(1), (2)(ii)(A) (capital losses), -3(d)(2)(iv) (general business credits), -55(h)(4)(iii)(B)(5) (minimum tax credits). As a result of this exception, the SRLY limitation rules only apply in rare circumstances. For example, if a member of a consolidated group acquires a 75% interest in a target corporation and acquires the remaining stock more than six months later, both section 382 and SRLY (and potentially section 384) apply. Treas. Reg. § 1.1502-21(g)(5)(iii).

The overlap rules refer to the date on which the member joins the consolidated group as the SRLY event and the date of the ownership change as the section 382 event. Treas. Reg. §§ 1.1502-15(g)(2)(ii)(A) (built-in losses), -21(g)(2)(ii)(A) (NOLs), -22(g)(2)(ii)(A) (capital losses). The overlap exception only applies to carryforwards and not to carrybacks. Treas. Reg. §§ 1.1502-3(d)(2)(iv) (general business credits), -21(g)(1) (NOLs), -22(g)(1) (capital losses), -55(h)(4)(iii)(B)(5) (minimum tax credits).

In order for the overlap exception to apply, the member must undergo a section 382 ownership change within six months of the SRLY event. In order to undergo an ownership change, the member must have been a loss corporation (or a member of a loss group or subgroup). As a result, if the member did not have any tax attributes subject to section 382 at the time of a more than 50 percentage point cumulative owner shift, then an ownership change would not occur. It appears that the overlap rules do not apply if the member

was not a loss corporation at the time of a transaction that would normally result in an ownership change. For example, if a member of a consolidated group acquires 75% of a corporation (at a time when the corporation does not have a NUBIL or NOL (or other) carryforward), the overlap rule would not apply if the corporation later joins the consolidated group. If the corporation joins the consolidated group within six months of the 75% stock purchase and has a NUBIL at the time, the built-in losses will be subject to the SRLY limitation. Treas. Reg. § 1.1502-15(g)(6) Ex. 1(vi), (ix).

There is some uncertainty as to whether the overlap exception applies with respect an ownership change to which section 382(l)(5) applies. The overlap exception only applies if there is an “ownership change giving rise to a section 382(a) limitation.” Treas. Reg. §§ 1.1502-15(g)(2)(ii)(A) (built-in losses), -21(g)(2)(ii)(A) (NOLs), -22(g)(2)(ii)(A) (capital losses). Since section 382(l)(5) is an exception to the section 382(a) limitation, it would appear that the overlap exception does not apply to a section 382(l)(5) transaction. In situations where a bankrupt loss corporation joins a group within six months of an ownership change, an election out of section 382(l)(5) could be beneficial to avoid the SRLY limitation rules.

If the SRLY event occurs on the same date as the section 382 event, then the overlap exception applies beginning with the taxable year that includes the SRLY event (i.e., the members first taxable year as a member of the group). Treas. Reg. §§ 1.1502-15(g)(3)(i), (6) Ex. 2 (built-in losses), -21(g)(3)(i), (5)(i), (viii)(C) (NOLs), -22(g)(3)(i).

If the SRLY event occurs after the section 382 event (but within six months), then the overlap exception applies beginning with the taxable year that includes the SRLY event (i.e., the members first taxable year as a member of the group). Treas. Reg. §§ 1.1502-15(g)(3)(i), (6) Ex. 3 (built-in losses), -21(g)(3)(i), (5)(ii) 2 (NOLs), -22(g)(3)(i) (capital losses). The overlap exception also applies to carryforwards that arise within the period beginning with the section 382 event and ending with the SRLY event. Treas. Reg. §§ 1.1502-21(g)(2)(ii)(B) (NOLs), -22(g)(2)(ii)(B) (capital losses).

The overlap exception does not apply to built-in losses if a corporation acquires assets from a person (other than a member of the consolidated group) after the section 382 event but before the SRLY event. This rule only applies if the transferor has a NUBIL in excess of the NUBIL threshold requirement (i.e., the lesser of 15% or \$10 million) and, as a result, the corporation increases its NUBIL before the SRLY event. Treas. Reg. § 1.1502-15(g)(3)(i). This rule is designed to prevent taxpayers from avoiding the section 382 NUBIL rules by transferring assets that are otherwise exempt from the SRLY limitation rules. This rule could be a trap for the unwary since the purpose (and the relative size) of the transfer appears to not be relevant.

If the SRLY event occurs before the section 382 event (but within six months), then the overlap exception applies beginning with the taxable year that includes the section 382 event (i.e., the members first taxable year as a member of the group). Treas. Reg. §§ 1.1502-15(g)(3)(ii) (built-in losses), -21(g)(3)(ii) (NOLs), (5)(iv), -22(g)(3)(ii) (capital losses). As a result, a carryforward to the taxable year preceding the section 382 event would be subject to the SRLY limitation rules. For example, if the SRLY event occurs on December 1, 2010 and the section 382 event occurs on March 1, 2011, a carryforward to the calendar year 2010 taxable year would be subject to a SRLY limitation. If the NOL carryforward is disallowed (in whole or in part) by the SRLY limitation rules in 2010, the overlap rule would apply in 2011 (and later years) to the amount of the NOL carryforward not allowed in 2010.

The overlap exception does not apply to built-in losses if a corporation transfers assets with a UBIL to another member of the consolidated group after the SRLY event but before the 382 event unless the corporation recognizes the built-in loss upon the transfer. Treas. Reg. § 1.1502-15(g)(3)(i). This rule is designed to prevent taxpayers from avoiding the section 382 NUBIL rules by transferring assets that are

otherwise exempt from the SRLY limitation rules. This rule could be a trap for the unwary since the purpose (and the relative size) of the transfer appears to not be relevant.

The overlap rule will not apply to a second SRLY event unless a section 382 event occurs within six months of the second SRLY event. For example, if 100% of Target stock is acquired by Acquiring (the common parent of a consolidated group) on January 1, 2009 and Parent (the common parent of a consolidated group) acquires Acquiring on January 1, 2011, the Target carryforwards to the taxable years of the Parent consolidated group will not qualify for the overlap exception unless a section 382 event occurs within six months of January 1, 2011. Treas. Reg. § 1.1502-21(g)(5)(viii).

Special rules apply to the overlap exception with respect to built-in losses. The regulations clarify that the overlap rules can apply even if the “size and composition” of a NUBIL is not the same on the dates of the SRLY and section 382 events. Treas. Reg. § 1.1502-15(g)(2)(ii)(A). For example if a loss corporation has a section 382 event at a time when the NUBIL is \$25 million and later has a SRLY event when the NUBIL has grown to \$35 million (due to fluctuations in value), the overlap rules apply to the full \$35 million. Treas. Reg. § 1.1502-15(g)(6) Ex. 4.

The overlap exception to the built-in loss SRLY limitation rules does not apply with respect to asset acquisitions by the corporation that occur after the later of the SRLY or section 382 events. Treas. Reg. § 1.1502-15(g)(5), (6) Ex. 2 (contribution of NUBIL assets to capital after SRLY and section 382 event). It appears that this rule applies even if the asset acquisition occurs within six months of the section 382 event.

D. Limitation on Deduction Carryforwards

In this subsection, we will discuss the determination of the SRLY limitation on NOL and capital loss carryforwards, as well as the rules for disallowed business interest. Generally, the SRLY limitation equals the member’s aggregate contribution to consolidated taxable income (in the case of NOL carryforwards) or consolidated capital gain net income (in the case of capital loss carryforwards). The limitation on disallowed business interest is generally equal to the section 163(j) limitation of the member on a standalone basis.

NOL Carryforwards

The SRLY limitation on NOL carryforwards in a taxable year equals the aggregate consolidated taxable income for all consolidated return years of the consolidated group, recomputed by reference to only the member’s items of income, gain, deduction or loss (“taxable income items”). Treas. Reg. § 1.1502-21(c)(1)(i). This recomputed consolidated taxable income amount is generally referred to as the “SRLY register” since the amount is cumulative. Treas. Reg. § 1.1502-21(h)(1)(i).

The SRLY register is computed with regard to the member’s taxable income items (but without regard to their source). As a result, it is possible to increase the SRLY register by transferring assets which are expected to produce positive taxable income to a member that is subject to SRLY. *See* PLR 201003012 (Sept. 25, 2009) (SRLY register takes into account taxable income items of business acquired by merger). While it appears that this technique can be used to increase the SRLY register, there are other tax provisions could effectively limit the benefits (e.g., sections 269 and 384).

The SRLY register is computed without regard to any consolidated NOL deductions. Treas. Reg. § 1.1502-21(c)(1)(i)(A). Instead, the SRLY register takes into account the member’s losses and deductions (including capital losses) that are actually absorbed by the consolidated group in a consolidated return year. The losses and deductions are taken into account if absorbed by the group (whether or not they are absorbed by the member). Treas. Reg. § 1.1502-21(c)(1)(i)(B).

There is an issue as to how to apply the rules when a group deducts a member's SRLY limited loss and the member's share of a subsequent consolidated NOL in the same taxable year. For example, assume that Sub has an NOL carryforward from 2018 (subject to SRLY) of \$100 million. In addition, the group has a consolidated NOL carryforward from 2019 of \$80 million (of which \$40 million is attributable to Sub). In 2020, the group has consolidated taxable income (before NOLs) of \$140 million (\$60 million of which is attributable to Sub).

In the above example, the SRLY NOL is older than the consolidated NOL, so it is deductible first under the NOL ordering rule. For 2020, the SRLY register would equal \$60 million, which would allow the group to deduct \$60 million of the SRLY NOL (bringing the SRLY register to zero). The group would then be entitled to deduct \$80 million of the consolidated NOL from 2019 (half of which is allocable to Sub). If the group were allowed to deduct Sub's \$40 million share of the NOL (50% of \$80 million), that would bring the SRLY register down to negative \$40 million.

One possible solution to the above anomaly is to limit the deduction of Sub's share of the consolidated NOL to the amount of the SRLY register (after taking into account the deduction of the SRLY NOL). On these facts, the limit would be zero and the group would be allowed to deduct the portion of the consolidated NOL that is not attributable to Sub (\$40 million), resulting in consolidated taxable income (after NOLs) of \$40 million. Alternatively, the group could deduct the \$40 million of consolidated NOL attributable to Sub that was tentatively arrived at in the above computation (by analogy to section 1.1502-11(c) of the Treasury regulations), allowing a deduction of \$20 million of the SRLY NOL. This alternative results in the same amount of consolidated taxable income (\$40 million) as the first alternative.

It should be noted that some taxpayers take the position that no portion of a subsequent year consolidated NOL is taken into account in determining the SRLY register. This position would allow Sub to end up with a negative SRLY register (of \$40 million in the example). This position is based on the view that the SRLY register does not become negative until after the SRLY loss is calculated and absorbed. This later position appears to ignore the words in the regulation that require that all losses of the member that are actually absorbed by the group in the year to which the loss is carried be taken into account. Treas. Reg. § 1.1502-21(c)(1)(i)(B), (C)(1).

In determining the SRLY register, consolidated return years are taken into account only for the period the member has been continuously included in the consolidated group's consolidated return. The consolidated return year to which the NOL is carried is taken into account. Treas. Reg. § 1.1502-21(c)(1)(i)(C). However, consolidated return years after the year to which the NOL is carried are not taken into account. Treas. Reg. § 1.1502-21(c)(1)(i)(C)(1). As a result, there is no recapture if the member has a loss in a year following the year in which a SRLY NOL is used.

In determining the SRLY register of a member, the taxable income items of a predecessor or successor are taken into account "as the context may require." Treas. Reg. § 1.1502-21(f)(1). Whether the context requires the taxable income items to be included will depend upon the facts and circumstances and taking into account the purposes of the rules. In many cases, whether the context requires taking into account taxable income items of a predecessor will be determined by reference to the treatment that would govern if a consolidated return had not been filed. CCA 200924042 (Jan. 30, 2009); TAM 200514019 (Apr. 5, 2004).

Generally, for section 332 liquidations and acquisitive asset reorganizations, the corporation that received the assets in the transaction will be considered a successor to the corporation that transferred the assets. Treas. Reg. § 1.1502-1(f)(4)(i). In addition, a corporation that receives assets from another corporation in a section 351 transaction (or other transferred basis transaction) is considered a successor to the corporation that transferred the assets. Treas. Reg. § 1.1502-1(f)(4)(ii).

Where a member acquires the assets of a member that is subject to SRLY in a section 332 liquidation or acquisitive asset reorganization, it appears that the SRLY register takes into account the pre-transaction taxable income items of the predecessor (for the period in which it was a member of the consolidated group) and the post-transaction taxable income items of the successor. CCA 200924042 (section 332 liquidation); TAM 200514019 (type F reorganization); PLR 200252070 (Dec. 27, 2002) (section 332 liquidation).

If a parent corporation makes an election to reattribute the attributes of a subsidiary under the uniform loss rules, the parent corporation succeeds to the attributes of the subsidiary (even if the subsidiary is not a direct subsidiary of the parent corporation). Treas. Reg. § 1.1502-36(d)(6)(i)(B). The IRS has treated the parent corporation as a successor for SRLY purposes where a reattribution election is made by applying the “as the context may require” language in the successor rules. For purposes of applying the SRLY register, the IRS held that only the post-separation taxable income of the parent corporation is to be taken into account. FAA 20150301F (Sept. 10, 2014).

Where a member subject to SRLY becomes a successor of another corporation there is some uncertainty as to how to apply the rules. For example, if T merges with A (and tax attributes of A are subject to SRLY), is the SRLY register recomputed to take into account pre-merger taxable income items of T? Some taxpayers have taken the position that the SRLY register includes the taxable income items of the predecessor for the pre-transaction period. The IRS in Private Letter Ruling 201003012 (Sept. 25, 2009) held that the pre-transaction period is not taken into account. However, the pre-transaction period in the ruling involved taxable years of a different consolidated group. It is not clear as to how the IRS would have ruled if the merger had been between two members of a consolidated group.

There is also some uncertainty as to how to apply the successor rule in the context of transferred basis transactions. For example, if a member that is subject to a SRLY limitation transfers some (but not all of its assets) in a section 351 transaction to another member, the transferee is a successor of the transferor. In determining the SRLY register, there is uncertainty as to whether to take into account the taxable income items of the transferee or just taxable income items relating to the transferred assets. *See* Treas. Reg. § 1.1502-15(d) Ex. 1(iv) (all taxable income items of transferee taken into account where transferor transferred all of its assets and liabilities in a section 351 transaction); PLR 201342004 (July 15, 2013) (net positive or negative income taken into account after transfer of single business in a section 351 transaction); *see also* TAM 200514019 (taxable income items of distributing corporation not taken into account in divisive type D reorganization).

SRLY Example. Assume Sub joins the Parent Group on January 1, 2011 in a transaction that does not result in a section 382 ownership change. Sub has an available NOL carryforward to the 2011 taxable year of \$150 million which is subject to the SRLY limitation rules. In 2011, the Parent Group has consolidated taxable income (before NOL deductions) of \$90 million (and Sub contributes \$60 million to that amount). The SRLY register in 2011 would equal \$60 million and the Parent Group would be entitled to deduct \$60 million of Sub’s NOL.

In 2012, the Parent Group has consolidated taxable income (before NOL deductions) of \$50 million (and Sub contributes \$40 million to that amount). The SRLY register in 2012 would equal \$100 million (the sum of Sub’s taxable income items in 2011 and 2012). Since the Parent Group has already taken a \$60 million NOL deduction in 2011, a \$40 million NOL deduction is available in 2012. Treas. Reg. § 1.1502-21(c)(1)(iii)(E).

In 2013, the Parent Group has consolidated taxable income (before NOL deductions) of zero (and Sub has positive taxable income items of \$50 million). The SRLY register in 2013 would equal \$150 million (the sum of Sub’s taxable income items in 2011 through 2013). Since the Parent Group

has already taken a \$100 million NOL deduction in 2011 and 2012, the remaining \$50 million is available for deduction under the SRLY limitation rules. However, the Parent Group consolidated NOL deduction cannot exceed its consolidated taxable income of zero. As a result, none of the NOL can be deducted in 2013.

In 2014, the Parent Group has consolidated taxable income (before NOL deductions) of \$50 million (and Sub has negative taxable income items of \$10 million). The SRLY register in 2014 would equal \$140 million (the sum of Sub's taxable income items in 2011 through 2014). Since the Parent Group has already taken a \$100 million NOL deduction in 2011 and 2012, \$40 million of the remaining NOL carryforward is available for deduction.

Examples of the application of the SRLY limitation rules with respect to NOL carryforwards can be found in Examples 1, 2, and 5 found in section 1.1502-21(c)(1)(iii) of the Treasury regulations.

Capital Loss Carryforwards

The SRLY limitation on capital loss carryforwards in a taxable year equals the aggregate consolidated capital gain net income for all consolidated return years of the consolidated group, recomputed by reference to only the member's items of capital gain or loss (including section 1231 gain or loss). Treas. Reg. § 1.1502-22(c). This recomputed consolidated capital gain net income amount is generally referred to as the "SRLY register" since the amount is cumulative. Treas. Reg. § 1.1502-22(h)(1)(i).

The SRLY register is computed without regard to any consolidated capital loss carryforward deductions. Instead, the SRLY register takes into account the member's capital and section 1231 losses that are actually absorbed by the consolidated group in a consolidated return year. The losses are taken into account if absorbed by the group (whether or not they are absorbed by the member). Treas. Reg. §§ 1.1502-21(c)(1)(i)(A), (B), 22(c).

In determining the SRLY register, consolidated return years are taken into account only for the period the member has been continuously included in the consolidated group's consolidated return. The consolidated return year to which the capital loss is carried is taken into account. However, consolidated return years after the year to which the capital loss is carried is not taken into account. Treas. Reg. §§ 1.1502-21(c)(1)(i)(C), -22(c).

In determining the capital loss SRLY register of a member, the taxable income items of a predecessor or successor are taken into account. Treas. Reg. § 1.1502-22(f). Generally, for section 332 liquidations and acquisitive asset reorganizations, the corporation that received the assets in the transaction will be considered a successor to the corporation that transferred the assets. Treas. Reg. § 1.1502-1(f)(4)(i). In addition, a corporation that receives assets from another corporation in a section 351 transaction (or other transferred basis transaction) is considered a successor to the corporation that transferred the assets. Treas. Reg. § 1.1502-1(f)(4)(ii).

Where a member has both an NOL and a capital loss carryforward that are subject to the SRLY limitation rules, the SRLY register for NOLs and capital losses are computed independently of each other. Treas. Reg. § 1.1502-21(c)(1)(iii)(E)(2).

Disallowed Business Interest

Regulations issued in 2020 expanded the SRLY limitation rules to cover disallowed business interest expense under section 163(j). The SRLY limitation rules apply to disallowed business interest expense, but

do not appear to apply to excess business expense (i.e., a business interest expense carryforward that is allocated from a partnership). Treas. Reg. § 1.163(j)-5(d). Carryforwards of disallowed disqualified interest (i.e., interest that was disallowed under the pre-TCJA version of section 163(j)) can also be subject to SRLY (even though they were not subject to SRLY before the enactment of the TCJA). Treas. Reg. § 1.163(j)-11(b)

The section 163(j) SRLY regulations apply to taxable years beginning on or after November 13, 2020. However, a taxpayer can choose (or can be required) to apply these rules to earlier periods if the taxpayer (and all related parties) consistently applies the section 163(j) regulations to such earlier periods in their entirety. Treas. Reg. §§ 1.163(j)-5(h), -11(d).

The SRLY limitation on disallowed business interest carryforwards in a taxable year equals the group's section 163(j) limitation (determined by reference only to the member's (or subgroup's) items of income, gain, deduction, and loss for the year). This amount is reduced (but not below zero) by the members business interest expense (including disallowed business interest expense carryforwards) absorbed by the group in all consolidated return years. This amount after reduction is the "cumulative section 163(j) SRLY limitation." This cumulative section 163(j) SRLY limitation is generally referred to as the "SRLY register" since the amount is cumulative.

For purposes of computing the cumulative section 163(j) SRLY limitation, intercompany items are generally taken into account. However, interest income and expense on intercompany obligations is ignored. Income and expense (other than interest income and expense) from an intercompany transaction (e.g., transaction expenses) is taken into account for SRLY purposes. Additionally, interest expense with regard to intercompany obligations is not treated as business interest expense for purposes of this calculation. Treas. Reg. § 1.163(j)-5(d)(1)(A).

The final regulations adopted a SRLY register approach that is similar to the approach that is used for other attributes that are subject to SRLY. The proposed regulations would have used a year-by-year approach instead of a register. The year-by-year approach was criticized by many commentators as being complicated and likely to produce anomalous results. TD 9905, 85 Fed. Reg. 56686, 56715-16 (2020).

The amount of SRLY-limited business interest expense deductions are further limited by the consolidated section 163(j) limitation. For this purpose, SRLY-limited deductions are deductible on a pro rata basis with non-SRLY limited carryforwards from the same taxable year. Treas. Reg. § 1.163(j)-5(d)(2).

SRLY Example. Parent acquires 100% of the stock of Target on December 31, 2021. (The transaction did not result in an ownership change.) At the time of the acquisition, Target has a disallowed business interest carryforward of \$100M.

Parent and Target choose to file a consolidated return in 2022. In 2022, neither Parent nor Target accrues any interest income or expense. The section 163(j) limitation (computed on a consolidated basis) is \$150M (i.e., consolidated adjusted taxable income equals \$500M). However, the limitation determined solely by reference to Target is \$70M (i.e., Target's adjusted taxable income equaled \$233.33M).

Under these facts, the SRLY limitation for 2022 (before the deduction) equals \$70M. As a result, Target is able to deduct \$70M of the disallowed business interest expense in 2022 and carries forward \$30M of the deduction to 2023. After taking the \$70M deduction, the cumulative SRLY limitation is reduced to zero. Treas. Reg. § 1.163(j)-5(d)(3)(i)(A), (B).

If Target's adjusted taxable income for 2022 (computed on a separate company basis) has been a negative amount, the SRLY limitation for 2022 would equal zero. As a result, Target's business interest expense deduction would be limited to zero and the entire \$100M would be carried forward to 2023. The cumulative SRLY limitation at the beginning of 2023 would equal zero. Treas. Reg. § 1.163(j)-5(d)(3)(i)(C).

Other examples of the application of the SRLY limitation rules can be found in section 1.163(j)-5(d)(3)(iii) of the Treasury regulations.

E. Limitation on Built-in Losses.

In this subsection, we will discuss the determination of the SRLY limitation on built-in losses. The built-in loss SRLY limitation rules only apply if the member has a NUBIL at the time it joins the group. Built-in losses (i.e., RBILs) are generally subject to SRLY limitation under the rules described above with respect to NOL and capital loss carryforwards, depending upon whether the loss or deduction is ordinary or capital. A built-in loss is treated as a hypothetical NOL or capital loss carryforward arising in a SRLY.

In applying the SRLY limitation rules as they apply to built-in losses, the terms "NUBIL" and "RBIL" generally have the same meaning as with respect to the section 382 built-in gain or loss rules. However, in certain instances the meaning of the term is modified. Treas. Reg. § 1.1502-15(b)(1).

NUBIL

A SRLY limitation on built-in losses only applies if a corporation has a NUBIL on the day it becomes a member of an affiliated group (whether or not the group files a consolidated return). A NUBIL is determined separately for each member (except if the subgroup rules described below apply). Treas. Reg. § 1.1502-15(b)(1).

The term "NUBIL" for purposes of the SRLY limitation rules generally has the same meaning as it does under section 382. However, various operating rules and modifications apply.

If a member joins an affiliated group in a stock acquisition, the NUBIL is determined as if the member had an ownership change on the day the member joined the group. Other events that may have caused an ownership change on different dates are ignored. Treas. Reg. § 1.1502-15(b)(2)(i), (d) Ex. 1(ii). For example, if a member of a consolidated group acquires 55% of a corporation in January 2011 (causing an ownership change) and the remaining 45% in March 2012, the corporation is treated as undergoing an ownership change in March 2012 for purposes of the applying the built-in loss SRLY limitation rules. Treas. Reg. § 1.1502-15(d) Ex. 2.

Special rules apply if the affiliated group acquires assets from a non-member. In such case, the assets or liabilities acquired directly from the same transferor pursuant to the same plan are treated as the assets or liabilities of a corporation that became a member of the group on the date of the acquisition. The hypothetical new member is treated as having had an ownership change on the date of acquisition. The tax status of the transferor is not relevant for this rule to apply. It applies to non-corporate transferors (e.g., a partnership), as well as foreign transferors. Treas. Reg. § 1.1502-15(b)(2)(ii), (d) Ex. 1(iv). It appears that this rule only applies to an asset acquisition for which the acquiring member (or members) are a successor of the transferor (i.e., a section 332 liquidation, corporate reorganization, section 351 transaction, or other transferred basis transaction). See Treas. Reg. § 1.1502-1(f)(4), 1.1502-15(e).

The regulations state that the principles of section 1.1502-94(c) of the Treasury regulations apply, with appropriate adjustments, in determining a member's NUBIL. Treas. Reg. § 1.1502-91(b)(2). As a result, it appears that a member's separately computed NUBIL is computed without reference to UBIGs or UBILs with respect to debt obligations issued by another member of the group. Treas. Reg. §§ 1.1502-91(g)(1), -94(c). A further adjustment appears to be required to a member's separate NUBIL to exclude a UBIG or UBIL with respect to assets acquired with a principal purpose to affect the amount of the separate NUBIL. Treas. Reg. § 1.1502-91(g)(4).

Built-in Loss

A deduction or loss of a member is considered a built-in loss to the extent it would be treated as an RBIL under section 382. Treas. Reg. § 1.1502-15(b)(1). The change date (and the beginning of the five-year recognition period) for purposes of determining whether an item is an RBIL is generally the date the member joined the affiliated group. Treas. Reg. § 1.1502-15(b)(2)(i). In the case of an asset acquisition by the group, the change date is the date of the acquisition. Treas. Reg. § 1.1502-15(b)(2)(ii).

For section 382 purposes, the aggregate amount of an RBIL is limited to the NUBIL. IRC § 382(h)(1)(B)(ii). This limitation does not apply for purposes of determining whether a deduction or loss is a built-in loss. Treas. Reg. § 1.1502-15(b)(2)(iii). As a result, the aggregate built-in losses can exceed the NUBIL. Treas. Reg. § 1.1502-15(d) Ex. 1(iii).

A loss or deduction that is taken into account during the recognition period but is disallowed or deferred (other than by the SRLY limitation rules) is not treated as a built-in loss unless and until it would otherwise be allowed (and only if it is allowed during the recognition period). The regulations include as examples of provisions that can disallow or defer a deduction, section 267 and the unified loss rules of section 1.1502-36 of the Treasury regulations. Treas. Reg. § 1.1502-15(d)(2)(iii). The intercompany transaction rules of section 1.1502-13 are not listed as an example of a provision that defers a deduction. It would not appear that this omission was intentional.

The regulations state that the principles of section 1.1502-94(c) of the Treasury regulations apply, with appropriate adjustments, in determining a member's built-in losses. Treas. Reg. § 1.1502-91(b)(2). As a result, it appears that a recognized loss on the disposition of stock of another member is generally treated as a built-in loss (to the extent the other requirements are met). A recognized loss on the disposition of an intercompany obligation (a debt or other financial obligation of another member of the group) would not generally be treated as a built-in loss. Treas. Reg. §§ 1.1502-91(h)(2), -94(c).

SRLY Limitation

Built-in losses are generally subject to the SRLY limitation rules that apply to NOL carryforwards (in the case of ordinary losses and deductions) or capital loss carryforwards (in the case of capital losses), as the case may be. For this purpose, a built-in loss is treated as either a hypothetical NOL or capital loss carryforward (depending upon the character) arising in a SRLY.

Built-in losses are generally treated as deductions or losses in the year recognized to the extent allowed by the SRLY limitation rules. The amount allowed offsets any consolidated taxable income for the taxable year before any loss carryforwards or carrybacks. Treas. Reg. §§ 1.1502-15(a), (d) Ex. 4, -21(c)(1)(i)(D), (iii)(D), -22(c).

To the extent a built-in loss is disallowed under the SRLY limitation rules, it is treated as a separate NOL or net capital loss carryforward or carryback arising in the year of recognition. The year of recognition is

treated as a SRLY. Treas. Reg. §§ 1.1502-15(a), -21(c)(1)(ii), -22(c). As a result, the amount carried forward remains subject to the SRLY limitation rules.

To illustrate the above concepts, assume that Target joins the Parent Group on December 31, 2010 in a transaction that does not cause an ownership change within six months. At the time Target joined the group, Target had a NUBIL. In 2011, Target recognizes a built-in loss of \$45 million. Target had taxable income in 2011 (before deduction of built-in losses) of \$25 million. Consolidated taxable income in 2011 (before deduction of built-in losses) was \$10 million. The SRLY register in 2011 for NOLs (including ordinary built-in losses) is \$25 million. As a result, \$20 million of the built-in loss is disallowed and can be carried back or forward (but subject to the SRLY limitation rules). The allowance of a current built-in loss deduction of \$25 million results in a consolidated NOL of \$15 million. This NOL can be carried back or forward (free of any limitation under the SRLY limitation rules). Treas. Reg. § 1.1502-15(d) Ex. 5.

Where the built-in loss SRLY rules apply to an asset acquisition, the SRLY register is computed based upon all of the taxable income items of the transferee member. For example, if a partnership contributes assets with a NUBIL to a member of the group in a section 351 transaction, the SRLY register takes into account all of the taxable income items of the member (and is not computed solely based upon the assets and liabilities contributed). Treas. Reg. § 1.1502-15(d) Ex. 1(iv).

The SRLY limitation rules generally do not apply to a loss recognized by a consolidated group on an asset held by the common parent on the date the consolidated group is formed. Treas. Reg. § 1.1502-15(f)(1). This exception is similar to the lonely parent exception described above. The exception applies to assets held by the common parent when the group is formed even if the assets are subsequently transferred to other members of the group. PLR 201232011 (May 10, 2012) (group formed by revocation of REIT election).

In the case of a reverse acquisition (as described in section 1.1502-75(d)(3) of the Treasury regulations) or a downstream asset acquisition (as described in section 1.1502-75(d)(2)(ii) of the Treasury regulations), the common parent exception applies to the member that was the common parent immediately before the acquisition. Treas. Reg. § 1.1502-15(f)(1). The exception for common parent losses does not apply if the common parent acquires assets with a NUBIL in excess of the NUBIL threshold requirement (i.e., the lesser of 15% or \$10 million) prior to, and in anticipation of, the formation of the consolidated group. Treas. Reg. § 1.1502-15(f)(2).

F. Limitation on Credits.

In this subsection, we will discuss the determination of the SRLY limitation on general business and minimum tax credit carryforwards. Generally, the SRLY limitation equals the member's aggregate contribution to the consolidated credit limitation.

General Business Credit Carryforwards

The SRLY limitation on general business credit carryforwards in a taxable year equals the aggregate of the member's contribution to the consolidated section 38(c) limitation for all consolidated return years of the consolidated group. This amount is reduced by the aggregate of the member's general business credits arising and absorbed in all consolidated return years. Treas. Reg. § 1.1502-3(d)(1).

The consolidated section 38(c) limitation in a consolidated taxable year equals the excess of the "consolidated net income tax" over the greater of (i) the "consolidated tentative minimum tax", or (ii) the "consolidated net regular tax liability" (less the group's share of \$25 thousand) multiplied by 25%. The

consolidated net income tax generally equals the tax liability of the group before allowance of the general business and minimum tax credits. The consolidated tentative minimum tax equals the tentative amount of tax owed by the group under alternative minimum tax rules before reduction for regular tax. The consolidated net regular tax liability equals the regular tax liability of the group before the allowance of the general business and minimum tax credits. IRC §§ 38(c)(1), 55(b); Treas. Reg. § 1.1502-3(d)(2)(i), (5) Ex.

A member's contribution to the consolidated section 38(c) limitation is determined depending upon whether the limitation in a consolidated return year is based upon consolidated tentative minimum tax or consolidated net regular tax liability. If the consolidated section 38(c) limitation for a year is determined by reference to the consolidated tentative minimum tax, then the member's contribution equals the member's share of the consolidated net income tax, less the member's share of the consolidated tentative minimum tax. If the consolidated section 38(c) limitation for a year is determined by reference to the consolidated net regular tax liability, then the member's contribution generally equals the member's share of the consolidated net income tax, less 25% of the member's share of the net regular tax liability. If the limitation is determined based upon the net regular tax liability, the member's contribution also takes into account the member's share of the \$25 thousand amount. However, the group can apportion all or part of the \$25 thousand amount to one or more members. Treas. Reg. § 1.1502-3(d)(2)(i).

The formulas described in the prior two paragraphs make liberal references to AMT concepts. The TCJA repealed the corporate AMT. However, AMT will still be relevant for determining the SRLY register for general business credits to the extent that the credits are being carried forward from pre-2018 taxable years. In any case, the tentative minimum tax for a corporate taxpayer is deemed to be zero for taxable years beginning after December 31, 2017. IRC § 38(c)(6)(E); TCJA, PL 115-97 § 12001(b)(1) (2017).

In determining the SRLY limitation, the member's contribution to the consolidated section 38(c) limitation for all consolidated return years of the consolidated group is reduced by the aggregate of the member's general business tax credits arising and absorbed in all consolidated return years. The reduction is based upon the member's share of the consolidated general business tax credit for a consolidated return year to the extent absorbed by the group (even if absorbed by another member). Treas. Reg. § 1.1502-3(d)(1).

No guidance has been issued as to how to allocate the consolidated general business tax credit to members. Applicable regulations provide that consolidated investment credit (a predecessor provision to the general business tax credit rules) is allocable to member's based upon the credit's earned by each member (on a separate company basis). Treas. Reg. § 1.1502-79(c)(2)(ii). Presumably, a reasonable method of allocating the consolidated general business tax credit would be acceptable.

In determining the SRLY limitation, consolidated return years are taken into account only for the period the member has been continuously included in the consolidated group's consolidated return. The consolidated return year to which the general business tax credit is carried is taken into account. Treas. Reg. § 1.1502-3(d)(2)(ii). However, consolidated return years after the year to which the general business tax credit is carried are not taken into account. Treas. Reg. § 1.1502-3(d)(2)(ii)(A).

In determining the SRLY limitation of a member, the activity of a successor is taken into account. Treas. Reg. §§ 1.1502-3(d)(2)(iii), -21(f)(1). Generally, for section 332 liquidations and acquisitive asset reorganizations, the corporation that received the assets in the transaction will be considered a successor to the corporation that transferred the assets. Treas. Reg. § 1.1502-1(f)(4)(i). In addition, a corporation that receives assets from another corporation in a section 351 transaction (or other transferred basis transaction) is considered a successor to the corporation that transferred the assets. Treas. Reg. § 1.1502-1(f)(4)(ii).

Section 1552. To determine a member's contribution to the consolidated section 38(c) limitation for a consolidated return year, the group must determine the member's share of one or more components of the group's federal tax liability for the year. A member's share of a component of tax liability is determined under the principles of section 1552 and the percentage method under section 1.1502-33(d)(3) of the Treasury regulations (assuming a 100% allocation of any decreased tax liability). The group takes into account in the computation, the taxes and credits that are taken into account for purposes of the allocation of the component of federal tax liability (e.g., consolidated net regular tax liability takes into account the group's regular tax liability and the consolidated foreign tax credit). Treas. Reg. § 1.1502-3(d)(2)(i).

Section 1552 provides rules for allocating the federal tax liability of a consolidated group among its members. Section 1552 provides for three different methods to perform the allocation. In addition, a consolidated group can adopt a method that differs from the three described in the statute with the approval of the IRS. IRC § 1552(a); Treas. Reg. § 1.1552-1(a).

A consolidated group must generally elect a section 1552 method on the first consolidated return year for the group. IRC § 1552(a); Treas. Reg. § 1.1552-1(c). If a group does not make a valid timely election on the first consolidated return, the method described in section 1552(a)(1) applies. IRC § 1552(b); Treas. Reg. § 1.1552-1(d). Since it is rare for a consolidated group to make an election to use an alternative method, we will only discuss the section 1552(a)(1) method.

Under the section 1552(a)(1) method, the federal tax liability of the consolidated group is allocated among the members with positive separate taxable income (with adjustments) based on each member's positive amount. As a result, a member with negative separate taxable income (as adjusted) is allocated an amount of zero. IRC § 1552(a)(1); Treas. Reg. § 1.1552-1(a)(1), (f) Ex.

The percentage method of section 1.1502-33(d)(3) is generally an elective method that is applied to adjust the results under section 1552. For purposes, of the general business credit SRLY limitation, the percentage method is applied regardless of whether the consolidated group has made the election. The percentage method allocates federal tax liability based upon current year absorption of tax attributes (e.g., NOLs).

Under the percentage method, a member's allocation of federal tax liability under section 1552 is increased by 100% of the excess of (i) the member's separate return tax liability for the consolidated return year, over (ii) the amount allocated to the member under section 1552. Treas. Reg. §§ 1.1502-3(d)(2)(i), -33(d)(3)(i). A member's separate return tax liability is the tax liability of a member computed as if it had filed a separate return for the taxable year (with adjustments). Treas. Reg. §§ 1.1502-33(d)(3)(i)(A), 1.1552-1(a)(2)(ii).

Under the percentage method, the group computes the excess described in the previous paragraph, if any, for each member. The aggregate of all of the increases to the members is then allocated to members whose tax attributes were absorbed in the taxable year and is allocated in a manner that reasonably reflects the absorption of the tax attributes. Treas. Reg. § 1.1502-33(d)(3)(ii). For example, a member with a negative separate taxable income would be allocated a portion of the excess to the extent the group offset that member's loss against profits of other members.

To illustrate the allocation of federal tax liability rules, assume that S1 had adjusted separate taxable income of \$200 million and S2 had adjusted separate taxable income of negative \$150 million. The consolidated group would have a consolidated net regular tax liability of \$10.5 million (\$50 million multiplied by 21%). The full \$10.5 million would be allocated to S1 under section 1552 (assuming that an election to use an alternative method was not made). S1's separate return tax liability would equal \$42 million (\$200 million multiplied by 21%). Under the percentage method, S1's share of the consolidated net regular tax liability would be increased to \$42 million. The excess over the section 1552 method amount would be allocated to

S2, since the group applied S2's loss against S1's profit. S2's share of the consolidated net regular tax liability would equal negative \$31.5 million (\$42 million less \$10.5 million). Treas. Reg. § 1.1502-33(d)(6) Ex. 2.

GBC Example. Assume Sub is acquired by Parent on January 1, 2011 in a transaction that does not result in a section 382 ownership change. Parent chooses to file a consolidated tax return for the 2011 taxable year and does not make a section 1552 election. Sub has an available general business tax credit carryforward to the 2011 taxable year of \$10 million which is subject to the SRLY limitation rules.

In 2011, the Parent Group has consolidated taxable income of \$200 million (and Sub contributes \$80 million to that amount). The Parent Group has consolidated alternative minimum taxable income of \$400 million (and Sub contributes \$80 million to that amount).

In 2011, the Parent Group has a consolidated net regular tax of \$70 million (\$200 million multiplied by 35%) and a consolidated tentative minimum tax of \$80 million (\$400 million multiplied by 20%). As a result, the consolidated section 38(c) limitation is determined based upon the consolidated tentative general business tax and is zero (\$80 million exceeds \$70 million). None of Sub's general business tax credit is allowed in 2011.

In 2012, the Parent Group has consolidated taxable income of \$120 million (and Sub has taxable income items of negative \$30 million). The Parent Group has consolidated alternative minimum taxable income of \$150 million (and Sub has taxable income items of negative \$20 million). It should be noted that Sub's 2012 losses were fully absorbed by other members of the group for both regular and alternative minimum tax purposes.

In 2012, the Parent Group has a consolidated net regular tax of \$42 million (\$120 million multiplied by 35%) and a consolidated tentative minimum tax of \$30 million (\$150 million multiplied by 20%). As a result, the consolidated section 38(c) limitation is determined based upon the consolidated tentative minimum tax and is \$12 million (\$42 million less \$30 million).

To determine the SRLY limitation on Sub's general business tax credit, the aggregate of Sub's contribution to the consolidated section 38(c) limitation for 2011 and 2012 must be determined. Since the consolidated section 38(c) limitation in both such years was determined based upon the consolidated minimum tax, the contribution to the consolidated section 38(c) limitation is based upon the excess of Sub's share of consolidated net income tax over Sub's share of consolidated tentative minimum tax.

In 2011, Sub's share of consolidated net income tax equals its share of the consolidated net regular tax of \$28 million (\$80 million multiplied by 35%). Sub's share of consolidated tentative minimum tax equals \$16 million (\$80 million multiplied by 20%). As a result, Sub's share of the consolidated section 38(c) limitation equals \$12 million (\$28 million less \$16 million).

In 2012, Sub's share of consolidated net income tax equals its share of the consolidated net regular tax of negative \$10.5 million (negative \$30 million multiplied by 35%). Sub's share of consolidated tentative minimum tax equals negative \$4 million (negative \$20 million multiplied by 20%). As a result, Sub's share of the consolidated section 38(c) limitation equals negative \$6.5 million (negative \$10.5 million less negative \$4 million).

Based upon the above analysis, the SRLY limitation in 2012 on Sub's general business tax credit equals \$5.5 million (\$12 million plus negative \$6.5 million). Since this amount is less than the consolidated limitation of \$12 million, the group can use \$5.5 million of Sub's \$10 million credit carryforward. Treas. Reg. § 1.1502-3(d)(5) Ex.

Minimum Tax Credit Carryforwards

Applicable regulations limit the allowability of the minimum tax credit in a carryforward to a separate return year that is a SRLY. As described in more detail in Section 1.D above, the minimum tax credit is fully refundable in 2018 or 2018 and 2019. IRC § 53(e). As a result, it is not anticipated that the SRLY rules described herein will have any practical effect after 2019.

The SRLY limitation on minimum tax credit carryforwards in a taxable year equals the aggregate of the member's contribution to the consolidated section 53(c) limitation for all consolidated return years of the consolidated group. This amount is reduced by the aggregate of the member's minimum tax credits arising and absorbed in all consolidated return years. Treas. Reg. § 1.1502-55(h)(4)(iii)(A).

The consolidated section 53(c) limitation in a consolidated taxable year equals the excess of the "modified consolidated regular tax liability" over the "consolidated tentative minimum tax." The modified consolidated regular tax liability generally equals the regular tax liability of the group before the allowance of minimum tax credits. The consolidated tentative minimum tax equals the tentative amount of tax owed by the group under alternative minimum tax rules before reduction for regular tax. IRC §§ 53(c), 55(b); Treas. Reg. § 1.1502-55(h)(4)(iii)(B)(1); Prop. Reg. § 1.1502-55(h)(5).

A member's contribution to the consolidated section 53(c) limitation equals the member's share of the modified consolidated regular tax liability, less the member's share of the consolidated tentative minimum tax. Treas. Reg. § 1.1502-55(h)(4)(iii)(B)(1). It should be noted that the applicable regulations use the term "consolidated net regular tax liability" instead of "modified consolidated regular tax liability." This reference appears to be incorrect as consolidated net regular tax liability is computed without benefit for general business credits. *See* IRC § 38(c)(1).

The member's share of consolidated tentative minimum tax in a taxable year equals the member's share of consolidated AMT for the year. The group must use the same method to allocate consolidated AMT to a member that it uses to determine the member's share of the consolidated minimum tax credit (discussed above). Treas. Reg. § 1.1502-55(h)(4)(iii)(B)(2).

The formulas described in the prior three paragraphs make liberal references to AMT concepts. The TCJA repealed the corporate AMT. However, AMT will still be relevant for determining the SRLY register for minimum tax credits to the extent that the credits are being carried forward from pre-2018 taxable years. In any case, the tentative minimum tax for a corporate taxpayer is deemed to be zero for taxable years beginning after December 31, 2017. IRC § 53(d)(2); TCJA, PL 115-97 § 12001(b)(2) (2017).

To determine a member's contribution to the consolidated section 53(c) limitation for a consolidated return year, the group must determine the member's share of one or more components of the group's federal tax liability for the year. A member's share of a component of tax liability is determined under the principles of section 1552 and the percentage method under section 1.1502-33(d)(3) of the Treasury regulations (assuming a 100% allocation of any decreased tax liability). (Section 1552 and the percentage method are discussed above with respect to the SRLY limitation on the general business credit.) The group takes into account in the computation the taxes and credits that are taken into account for purposes of the allocation of the component of federal tax liability (e.g., modified consolidated regular tax liability takes into account

the group's regular tax liability, the consolidated foreign tax credit, and the consolidated general business credit). Treas. Reg. § 1.1502-55(h)(4)(iii)(B)(1).

In determining the SRLY limitation, the member's contribution to the consolidated section 53(c) limitation for all consolidated return years of the consolidated group is reduced by the aggregate of the member's minimum tax credits arising and absorbed in all consolidated return years. The reduction is based upon the member's share of the consolidated minimum tax credit for a consolidated return year to the extent absorbed by group (even if absorbed by another member). Treas. Reg. § 1.1502-55(h)(4)(iii)(A)(2).

No guidance has been issued as to how to allocate the consolidated minimum tax credit to members. Regulations were proposed in 1992 regarding certain consolidated AMT calculations. The proposed regulations have not been finalized or withdrawn. These proposed regulations provide that the consolidated minimum tax credit is allocable to members based upon each member's share of the consolidated AMT liability for the taxable year. A member's share of the consolidated AMT liability equals the excess, if any, of the consolidated AMT for the year, over the consolidated AMT for the year (recomputed to exclude the member's taxable income items and credits). Prop. Reg. § 1.1502-55(h)(6)(iii)(A), (iv). Since final or temporary regulations have not been issued, it appears that taxpayers can use any reasonable method to allocate minimum tax credits to members. The preamble to the proposed regulations describe other approaches that were considered by the drafters of the proposed regulations. IA-57-89, 1993-1 CB 799. It is possible that one or more of these approaches may be reasonable.

In determining the SRLY limitation, consolidated return years are taken into account only for the period the member has been continuously included in the consolidated group's consolidated return. The consolidated return year to which the minimum tax credit is carried is taken into account. However, consolidated return years after the year to which the minimum tax credit is carried are not taken into account. Treas. Reg. § 1.1502-55(h)(4)(iii)(B)(3). Under a rule to transition from the old SRLY regime to the present one, the group does not take into account consolidated return years for which the due date (without extensions) is on or before March 13, 1998. Treas. Reg. § 1.1502-55(h)(4)(iii)(C)(1)(i).

In determining the SRLY limitation of a member, the activity of a successor is taken into account. Treas. Reg. §§ 1.1502-55(h)(4)(iii)(B)(4), -21(f)(1). Generally, for section 332 liquidations and acquisitive asset reorganizations, the corporation that received the assets in the transaction will be considered a successor to the corporation that transferred the assets. Treas. Reg. § 1.1502-1(f)(4)(i). In addition, a corporation that receives assets from another corporation in a section 351 transaction (or other transferred basis transaction) is considered a successor to the corporation that transferred the assets. Treas. Reg. § 1.1502-1(f)(4)(ii).

G. Limitation on Carrybacks

In this subsection, we will discuss the determination of the SRLY limitation on NOL, capital loss, and general business credit carrybacks. The SRLY limitation on carrybacks will generally arise if a member leaves the consolidated group and carries back a separate tax attribute to a consolidated taxable year.

The SRLY limitation on carrybacks is computed similarly to the computation of the limitation for carryforwards. Thus, the SRLY limitation generally equals the member's aggregate contribution to consolidated taxable income (in the case of NOL carrybacks), consolidated capital gain net income (in the case of capital loss carrybacks), or the consolidated section 38(c) limitation (in the case of general business credit carrybacks). Treas. Reg. §§ 1.1502-21(c)(1)(i) (NOLs), -22(c) (capital losses), -3(c)(2) (general business credits).

In determining the SRLY register for carryback purposes, consolidated return years are taken into account only for the period the member has been continuously included in the consolidated group's consolidated return. The consolidated return year to which the loss or credit is carried is taken into account. Treas. Reg. § 1.1502-21(c)(1)(i)(C). However, consolidated return years ending after the year to which the loss or credit arose are not taken into account. Treas. Reg. §§ 1.1502-21(c)(1)(i)(C)(2) (NOLs), -22(c) (capital losses), -3(c)(2)(ii)(B) (general business credits).

SRLY Example. Sub has been a member of the Parent Group since 2017. In 2017, the Parent Group has consolidated taxable income (before NOL deductions) of \$150 million (and Sub contributes \$30 million to that amount). In 2018, the Parent Group has consolidated taxable income (before NOL deductions) of \$90 million (and Sub contributes \$10 million to that amount). In 2019, the Parent Group has consolidated taxable income (before NOL deductions) of \$60 million (and Sub has deductions in excess of gross income of \$50 million).

On December 31, 2019, Parent sells all of the stock of Sub to a partnership and Sub leaves the Parent Group. Sub files a separate tax return in 2020 and reports an NOL of \$30 million.

Sub is permitted to carry back a 2020 NOL for five taxable years. Without the existence of the SRLY rules, Sub would have been permitted to carryback the \$30 million NOL in full.

The SRLY register in 2020 equals negative \$10 million (the sum of \$30 million and \$10 million, less \$50 million). As a result, the SRLY limitation equals zero. Sub is not able to carry back the NOL. Instead, Sub carries the NOL forward. Treas. Reg. § 1.1502-21(c)(1)(iii)(C).

H. Subgroup Rules.

The SRLY limitation rules generally apply to each member on a separate company basis. However, if a SRLY subgroup exists the SRLY limitation rules apply to the subgroup and not separately to the members. Treas. Reg. §§ 1.1502-15(c)(1) (built-in losses), -21(c)(2) (NOLs).

The rules with respect to SRLY subgroups are spelled out in detail with respect to NOLs. Treas. Reg. § 1.1502-21(c)(2). The same rules apply to other carrybacks and carryforwards subject to the SRLY limitation rules under the principles that apply to NOLs. Treas. Reg. §§ 1.163(j)-5(d)(1)(B) (disallowed business interest), 1.1502-3(d)(2)(iii) (general business credits), -22(c) (capital losses), -55(h)(4)(iii)(B)(4) (minimum tax credits) The subgroup rules that apply to built-in losses differ from the rules that apply to NOLs.

The SRLY subgroup provisions provide rules to determine the makeup of a SRLY subgroup, as well as the application of the limitation rules and the section 382 overlap exception to a SRLY subgroups.

Carryforwards and Carrybacks

In the case of an NOL (or other) carryforward or carryback, the SRLY limitation rules apply on a subgroup basis if a subgroup (a "SRLY subgroup") exists. In such case, the rules are not applied separately to the members. Treas. Reg. § 1.1502-21(c)(2). (viii)(B)..

In the case of a carryforward, a SRLY subgroup consists of the members (the "loss members") carrying over the loss or credit and each other member that was a member of the former group that becomes a member of the new consolidated group at the same time as the loss members. Treas. Reg. § 1.1502-

21(c)(2)(i). This definition is similar to the definition of NOL subgroup for section 382 purposes except there is no requirement to have a subgroup parent.

A separate SRLY subgroup is determined for each carryforward. As a result, a consolidated group may include more than one SRLY subgroup. Treas. Reg. § 1.1502-21(c)(2). It is possible for a member of the consolidated group to be a member of more than one subgroup. Treas. Reg. § 1.1502-21(c)(2)(viii)(C).

A member remains a member of a SRLY subgroup with respect to a carryforward until it ceases to be affiliated with a loss member. Treas. Reg. § 1.1502-21(c)(2)(i), (viii)(D). If a loss member ceases to be affiliated with a SRLY subgroup, the remaining SRLY loss is allocated to the loss member under the rules that apply to the allocation of a consolidated NOL to a member that leaves a consolidated group. Treas. Reg. § 1.1502-21(c)(2)(vii).

In the case of a carryback, a SRLY subgroup consists of the member (the “loss member”) carrying back the loss or credit and each other member that was continuously affiliated with the loss member from the year in which the loss is carried through the year in which the loss arose. Treas. Reg. § 1.1502-21(c)(2)(ii). If multiple members of a group carry back an attribute, the members of the SRLY subgroup can be different with respect to each loss member. Similarly, the members of the SRLY subgroup can be different if a loss member carried back an attribute that arose in different taxable years.

A SRLY subgroup may exist only for a carryforward or carryback that arose in a taxable year that was not a SRLY with respect to the former affiliated group (whether or not the group was a consolidated group). A SRLY subgroup can also exist for a carryforward that was subject to the overlap exception with respect to the former group. Treas. Reg. § 1.1502-21(c)(2). For example, if the Parent acquired Target and later Holdco acquires Parent, the subgroup rule could apply to Parent and its subsidiaries since Parent NOLs did not arise in a SRLY with respect to the former Parent affiliated group. Treas. Reg. § 1.1502-21(c)(2)(viii)(A)(3), (B)(2). The subgroup rule could apply to Target and its subsidiaries with respect to the Holdco consolidated group if the overlap exception applied to Parent’s acquisition of Target. Treas. Reg. § 1.1502-21(c)(2)(viii)(A)(6), (7).

A SRLY subgroup is deemed not to exist if any one of the purported members is “formed, acquired, or availed of with a principal purpose of avoiding the application of, or increasing any limitation, under” the SRLY limitation rules. If an attempt is made to exclude a member from a subgroup “with a principal purpose” of avoiding the application of, or increasing any limitation under the SRLY limitation rules, then the member is included in the subgroup. Treas. Reg. § 1.1502-21(c)(2)(iv).

In determining the members of a SRLY subgroup, a successor of a member is treated as a member of the subgroup. Treas. Reg. § 1.1502-21(f)(1). Generally, for section 332 liquidations and acquisitive asset reorganizations, the corporation that received the assets in the transaction will be considered a successor to the corporation that transferred the assets. Treas. Reg. § 1.1502-1(f)(4)(i); PLR 201003012 (Sept. 25, 2009) (type F reorganization). In addition, a corporation that receives assets from another corporation in a section 351 transaction (or other transferred basis transaction) is considered a successor to the corporation that transferred the assets. Treas. Reg. §§ 1.1502-1(f)(4)(ii).

If a SRLY subgroup exists, the SRLY limitation is computed on a subgroup basis. With respect to an NOL carryforward or carryback, the SRLY register takes into account all of the taxable income items of the members of the subgroup. The NOL carryforwards that are subject to the limit are determined based on the aggregate NOL carryforwards of each loss member of the subgroup. Treas. Reg. § 1.1502-21(c)(2)(i), (viii)(B). Similar concepts apply to other loss and credit carryforwards. Treas. Reg. §§ 1.1502-3(d)(2)(iii) (general business credits), -22(c) (capital losses), -55(h)(4)(iii)(B)(4) (minimum tax credits). If a member

of the subgroup ceases to be a member, the departing member's taxable income items for the period it was a member continue to be taken into account. Treas. Reg. § 1.1502-21(c)(2)(viii)(D).

If a successor becomes a member of a SRLY subgroup, there is a limitation on the taxable income items of the successor that can be taken into account in determining the SRLY register of the SRLY subgroup. Any net positive income of the successor is excluded from the SRLY register. Net positive income equals the excess of items of income and gain over items of deductions and loss. Treas. Reg. § 1.1502-21(f)(2)(i). The regulations are unclear as to whether net positive income is computed year-by-year or cumulatively. Applying the limitation on a cumulative basis would be the more appropriate methodology.

The regulations provide for several exceptions to the net positive income limitation. The limit does not apply if the successor acquires substantially all of the assets and liabilities of a member of the subgroup and the member ceases to exist (e.g., a merger or liquidation). Treas. Reg. § 1.1502-21(f)(2)(ii)(A).

The net positive income limitation also does not apply if the successor was a member of the SRLY subgroup when the members of the subgroup became members of the group. Treas. Reg. § 1.1502-21(f)(2)(ii)(B). This exception can apply to a section 351 transfer from a member of a subgroup to another corporation if both transferor and transferee later join a new consolidated group. Treas. Reg. § 1.1502-21(c)(2)(viii)(A)(7).

There is also an exception to the net positive income limitation that applies if a successor is a subsidiary of one or more members of the SRLY subgroup. This exception applies if corporations that were members of the SRLY subgroup when the members joined the consolidated group own 100% of the stock of the successor. Treas. Reg. § 1.1502-21(c)(2)(viii)(A)(6), (7), (f)(2)(ii)(C). It appears that this exception applies for the period in which the 100% ownership requirement is met.

The regulations have given the IRS the authority to exempt other transactions from the net positive income limitation. Treas. Reg. § 1.1502-21(f)(2)(ii)(D). The IRS granted an exemption where the assets were contributed to a subsidiary for the purpose of obtaining a regulator's approval of a larger restructuring. PLR 201342004 (July 15, 2013).

The net positive income limit rules described above also apply to other carryforwards subject to the SRLY limitation rules under the principles that apply to NOLs, with appropriate adjustments. Treas. Reg. §§ 1.1502-3(d)(2)(iii) (general business credits), -22(f) (capital losses), -55(h)(4)(iii)(B)(4) (minimum tax credits).

As noted, it is possible for a corporation to be a member of more than one SRLY subgroup. For example, if Parent acquired Target and later Holdco acquires Parent, the members of the Target affiliated group could consist of one subgroup (with respect to Target NOLs) and also belong to a subgroup with Parent (with respect to Parent NOLs). Treas. Reg. § 1.1502-21(c)(viii)(C).

Where a member of a group is a member of a more than one subgroup, taxable income items are taken into account only once under an anti-duplication rule. In determining which subgroup should take into account a successor's taxable income items, the rules are applied in a manner that causes losses to be absorbed in accordance with the relevant ordering rules (generally, earliest NOLs first) and the underlying purposes of section 1.1502-21 (consolidated NOL deduction) of the Treasury regulations. Treas. Reg. § 1.1502-21(c)(2)(vi).

Example 3 of section 1.1502-21(c)(2)(viii) of the Treasury regulations describes a situation in which a corporation is a member of two subgroups. The corporation was a member of a consolidated group, then

became a member of a second consolidated group, and then became a member of a third consolidated group. The former members of the first consolidated groups and the former members of the second consolidated group each became a SRLY subgroup when they joined the third group. The corporation was a member of both such subgroups. The earliest NOLs available were the NOLs of the first subgroup. In computing the SRLY subgroup limitation with respect to the first subgroup's NOLs, the corporation's taxable income items are taken into account. The next NOLs available are the NOLs of the second subgroup. The regulations state that in computing the SRLY subgroup limitation for the second subgroup, the corporation's taxable income items are taken into account again (but offset by any NOL allowed with respect to the earlier NOL of the other subgroup). Treas. Reg. § 1.1502-21(c)(2)(viii)(C)(3).

It should be noted that the corporation's taxable income in example 3 is being taken into account with respect to two different SRLY subgroups. This appears to contradict the anti-duplication rule's statement that the item can only be taken into account only once. However, the methodology of the example comes to an appropriate resolution since the income is not used multiple times to aid in the absorption of NOLs.

Under the successor rules, it also is possible for a corporation to be a member of more than one SRLY subgroup. For example, if members of two different SRLY subgroups merge with a corporation in a corporate reorganization, the surviving corporation would be a member of both subgroups.

There is uncertainty as to how to apply to apply the anti-duplication rule where the NOLs of multiple subgroups are carried from the same taxable year. Some taxpayers apply the taxable income items in a manner that maximizes the absorption of NOLs (maximum usage approach). Other taxpayers allocate the taxable income items between the two subgroups based on relative size of NOLs from a given taxable year (allocation approach). A third approach would be to apply the taxable income items multiple times and reverse out items once they result in absorption of an NOL (duplication approach). The duplication approach seems to comport the closest to Example 3. *See* Treas. Reg. § 1.1502-21(c)(2)(viii)(C).

The regulations caution that the SRLY subgroup rules do not permit an NOL deduction in excess of other limitations and restrictions, such as "a limitation based upon the nature or activities of members." Treas. Reg. § 1.1502-21(c)(2)(v). For example, the amount of allowed NOL deduction could also be limited by the dual consolidated loss rules of section 1503(d) or the life-nonlife group rules of section 1.1502-47 of the Treasury regulations. Both of these limitation rules apply SRLY concepts.

Built-in Losses

In the case of a built-in loss, the SRLY limitation rules apply on a subgroup basis if a subgroup exists (a "built-in loss subgroup"). In such case, the rules are not applied separately to the members. Treas. Reg. § 1.1502-15(c)(1).

A built-in loss subgroup consists of the members that became members of the new consolidated group that had been continuously affiliated with each other for the sixty consecutive month period ending immediately before they became members of the group. Treas. Reg. § 1.1502-15(c)(2), (d), Ex. 3(ii). This definition is similar to the definition of NUBIL subgroup for section 382 purposes except there is no requirement to have a subgroup parent. There also does not appear to be a requirement that a built-in loss subgroup have a subgroup NUBIL to be treated as a subgroup. *See* Treas. Reg. § 1.1502-15(d) Ex. 3(ii) (separately computed NUBIGs and NUBILs of members of a subgroup "are aggregated for purposes of determining whether . . . any unrealized loss is treated as a built-in loss").

Certain members are deemed to meet the sixty-month affiliation requirement if the member had an ownership change within six months (before or after) of becoming a member of a prior consolidated group

and, as a result, the overlap exception applied. In such case, the member is treated as having been affiliated with the common parent of the group for sixty months. Treas. Reg. § 1.1502-15(c)(3). For example, if Sub joins the M consolidated group and has an ownership change upon joining the M consolidated group, Sub will be treated as affiliated with M for sixty months for built-in loss subgroup purposes if M and Sub become members of a new consolidated group three years later. In the case of a transaction in which a consolidated group is treated as continuing under either the downstream transaction rule or the reverse acquisition rule, the former common parent is treated as a predecessor of the new common parent in determining whether the sixty-month requirement is deemed to be met. Treas. Reg. §§ 1.1502-15(c)(3), -96(a)(2)(iii).

A member that is deemed to be affiliated with a common parent for sixty months under the rule described in the previous paragraph is also deemed to be affiliated with any other members who were affiliated with the common parent (or deemed to be affiliated with the parent) at that time. The member is deemed to be affiliated with other members for the same period of time each member is treated as affiliated with the common parent. Treas. Reg. § 1.1502-15(c)(3).

If two or more corporations become members of a consolidated group at the same time but one or more members are not deemed to meet the sixty-month affiliation requirement (e.g., the overlap rule did not apply when the member joined the prior consolidated group), then the corporations that are deemed to meet the sixty-month affiliation requirement are not treated as having been previously affiliated with the corporation that did not meet the requirement. Treas. Reg. § 1.1502-15(c)(3). For example, if S1 and S2 join the M consolidated group and S1 has an ownership change upon joining the M consolidated group (but S2 does not have an ownership change within six months), S1 and S2 will not be treated as affiliated with each other for sixty months for built-in loss subgroup purposes if S1 and S2 become members of a new consolidated group three years later.

A built-in loss subgroup is deemed not to exist if any one of the purported members is “formed, acquired, or availed of with a principal purpose of avoiding the application of, or increasing any limitation, under” the SRLY limitation rules. If an attempt is made to exclude a member from a subgroup “with a principal purpose” of avoiding the application of, or increasing any limitation under the SRLY limitation rules, then the member is included in the subgroup. Treas. Reg. §§ 1.1502-15(c)(2), -21(c)(2)(iv).

A member remains a member of a built-in loss subgroup until it ceases to be affiliated with a loss member. Treas. Reg. § 1.1502-15(c)(2). The regulations are silent as to the treatment of a member that ceases to be a member of a built-in loss subgroup. Since the NUBIL does not serve as a limitation on the amount of RBILs taken into account under the SRLY rules there is no need for rules to allocate the subgroup NUBIL among members.

In determining the members of a built-in loss subgroup, a successor of a member is treated as a member of the group. Similarly, it appears that for purposes of determining whether the sixty-month continuous affiliation requirement is met, any successor corporation and predecessor corporation are treated as a single corporation. Treas. Reg. §§ 1.1502-15(e), -21(f)(1). Generally, for section 332 liquidations and acquisitive asset reorganizations, the corporation that received the assets in the transaction will be considered a successor to the corporation that transferred the assets. Treas. Reg. § 1.1502-1(f)(4)(i). In addition, a corporation that receives assets from another corporation in a section 351 transaction (or other transferred basis transaction) is considered a successor to the corporation that transferred the assets. Treas. Reg. §§ 1.1502-1(f)(4)(ii), -21(c)(2)(viii)(A)(6), (7).

It is possible for a corporation to be a member of more than one built-in loss subgroup. In such case, the principles of the anti-duplication rule described above with respect to SRLY subgroups apply. Treas. Reg. §§ 1.1502-15(c)(2), -21(c)(2)(vi). Similarly, the principles described above with respect to the coordination

of the SRLY subgroup rules and other limitations also apply for purposes of built-in loss subgroups. Treas. Reg. §§ 1.1502-15(c)(2), -21(c)(2)(v).

The amount of a NUBIL for a built-in loss subgroup is generally determined on a subgroup basis. The amount of the subgroup NUBIL is determined by adding the total amount of separately-computed NUBIGs or NUBILs for each member of the subgroup that is taken into account. The threshold requirement (i.e., lesser of \$10 million or 15% of gross assets) applies on a subgroup basis and not separately to each member. Treas. Reg. §§ 1.1502-15(c)(1), (4), (d) Ex. 3, -91(g)(1).

A member's separately computed NUBIG or NUBIL is generally computed without reference to UBIGs or UBILs with respect to stock or debt obligations issued by another member of the subgroup. However, UBIGs and UBILs with respect to stock or debt obligations issued by a member of the consolidated group (who is not a member of the subgroup) is generally taken into account. Treas. Reg. §§ 1.1502-15(c)(4), (d) Ex. 3(iii), -91(g)(1).

A member's separate NUBIG or NUBIL is adjusted, as necessary, to prevent duplication of unrealized gain or loss attributable to a member's indirect ownership interest in another member through a nonmember of the subgroup. This could occur, for example, if a member indirectly owned 100% of another member through a corporation that is not a member of the built-in loss subgroup due to the sixty month affiliation requirement. An adjustment is only made if the member has a 5% or greater ownership interest in the nonmember. Treas. Reg. §§ 1.1502-15(c)(4), -91(g)(5). A further adjustment is required to a member's separate NUBIG or NUBIL to exclude an UBIG or UBIL with respect to assets acquired with a principal purpose to affect the amount of the separate NUBIG or NUBIL. Treas. Reg. §§ 1.1502-15(c)(4), -91(g)(4).

The amount of the RBILs for a built-in loss subgroup is generally determined on a subgroup basis. This equals the aggregate RBILs of all of the members of the subgroup. Treas. Reg. § 1.1502-15(c)(1), (d) Ex. 3(iv).

Recognized loss on the disposition of stock of another member is generally treated as an RBIL (to the extent the other requirements are met). A loss is treated as an RBIL even though UBIG or UBIL with respect to the stock was not taken into account in determining subgroup NUBIL. Treas. Reg. §§ 1.1502-15(c)(4), (d) Ex. 3(iii), -91(h)(2).

Recognized loss on the disposition of an intercompany obligation (a debt or other financial obligation of another member of the subgroup) is not generally treated as an RBIL. However, it is treated as an RBIL to the extent the transaction results in aggregate income or loss (on a consolidated basis). Treas. Reg. §§ 1.1502-15(c)(4), -91(h)(2).

If a loss is deferred (for example under section 267 or section 1.1502-13 of the Treasury regulations) by a member of the subgroup, the loss is not treated as an RBIL except to the extent taken into account by the consolidated group during the recognition period. Treas. Reg. §§ 1.1502-15(c)(4), -91(h)(3).

If the built-in loss SRLY limitation rules apply to a built-in loss subgroup, the SRLY register is computed by taking into account the taxable income items of each member of the subgroup. Treas. Reg. § 1.1502-21(c)(2)(i), (iii).

Built-in losses of a built-in loss subgroup are generally subject to the SRLY limitations that apply to NOL carryforwards (in the case of ordinary losses and deductions) or capital loss carryforwards (in the case of capital losses), as the case may be. For this purpose, a built-in loss is treated as either a hypothetical NOL or capital loss carryforward (depending upon the character) arising in a SRLY.

Built-in losses are generally treated as deductions or losses in the year recognized to the extent allowed by the SRLY limitation rules. The amount allowed offsets any consolidated taxable income for the taxable year before any loss carryforwards or carrybacks. Treas. Reg. §§ 1.1502-15(a), (d) Ex. 4, -21(c)(1)(i)(D), (iii)(D), -22(c).

To the extent a built-in loss is disallowed under the SRLY limitation rules, it is treated as a separate NOL or net capital loss carryforward or carryback arising in the year of recognition. The year of recognition is treated as a SRLY. Treas. Reg. §§ 1.1502-15(a), -21(c)(1)(ii), -22(c). As a result, the amount carried forward remains subject to the SRLY limitation rules.

Based upon the above-described rules, the built-in losses of a built-in loss subgroup are limited under the SRLY limitation rules that apply to NOLs and capital losses. Since a built-in loss subgroup excludes corporations that do not meet the sixty-month requirement, the composition of a SRLY subgroup and a built-in loss subgroup can differ. The regulations are silent as to how to apply the limitation rules on a subgroup basis when the composition of the subgroups differ. It appears that the limitation rules would be applied first to the current year built-in loss (based on the ordering rules) based upon a limit computed with respect to the members of the built-in loss subgroup and then to NOL or capital loss carryforwards based upon a limit computed with respect to the members of the SRLY subgroup. The concepts described in example 3 of section 1.1502-21(c)(2)(viii) of the Treasury regulations appear helpful in dealing with applying the rules to subgroups with different members.

Overlap Exception

As discussed in more detail above, the SRLY limitation rules do not apply if there is an overlap with the section 382 limitation rules. Generally, the overlap exception applies if a new member of the consolidated group undergoes an ownership change within six months of joining the group.

The SRLY regulations provide rules for determining the applicability of the overlap exception to a SRLY subgroup. Generally, if there is an NOL (or other) carryforward for which there is both a SRLY subgroup and an NOL subgroup (for section 382 purposes), the overlap exception applies to the SRLY subgroup and not separately to the members of the subgroup. Treas. Reg. § 1.1502-21(g)(4). However, the overlap exception only applies to the SRLY subgroup if all of the members of the SRLY subgroup with respect to the carryforward are also members of the NOL subgroup and all members of the NOL subgroup are also members of the SRLY subgroup. Treas. Reg. § 1.1502-21(g)(4)(i). Essentially, the overlap exception only applies to the extent both subgroups have the exact same members (i.e., coextensive subgroups). Treas. Reg. § 1.1502-21(g)(5)(v), (vi).

The key difference between the definitions of SRLY and NOL subgroups, is that the SRLY subgroup definition does not require a subgroup parent. Where the acquiring group makes an election to waive the subgroup parent requirement for NOL subgroup purposes, the SRLY and NOL subgroups will generally be coextensive and the overlap exception will generally apply to the SRLY subgroup. However, if the subgroup parent waiver election is not made and there is no subgroup parent, the benefits of the overlap exception appear to be lost. This may be a trap for the unwary as many taxpayers are not aware of the consequences of not making this election.

To illustrate the concepts of the above, assume that P, the common parent of a consolidated group, owns S and T, members of the P consolidated group. The P consolidated group has a consolidated NOL, some of which is allocable to both S and T. X, the common parent of a consolidated group, purchases both S and T from P. If X makes an election to waive the subgroup parent requirement, both S and T will be “coextensive” members of a SRLY and an NOL subgroup and the overlap exception applies. If the election

is not made, S and T would not be members of an NOL subgroup and the overlap exception does not apply to either member. In such case, section 382 applies to S and T separately and the SRLY limitation rules apply to S and T on a subgroup basis. Treas. Reg. § 1.1502-21(g)(5)(vi).

The SRLY regulations provide rules for determining the applicability of the overlap exception to a built-in loss subgroup. Generally, if there is a built-in loss for which there is both a built-in loss subgroup and a NUBIL subgroup (for section 382 purposes), the overlap exception applies to the built-in loss subgroup and not separately to the members of the subgroup. Treas. Reg. § 1.1502-15(g)(4). Similar to the application of the overlap exception for SRLY subgroups, the overlap exception only applies to the built-in loss subgroup if the built-in loss and NUBIL subgroups are co-extensive. Treas. Reg. § 1.1502-15(g)(4)(i), (ii).

The key difference between the definitions of built-in loss and NUBIL subgroups, is that the built-in loss subgroup definition does not require a subgroup parent. As with respect to the application of the overlap exception for SRLY subgroups, this represents a trap for the unwary for those taxpayers that do not make an election to waive the subgroup parent requirement.

XI. Definitions & Acronyms

The following definitions and acronyms are used in this paper.

5% owner	An individual that has a 5% or greater direct ownership interest in a first tier or a higher tier entity (at any time during the testing period).
5% shareholder	An individual with a direct ownership interest or indirect ownership interest in the loss corporation of 5% or greater or a public group.
AMT	Alternative Minimum Tax.
Amended segregation rules	Treas. Reg. § 1.382-3(j).
Bankruptcy case	Title 11 or similar case.
Bankruptcy Code	United States Bankruptcy Code, as amended, 11 USC.
Base annual section 382 limitation	Annual incremental section 382 limitation (before adjustments).
BEAT	Base erosion and anti-abuse tax.
Blue Book	Joint Committee on Taxation's explanation of the Tax Reform Act of 1986, JCS-11-87 (May 4, 1987).
Built-in deduction item	Deduction that is allowable during the recognition period but that is attributable to the pre-change period.
Built-in income item	Income that is properly taken into account during the recognition period but that is attributable to the pre-change period.

CARES Act	Coronavirus Aid, Relief, and Economic Security Act, PL 116-136 (2020).
Change date	A testing date on which an ownership change occurs.
Change year	A taxable year in which an ownership change occurs.
COBE	Continuity of business enterprise.
COD	Cancellation of debt.
Code	Internal Revenue Code of 1986, as amended.
Cumulative owner shift	Sum of increases in ownership by all 5% shareholders over the testing period.
Direct ownership interest	An equity interest in an entity (including a loss corporation) without regard to constructive ownership rules.
Equity structure shift	An acquisitive reorganization (other than a type F reincorporation) or recapitalization.
First tier entity	An entity that has a 5% or greater direct ownership interest in the loss corporation (at any time during the testing period).
Higher tier entity	An entity that has a 5% or greater direct ownership interest in a first tier or other higher tier entity (at any time during the testing period).
Highest tier entity	A first tier or higher tier entity that is not owned by a higher tier entity (at any time during the testing period).
Indirect ownership interest	An equity interest in an entity (including a loss corporation) determined solely as a result of constructive ownership rules and without regard to any direct ownership interest.
IRS	Internal Revenue Service.
Loss corporation	Corporation with a pre-change loss.
Loss group	A consolidated group with a pre-change consolidated attribute.
New loss corporation	A loss corporation (including a successor corporation) that exists after an ownership change.
Next lower tier entity	An entity (including the loss corporation) in which a first tier or higher tier entity has a direct ownership interest of 5% or more (at any time during the testing period).
NOL	Net operating loss.
NOL subgroup	A subgroup of corporations with an NOL that is a pre-change subgroup attribute.

NUBIG	Net unrealized built-in gain.
NUBIL	Net unrealized built-in loss.
NUBIL subgroup	A subgroup of corporations with a NUBIL that is a pre-change subgroup attribute.
Old loss corporation	A loss corporation as it existed before an ownership change.
Owner shift	Any event that causes a change in a 5% shareholder's percentage ownership interest.
Ownership change	A cumulative owner shift of greater than 50% over the testing period.
Percentage ownership interest	The percentage of stock of the loss corporation owned by a 5% shareholder (by value) taking into account both direct ownership interests and indirect ownership interests.
Post-change period	The period in a change year that includes a change date beginning on the day after the change date.
Post-change year	Any taxable year ending after the change date.
Pre-change consolidated attribute	A tax attribute available to a consolidated group that is potentially subject to limitation under section 382.
Pre-change credits	A tax credit that is potentially subject to limitation under section 383.
Pre-change loss	A tax attribute that is potentially subject to limitation under either section 382 or 383.
Pre-change subgroup attribute	An NOL or NUBIL available to a subgroup of corporations that is potentially subject to limitation under section 382.
Pre-change period	The period in a taxable year that includes a change date ending on the change date.
Proposed section 382(h) regulations	Prop. Reg. §§ 1.382-1, -2, -7.
Public group	A group of persons that have a less than 5% interest in the loss corporation (directly, or indirectly by attribution) that is treated, collectively, as a 5% shareholder.
Public owner	Any person that has a direct ownership interest in a first tier or higher tier entity of less than 5% (at all times during the testing period).
Public shareholder	Any person with a direct ownership interest in the loss corporation of less than 5% (at all times during the testing period).
Pure preferred stock	Stock described in section 1504(a)(4) .

RBIG	Recognized built-in gain.
RBIL	Recognized built-in loss.
Recognition period	The five-year period beginning on the change date.
Recognition period taxable year	A taxable year a portion of which is in the recognition period.
SEC	The Securities & Exchange Commission
Section 382 limitation	Limitation on use of losses and deductions after an ownership change.
Section 383 credit limitation	Limitation on use of credits after an ownership change.
Shift	An equity structure shift or owner shift (or both).
SRLY	Separate return limitation year.
TCJA	The so-called Tax Cuts and Jobs Act, PL 115-97 (2017).
Testing date	A date on which a loss corporation is required to determine if an ownership change occurred.
Testing period	The period over which the cumulative owner shifts are determined.
UBIG	Unrealized built-in gain.
UBIL	Unrealized built-in loss.

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