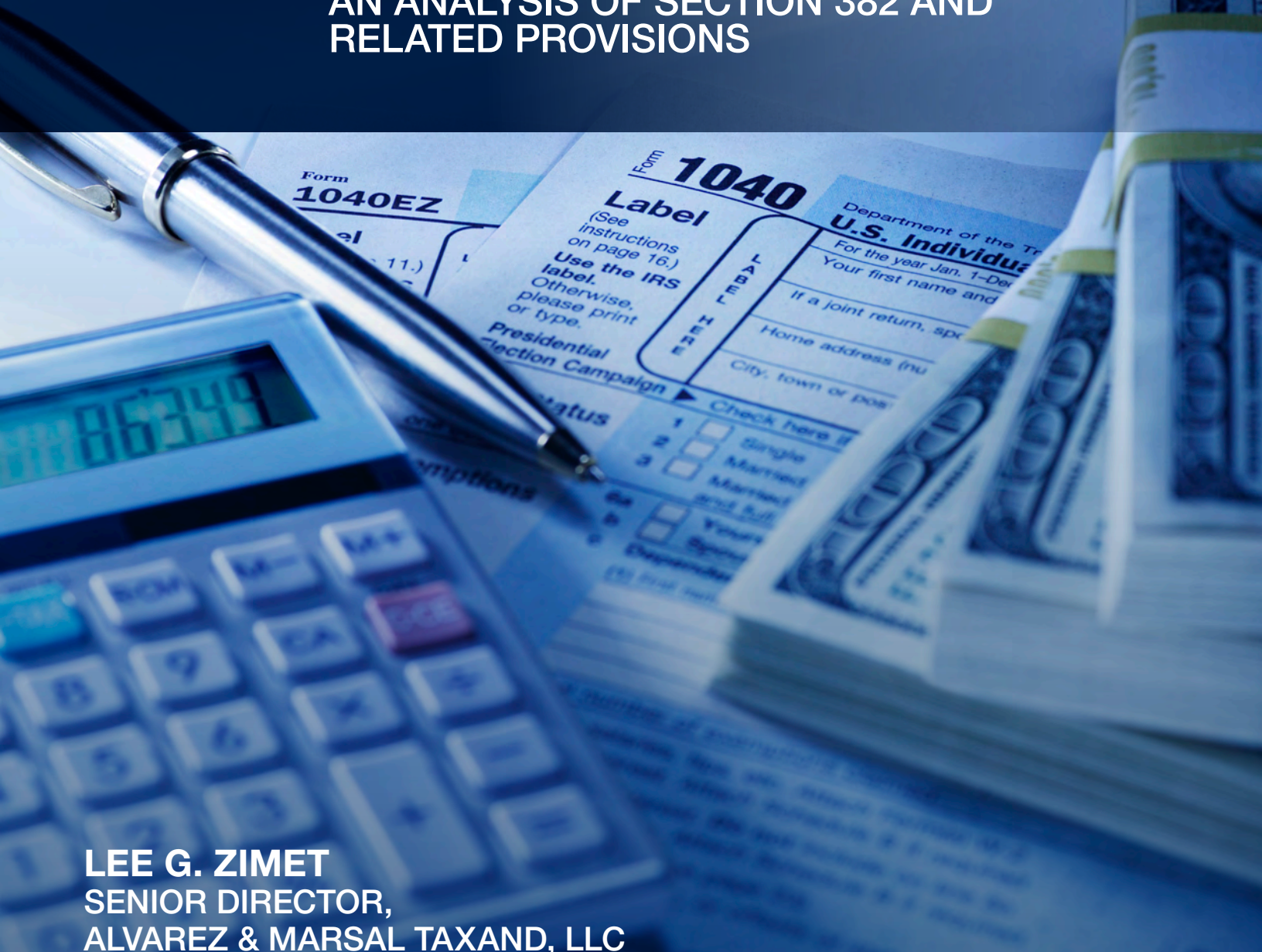




ALVAREZ & MARSAL TAXAND

# LIMITATIONS ON CORPORATE TAX ATTRIBUTES

## AN ANALYSIS OF SECTION 382 AND RELATED PROVISIONS



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## I. Introduction

As a result of the recent economic recession, many corporations found themselves with unprecedented losses from investments and operations. These losses can result in the creation of tax attributes for the corporation that can be used as deductions against 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 (carryforward and built-in items) by corporations. The bulk of the paper discusses the limitation rules of section 382, 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 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 times the long-term tax-exempt rate, a rate published monthly by the Internal Revenue Service (the "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 original version of section 382 was enacted in 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. 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 limit set of taxpayers.

The Congress became concerned that the pre-1986 version 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 (as amended, the "Code") 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, the 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.

The legislative and regulatory rules and IRS guidance described below have varying effective dates. The paper generally discusses the rules that apply to 2016 and later 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, 2000 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 concern 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 (almost thirty years after the enactment) is the legislative history.

Section X of this paper describes the separate return limitation year (“SRLY”) limitation rules contained within the consolidated return regulations. This provision 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.

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. Commissioner*, 531 US 206 (2001) (contradictory legislative history not referred to in majority opinion). In this paper, we have not attempted to give a view as to where we think the language in the Blue Book is a reliable guide and where it is not.

The TCJA. On December 22, 2017, the 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 (the “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).

The tax rate was changed from a graduated rate with a maximum 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 carryforward rules. Post-2017 NOLs can now be carried forward indefinitely (instead of a 20 year carryforward) but can 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 the Congress intended.

General Tax Attribute Rules. In order to help the reader better understand the tax attribute limitation rules, a brief overview of the corporate tax treatment of NOLs and other tax attributes follows.

Generally, corporations are liable for U.S. 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). A corporation’s taxable income generally equals gross income reduced by exemptions, deductions, and other allowances. IRC § 63(a). 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).

Certain large corporate taxpayers can be subject to the base erosion and anti-abuse tax (BEAT) of section 59A. This section provides for an alternative corporate tax with a higher base (disallowance of base erosion deductions) and a lower rate. The rate is 5% in 2018, 10% from 2019 to 2025, and 12.5% thereafter). Banks and registered securities dealers bear a rate of tax that is 1% higher. IRC § 59(a), (b).

The BEAT only applies to corporations with average annual gross receipts (for the prior three taxable years) of at least \$500 million. There is an exemption for (i) regulated investment companies (RICs) (i.e., mutual funds), (ii) real estate investment trusts (REITs), and (iii) S corporations. There is also an exemption for corporations whose base erosion payments are considered to be de minimis (i.e., 3% of total deductions for the taxable year). IRC § 59A(c)(4), (e)(1).

For pre-2018 taxable years, the 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).

The tentative minimum tax is generally computed based upon a corporation’s alternative minimum taxable income and is determined at a 20% rate. The 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. If a corporation’s tentative minimum tax exceeds the regular tax, the taxpayer owes an alternative minimum tax (“AMT”) equal to the excess. IRC § 55(a) (before amendment

by the TCJA). The regular tax liability always equals the amount of regular tax owed. Essentially, this mechanism causes a corporation to owe the greater of the regular tax, or the tentative minimum tax, as described above.

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 and tentative minimum tax rates 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 could end up with a regular tax rate as high as approximately 28% (or 10% for purposes of the tentative minimum tax) for the taxable year ending on June 30, 2018.

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). For AMT purposes (as in effect before 2018), the corporate NOL generally equals any negative amount of alternative minimum taxable income. IRC § 55(d)(2)(A).

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 manufacturing deduction under section 199 (with respect to pre-2018 taxable years), and (iii) the foreign-derived intangibles income (FDII) deduction (with respect to post-2017 taxable years). 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.

If a corporation has an NOL in a post-2017 taxable year, the NOL cannot generally be carried back. Instead, the NOL can be carried forward indefinitely. IRC § 172(b)(1)(A) (as amended by the TCJA). The NOL is deductible in the taxable year to which it is carried to. IRC § 172(a), (b)(2) (as amended by the TCJA). The NOL deduction cannot offset more than 80% of the corporation's taxable income (before NOL deduction). IRC § 172(a)(2) (as amended by the TCJA). This rule essentially results in a 4.2% "toll charge" to deduct an NOL (21% tax rate reduced by 80% limitation).

If a corporation has an NOL in a pre-2018 taxable year, the NOL can generally be carried back two taxable years and forward twenty taxable years. IRC § 172(b)(1)(A) (before amendment by the TCJA). 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 can generally 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 deduction). 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). (The 90% limitation does not apply to 2008 or 2009 NOLs for which a five year carryback election was made (and it appears so even if the NOLs were not carried back). IRC § 56(d)(1)(A)(ii).)

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-2018 NOLs will generally be used first and will not be subject to the 80% limit. Where both the pre-2018 NOLs do not completely eliminate taxable income, the post-2017 NOLs will be subject to the 80% limit. In such case, there is uncertainty as to how to compute the limit. Possibly, the limit is

computed after deducting the pre-2018 NOLs or before such deduction. Alternatively, the limit could be applied as if no deduction is allowed for pre-2018 NOLs. We understand that the IRS is aware of the uncertainty and, hopefully, will come to a view in the near future.

The blue book explanation for the TCJA states that the intent was that a taxpayer with both pre-2018 and post-2017 NOLs would deduct the pre-2018 NOLs first without limitation. The post-2017 NOLs would then be limited to 80% of the excess, if any, of taxable income (before post-2017 NOLs) over the pre-2018 NOL deduction. The authors of the blue book state that a technical correction may be necessary to reflect this intent. JCS-1-18 (Dec. 2018), p. 181-82, n. 903.

A taxpayer can elect to relinquish the ability to carryback a pre-2018 NOL from any taxable year. (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). 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 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), and (iii) the FDII deduction (with respect to post-2017 taxable years). However, adjusted taxable income cannot be less than zero. 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).

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 described above. 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 contribution carryforward into NOL carryforward. David Culp & V. Moore, *Complex Benevolence: Converting Charitable Contributions to NOLs*, 2012 TNT 113-12.

As an example of the conversion of contribution carryforward into 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 times 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.

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). 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). 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. A net capital loss cannot be carried back if the carry-back produces or increases an NOL. IRC § 1212(a)(1). 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.

A corporation’s charitable contribution deduction in any taxable year is limited to 10% of adjusted taxable income (or adjusted alternative minimum taxable income, for AMT purposes). IRC § 170(b)(2)(A). For this purpose, adjusted taxable income (or adjusted alternative minimum 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 manufacturing deduction under section 199 (with respect to pre-2018 taxable years), and (iv) NOL and capital loss carrybacks. IRC § 170(b)(2)(C); 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 of AMT gets quite interesting in a taxable year in which a corporation deducts both 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 alternative minimum taxable income for purposes of the 90% AMT limitation takes into account the charitable contribution deduction. IRC § 56(d)(1)(A)(i)(II). 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). ILM 201226021 (Mar. 13, 2012)

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). 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). The amount of the credit that is allowed in any taxable year is limited to the portion of the total U.S. Federal income tax that is attributable to foreign-source taxable income. IRC § 904(a). The limitation calculation is performed separately with respect to several statutorily-defined categories (or baskets) of income. IRC § 904(d). If a corporation has excess foreign taxes (i.e., amounts in excess of the limit) in a taxable year, the amount can generally be carried back one taxable year and forward ten taxable years. IRC § 904(c). 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). There is no provision to waive the carryback period for excess foreign taxes.

The foreign tax credit can be used to reduce a corporation’s tentative minimum tax liability (with limitations) as well as the regular tax liability. IRC § 59(a).

The general business credit is the combination of 36 separate tax credits (including, the investment credit and the research credit). For the full list see section 38(b) of the Code. The amount of general business credit allowed in a taxable year is generally limited to 75% of the U.S. Federal income tax for the year. IRC § 38(c)(1)(B). The amount allowed is further limited to prevent taxpayers from using the credit to offset the amount of tentative minimum tax. IRC § 38(c)(1)(A) (as in effect before the enactment of the TCJA). 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). There is no provision to waive the carryback period for an excess general business credit.

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). 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).

Before repeal by the TJCA, section 168(k)(4) permitted corporations to elect to forgo bonus depreciation (and accelerated depreciation) in a taxable year. If the election is made the limitation on the use of the minimum tax credit is increased by 20% of the foregone bonus depreciation deductions (subject to limitations). To the extent, the additional credit limitation amount exceeds the tax for the year, the excess is generally refundable. IRC § 168(k)(4) (as in effect before repeal by the TCJA). Section 168(k)(4) applies to taxable years beginning on or before December 31, 2017. TCJA, PL 115-97 § 12001(c).

Minimum tax credits with an increased limitation under section 168(k)(4) were 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. However, the IRS has ruled that section 383 only applied if the credits with the increased limit 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 refund under section 168(k)(4). ILM 201126029 (Mar. 17, 2011).

The IRS has stated that the refundable amount of the minimum tax credit owed to a taxpayer pursuant to section 168(k)(4) is subject to reduction under the sequester provisions of the Balanced Budget and Emergency Deficit Control Act of 1985, as amended. For refund claims that are processed during Federal fiscal year 2019 (on or after October 1, 2018 and on or before September 30, 2019), the amount of any refund will be reduced by 6.2%. IRS, “Effect of Sequestration on the Alternative Minimum Tax Credit for Corporations (fiscal year 2019)”, <https://www.irs.gov/newsroom/effect-of-sequestration-on-the-alternative-minimum-tax-credit-for-corporations-fiscal-year-2019> (last updated on March 8, 2019). A different rate applies to claims processed in prior Federal fiscal years. It appears that the reduction only applies to refunds and not to credits that reduce the amount of income tax owed.

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 creditable against tax due during those taxable years and the excess is refundable. 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 taxable years 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).

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 2021, the taxpayer would be eligible to receive a refund in 2018 of \$50 million. The maximum refund in 2019 would be \$25 million and the maximum refund in 2020 and 2021 would be \$12.5 million in each taxable year.

The normal amount of minimum tax credit can generally only be credited against the regular tax liability (reduced by any credits) of a corporation and is not generally refundable. IRC § 53(a), (c). The additional limitation portion of the credit can offset the entire income tax liability of the corporation (after nonrefundable credits). The excess is refundable as an overpayment. IRC §§ 53(e)(3), 6401(b)(1).

There is uncertainty as to whether and how section 383 might limit the additional limitation portion of the minimum tax credit. Presumably, 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) (described above).

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. <https://www.irs.gov/newsroom/effect-of-sequestration-on-the-alternative-minimum-tax-credit-for-corporations-fiscal-year-2019> (last updated on March 8, 2019).

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. A non-inclusive list is below:

- If a C corporation has a “corporate equity reduction transaction” (or “CERT”), then any NOL carryback to a taxable year preceding the year in which the CERT occurs is subject to limitation. (The CERT rules were repealed by the TCJA for taxable year ending after December 30, 2017.) A CERT is (i) a major stock acquisition by the corporation (i.e., an acquisition of 50% or more of the stock (directly, or indirectly in concert with others) of another corporation (by vote or value)), or (ii) an excess distribution (i.e., one or more distributions in a taxable year that exceed 150% of the average for the previous three taxable years). Where the CERT rules apply, the amount of NOL that is permitted to be carried back is recomputed as if no deduction is allowed with respect to interest on debt obligations that are allocable to a CERT. The NOL that is not carried back is permitted to be carried forward. IRC § 172(b)(1)(E), (h) (before repeal by the TCJA).
- 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. Commissioner*, 343 F.2d 713, 721-22 (9<sup>th</sup> Cir. 1965) (IRS could not challenge an NOL deduction under section 482 since it was not timely raised).

An appendix to this paper lists specialized terms and acronyms that are used throughout this paper.

## 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 or 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) Ex.

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) Ex. (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 percentage 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%.

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) Ex.

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.

## **A. 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 tax attributes limited by section 383. IRC § 382(k)(1); Treas. Reg. § 1.382-2(a)(1)(i)(A), Prop. Reg. § 1.382-2(a)(1)(i)(A) (excess business interest). The definition of a loss corporation also includes a corporation that generates an NOL or tax

attribute subject to section 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 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% of adjusted taxable income. IRC § 163(j)(1) (as amended by the TCJA); Prop. 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) (as amended by the TCJA); Prop. Reg. § 1.163-2(c). A corporation that is entitled to use a carryforward of disallowed interest under section 163(j) is considered to be a loss corporation. IRC § 382(k)(1) (as amended by the TCJA); Prop. Reg. § 1.382-2(a)(1)(i)(A).

Proposed regulations provide rules for determining whether a corporation is a loss corporation with respect to excess business interest deductions. A carry forward of excess business interest is treated as an attribute that causes the corporation to be a loss corporation. Prop. Reg. § 1.382-2(a)(7)(i). For example, if a corporation carries forward excess business interest deductions from 2018 to 2019, the corporation would be a loss corporation in 2019. In addition, if a corporation has excess business interest in a taxable year that includes a testing date, the corporation is treated as a loss corporation in such year. Prop. Reg. § 1.382-2(a)(7)(i). As a result, in the prior example, the corporation would also be treated as a loss corporation in 2018. These proposed regulations are proposed to be effective for testing dates occurring or of after the regulations are finalized. However, a taxpayer and related parties can rely upon the proposed regulations if they consistently apply the section 163(j) proposed regulations in their entirety. Prop. 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); Prop. Reg. § 1.382-2(a)(1)(ii) (excess business interest). Generally, for section 332 liquidations and acquisitive 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. 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).

There is an open question as to whether the section 382 rules apply to S corporations. In the preamble to the proposed 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. Notice of Proposed Rulemaking REG-106089-18 (Dec. 28, 2018), 2019-5 IRB 431.

Before the enactment of the TCJA, the only attribute of an S corporation that could potentially be limited by sections 382 and 383 was NUBILs. 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 the result is otherwise provided in the Code or 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. No. 826, 97<sup>th</sup> Cong., 1982-2 CB 730, 736; S. Rep. No. 640, 97<sup>th</sup> Cong., 1982-2 CB 718, 724. 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 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) of the Code (as modified by the TCJA) provides for a limitation on excess 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), Prop. Reg. § 1.163(j)-6(l).

The proposed section 163(j) regulations provides that excess business interest of an S corporation is carried forward using the same rules that apply to C corporations. Prop. Reg. § 1.163(j)-6(l)(5), (o)(16), (17). The carried forward amount is subject to section 382 if the S corporation has an ownership change. Prop. Reg. § 1.163(j)-6(l)(5)(ii). As a result, the proposed regulations would treat an S corporation as a loss corporation if the S corporation has an excess business interest deduction.

The proposed section 163(j) regulations with respect to S corporations are proposed to be effective for taxable years ending after the date they are finalized. Taxpayers and their related parties can rely on the proposed regulations if all of the proposed section 163(j) regulations are applied (in their entirety) on a consistent basis. Prop. Reg. § 1.163(j)-6(p).

## **B. 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 both losses 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).

The TCJA amended section 163(j) to limit the deduction of business interest by a corporation to generally 30% of adjusted taxable income. IRC § 163(j)(1) (as amended by the TCJA). The new limitation rules apply to taxable years beginning after December 31, 2017. The disallowed interest is carried forward indefinitely. IRC § 163(j)(2) (as amended by the TCJA). A carryforward of disallowed interest is subject to limitation by section 382. IRC § 382(d)(3) (as amended by the TCJA).

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 include only foreign tax credits, general business credits, and minimum tax credits. Treas. Reg. § 1.383-1(c)(2)(i), (ii), (3).

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

### C. 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. Commissioner*, 59 TC 248 (1972); Rev. Rul. 82-150, 1982-2 CB 150 (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. Commissioner*, 326 F.2d 264 (2d Cir. 1964) (deep in-the-money option respected); *Simmons v. Commissioner*, 23 TCM 1423 (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(1)(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 (9<sup>th</sup> 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 of the Code). 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).

#### **D. 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 particular 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 ILM 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 in ILM 201432015 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), the 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 Dates 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. ILM 201432015.

### **E. 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 combined only 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). However, the interests are combined if the loss corporation has actual knowledge of the facts. Temp. Reg. § 1.382-2T(k)(2)(i).

### **F. 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 loss and credit carryforwards 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 proposed 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 an excess business interest carryforward to the first taxable year ending after the testing date. Prop. Reg. § 1.382-2(a)(7), (8). For example, if a calendar year corporation has excess business interest in 2018 that carries forward to 2019, the testing period with respect to a testing period in 2019 would begin on January 1, 2018.

It is possible that the testing period for regular tax and AMT purposes could be different. For example, a loss corporation could have an NOL for AMT purposes, but not for regular tax purposes, due to AMT's 90% limit on use of NOLs. There is uncertainty as to whether the ownership change calculations are to be performed separately for purposes of the two regimes where a loss corporation has pre-change losses in one regime but not the other. The AMT regulations state that the provisions of the Code that apply in determining regular taxable income also apply, except as otherwise provided, in determining alternative minimum taxable income. Treas. Reg. § 1.55-1(a). This seems to indicate that section 382 applies for AMT purposes, but does not clearly state how it is to apply. The equivalent language in the adjusted current earnings ("ACE") regulations goes on to state that in applying provisions of the Code the adjustments under the ACE regime are to be taken into account. *See* Treas. Reg. § 1.56(g)-1(a)(5). As a result, a position may be available to apply section 382 for AMT purposes only if an ownership change occurs for regular tax purposes.

This issue of separate ownership change calculations will not generally arise for ACE purposes since the regulations generally define "ownership change" for ACE purposes by reference to the definition for regular tax purposes. *See* Treas. Reg. § 1.56(g)-1(k)(3), (4) Ex. (iv).

## **G. 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).

## H. 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 shares issued on 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.

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).

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.

Taxpayers are permitted to apply the notice retroactively to testing dates that occurred before the issuance of the notice. For prior taxable years, a taxpayer may generally change approaches by amending a tax return. Notice 2010-50, § II.B. A taxpayer is generally free to adopt a single methodology for a consistency period as long as any inconsistent returns can be and are amended. Notice 2010-50, § II.C.

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 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. Guidance on fluctuations in value are not included on the list of priority guidance projects. Office of Tax Policy. and the IRS, 2018-2019 Priority Guidance Plan (April 5, 2019).

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(1)(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. Similar conventions are permitted for shares acquired before May 6, 1986 or January 1, 1987. 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%.

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.

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 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	Sep. 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.

## I. 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).

Example. Individual A files a tax return on a calendar year basis. It 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 (1<sup>st</sup> 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 (2<sup>nd</sup> Cir.), *cert. denied*, 502 US 821 (1991).

## **J. 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 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. 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.

Special rules apply with respect to the determination of whether an ownership change has occurred after a section 332 liquidation or acquisitive 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).

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 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). The regulations do not describe how the rules apply in such situations. In addition, there are some unresolved overlap issues with respect to how section 362(e)(2) applies in such a situation.

## **K. 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 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 he has an interest in helping the loss corporation protect the NOLs (and other tax attributes).

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 he knowingly contributes to an ownership change. *See A.W. Chesterton Co. v. Chesterton*, 128 F.3d 1 (1<sup>st</sup> Cir. 1997) (shareholder injunction to prevent loss of S corporation status). 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 (7<sup>th</sup> Cir. 2005) (shareholders were injured by issuance of injunction preventing sale of stock but were not entitled to damages).

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.

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. *See, e.g., in re: General Motors Corp.*, No. 09-50026 (Bankr. SDNY), 2009 TNT 131-19 (order providing for trading restrictions). 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).

A relatively new technique for protecting tax attributes is the section 382 poison pill. About 90 public companies have adopted them in some form (as of January 2015). Anthony Garcia, *Poison Pills and Net Operating Loss Assets: Protecting the Balance Sheet or the Board of Directors*, <https://insight.factset.com/poison-pills-and-net-operating-loss-assets-protecting-the-balance-sheet-or-the-board-of-directors>. 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.

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 shareholders were generally grandfathered, except if they acquired an additional 0.5% of the stock.

One of Selectica’s competitors (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 chose 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.).

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.). As a result, it appears that 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 U.S. subsidiary of a foreign corporation, it may not be possible to enter into measures to protect against an ownership change.

## **L. 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 tax 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.

## **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 he owns 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. 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 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 (the "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).

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 Forms 3, 4, or 5 can be similarly relied upon.

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 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.

1. 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).
2. 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.
3. 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).

4. 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.
5. 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) of the Code, 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 201110006 (Sept. 10, 2010) (determining “overlapping” shareholders in a merger). 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 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).

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.

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).

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.

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. ILM 201215007 (Jan. 5, 2012),

The IRS treated the funds in ILM 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. ILM 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).

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. Notice of Proposed Rulemaking 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).

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 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).

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).

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). The public groups that own at least 5% on the testing date are 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 public group of the loss corporation.

The public group of the loss corporation 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).

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, an 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 (as amended by TD 9638); 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 Fund), the public group would be treated as owning 14.9% on the testing date (and 15.1% prior to the testing date).

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 his indirect ownership interest is only 1.5% (15% interest in Corp B times 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 times 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 times 70% interest in Partnership C times 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 times 70% interest in Partnership C times 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 times 70% interest in Partnership C times 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	50.0%
Total	100.0%

*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 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. 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). 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)(v)(B) Ex.

In Notice 2010-49, 2010-2 CB 10, the IRS and the Treasury Department announced that they were currently considering modifying the segregation rules, as well as other similar rules, with regard to the treatment of small shareholders (i.e., shareholders who do not directly own 5% of the loss corporation). They were studying the operation of the rules relating to small shareholders and trying to determine whether the current rules or potential modifications best reflect policy considerations.

Notice 2010-49 describes the treatment of small shareholders under the existing rules as based upon an “ownership tracking approach.” That is, the current rules track all changes in ownership without regard to their particular circumstances (with concessions for administrative convenience). The notice describes a potential alternative regulatory regime based upon a “purposive approach.” Under a purposive approach, there would be fewer transactions that would result in the creation of new public groups. For example, if a 5% shareholder purchases and then sells a block of shares to and from small shareholders during a testing period, current law treats the transactions as two owner shifts resulting in a new public group that owns the

block of shares at the end of the testing period. Under the purposive approach, it is possible that a public group would be treated as owning the block of shares during the entire testing period. The notice describes other more limited implementation possibilities for the purposive approach.

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 additional exceptions to the segregation rules based upon a purposive approach. 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 the date of an ownership change 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 entity. 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 amend the current 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. Temp. 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. Temp. 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). Temp. 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).

Example 8 of the Amended Segregation Rules illustrates the application of the rule described in the previous paragraph. In the 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% times 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 he is treated as owning 5.4% of L, indirectly by attribution (67.5% times 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% times 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%).

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 that are acquisitive asset reorganizations 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) merger). *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)(13) Ex. 1(i), or debt obligations of the issuer. *See* Treas. Reg. § 1.382-3(j)(13) 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).

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. Preamble, 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) of the Code 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)(13) 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).

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)(13) 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)(13) 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)(13) 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)(13) Ex. 1(iv), (v).

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 times 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)(13) 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 the segregation rules. 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.

The Amended Segregation Rules revise the segregation rules with respect to redemptions. The amendments exempt from the segregation rules "small redemptions." 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 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.

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.

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) of the Code 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. Preamble, 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). 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. Preamble, 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).

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. 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 of the Code 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 over 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) of the Code (a U.S. 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. 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.

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).

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).

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.*

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).

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) of the Code. 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.*

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.*

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.*

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) his spouse (other than one that is legally separated under a decree of divorce or separate maintenance), (ii) his children, (iii) his grandchildren, and (iv) his 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 have stated 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 (5<sup>th</sup> 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 and had ever 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 of the Code (i.e., property acquired from a decedent),
- the basis of the shareholder's stock is determined under section 1015 of the Code (i.e., property acquired by gift),
- the basis of the shareholder's stock is determined under section 1041(b)(2) of the Code (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) of the Code (a trust under a U.S. 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.

The effective date for rules with respect to qualified trusts is for distributions after June 23, 2006. Section 1.382-10T of the temporary Treasury regulations applies to earlier distributions after June 27, 2003. Temp. Reg. § 1.382-10T(a)(4)(i). The rules under section 1.382-10T are similar to the current rules. Loss corporations can apply section 1.382-10T retroactively to either (i) all distributions on or before June 27, 2003 that are within a testing period that includes June 27, 2003, or (ii) all distributions after December 31, 1986. Temp. Reg. § 1.382-10T(a)(4)(ii).

## **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) times the “long-term tax-exempt rate.” IRC § 382(b)(1), (e)(1), (k)(5); Treas. Reg. § 1.382-5(a).

The long-term tax-exempt rate is a rate published monthly by the IRS (generally 8-10 days before the beginning of the month). It is designed to mimic the rate of long-term municipal bonds. *See* IRC § 382(f). The rate has been in the 2-5% range for the last several years. The rate is 2.20% for ownership changes that occur in May 2019. Rev. Rul. 2019-12, 2019-19 IRB 1081.

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 of the Code 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 affect 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) times an adjustment factor. The adjustment factor equals 100%, minus 59% times 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. Notice of Proposed Rulemaking 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% times adjustment rate of 74.39% (100% minus (59% times 43.4% (39.6% plus 3.9%))).

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).

If a post-change year has less 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 of the Code). 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); Prop. Reg. § 1.382-5(d)(1) (excess business interest). 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 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 arms-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 40% to 60%, the amount paid for the new shares would not dictate the value of the remaining 80%. 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. Commissioner*, 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). It appears that 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 presumption that a negative adjustment to value was required for capital contributions made within two years of the change date. This presumption was eliminated for ownership changes that occur in any taxable year ending on or after September 26, 2008. 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 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 of the Code); 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 gives 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. Commissioner*, 104 TC 584, 640-44 (1995), *aff'd*, 98-1 USTC P50398 (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 guidance in this area for ownership changes that occur in taxable years ending on or after September 26, 2008. Notice 2008-78, 2008-2 CB 851. This guidance 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.” *Commissioner 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. Commissioner*, 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 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.*

In Notice 2010-2, 2010-1 CB 251, the IRS stated that any amounts received with respect to a capital contribution made by the Treasury pursuant to a Troubled Asset Relief Program (“TARP”) is not to be considered to have been made for a principal purpose of tax avoidance. Notice 2010-2, § III.F.

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.

Notice 2008-78 may be relied upon by taxpayers with respect to ownership changes that occur in any taxable year ending on or after September 26, 2008. The notice will continue to apply 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 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).

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 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 or 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) of the Code 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).

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) of the Code. 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 of the Code 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 person that is related to a corporation based upon a relationship specified in either section 267(b) or 707(b)(1) of the Code. 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” is different than the definition of “related party” (described above).

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 of the Code). For purposes of the retirement plan safe harbor, a retirement plan is a plan that qualifies under either section 401(a) or 403(a) of the Code. Treas. Reg. § 1.355-7(d)(9)(i). Section 401(a) applies to an employee U.S. 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 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 of the Code) 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.

The IRS and the Treasury Department have 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.

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 regulated investment companies (e.g., mutual funds), REITs, or real estate mortgage investment conduits ("REMICs"). IRC § 382(l)(4)(B)(ii).

The term "nonbusiness assets" is defined as assets 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. Commissioner*, 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 is 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 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. v. Commissioner*, 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% of 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.

Example. Lossco has nonbusiness assets with a fair market value of \$100 thousand. 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. Commissioner*, 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 U.S. trade or business (e.g., a U.S. 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 U.S. 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 U.S. trade or business. It appears that stock in a subsidiary will generally not be treated as connected with a U.S. trade or business. *See* 1997 FSA Lexis 17. However, if a subsidiary is a U.S. real property holding company, within the meaning of section 897(c)(2) of the Code, it is possible that it would be taken into account for section 382 value purposes. *See* IRC § 897(a)(1).

Section 1.882-5 of the Treasury regulations requires foreign corporations with a U.S. trade or business to determine its U.S.-connected liabilities based on a formula. Treas. Reg. § 1.882-5(c). This calculation is performed to determine the amount of interest expense that is allocable to the U.S. trade or business. Temp. Reg. § 1.882-5T(a)(1)(i). There is uncertainty as to whether this formula should be used for section 382 purposes.

Many foreign corporations with both a U.S. branch and one or more foreign branches have had difficulty assigning a fair market value to the net assets of the U.S. branch. In many cases, the business conducted by the U.S. 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 U.S. branch based on relative sales (or some other objective measure).

As a result of the enactment of the GILTI (global intangible low-taxed income) regime by the TCJA, controlled foreign corporations (CFCs) are now generally required to determine their taxable income as if they were a domestic corporation. IRC § 951A(c)(2)(A); Treas. Reg. § 1.952-2(b)(1); Prop. Reg. § 1.951A-2(b), (c)(2). Section 382 could apply for GILTI purposes if the CFC has a NUBIL or an excess business interest carryforward (pursuant to section 163(j) at the time of an ownership change. (Proposed regulations do not permit CFCs to carryforward NOLs or capital losses for GILTI purposes. Treas. Reg. § 1.952-2(c)(5); Prop. Reg. § 1.951A-2(c)(2).) There is uncertainty as to how to determine the value of a CFC for GILTI purposes for section 382 limitation purposes. It is possible that the value is taken into account (regardless of whether it is related to a U.S. 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 (assuming that the CFC

does not have a U.S. trade or business). We understand that the IRS is aware of the issue and is working on guidance.

## **B. Controlled Groups**

The Treasury Department has the regulatory authority to provide rules with respect 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, these 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).

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.

Two or more corporations are treated as members of a controlled group if they are either members of a “parent-subsidiary 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-subsidiary 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-subsidiary 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) (as in effect for tax years beginning on or before October 22, 2004), 1563(f)(5) (as in effect for tax years beginning after October 22, 2004); Treas. Reg. § 1.382-8(e)(2).

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-subsidiary 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); Treas. Reg. § 1.382-8(e)(3).

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 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. Special rules apply for purposes of determining the taxable year to which a NUBIL is attributable. Treas. Reg. § 1.382-8(b)(2). 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.

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 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.

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 (for base annual section 382 limitation purposes) if the loss corporation directly owns stock in another component member immediately *after* the ownership change. 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. There is some uncertainty as to whether the value or adjusted value (adjusted for capital contributions, etc.) is used for purposes of the reduction.

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 amount of the reduction by the higher tier member, or (ii) the value of the “electing member’s” stock (determined immediately before the ownership change and taking into account reductions and restorations under the controlled group rules). Treas. Reg. § 1.382-8(c)(2), (g) Ex. 3. An election can be made (and is generally advisable) for a corporation that is not a loss corporation (that is, it 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 the 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 controlled foreign corporation). 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).

For taxable years beginning on or after May 30, 2006 (and certain returns filed after May 30, 2006), 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 U.S. 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 U.S. 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).

For taxable year beginning before May 30, 2006, a deemed election to restore the value of a foreign component member is generally not available. For taxpayers that discovered that a timely filed election was not made in such years for a foreign component member, section 9100 relief may be available. The IRS has been generous about granting relief for taxpayers that failed to make a timely election to restore value from a foreign component member. *See, e.g.*, PLR 201232016 (May 3, 2012). For taxpayers that did not make a timely election and did not receive section 9100 relief from the IRS, it is possible that a domestic loss corporation may be required to reduce the value by the value of the foreign component member. Such reduction may not provide any tax benefit to the foreign component member since generally the section 382 value of a foreign corporation without a U.S. trade or business is zero. *See* IRC § 382(e)(3); 1999 FSA Lexis 401.

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 contemplate the possibility of a different base annual section 382 limitations with respect to the same ownership change. Notice of proposed rulemaking CO-077-90 (Feb. 4, 1991) (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, (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.

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.

### **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. 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).

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. Commissioner*, 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 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) Ex. (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 to 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 date after the change date). Treas. Reg. § 1.382-6(a), (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), (e). 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). 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 taxable year that includes the relevant change date. 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).

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 U.S. 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-change and the post-change periods based upon the number of days in each period. Treas. Reg. § 1.382-6(a). 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).

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) of the Code), (vi) current year business credits (within the meaning of section 38(b) of the Code), and (vii) minimum tax credits (within the meaning of section 53(b)). Treas. Reg. § 1.382-6(a), (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 taxable 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 taxable 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 taxable 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 taxable 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.

Example. Lossco, a calendar year taxpayer, has an ownership change on July 1, 2008. Lossco has taxable income 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.

The proposed section 163(j) regulations provide that excess business interest expense allocated between the pre- and post-change period based upon the number of days in each period. This rule applies regardless of whether a closing-of-the-books election is 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 excess 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).

The proposed allocation rule described in the prior paragraph is proposed to apply ownership changes with respect to taxable years ending after the rule is finalized. However, taxpayers and related parties can rely upon the proposed section 163(j) regulations if they are applied consistently in their entirety. 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 AMT and special taxes described in section 26(b)(2) of the Code. 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).

The list of tax attributes that are limited by sections 382 and 383 are as follows:

- NOLs under section 172 of the Code,
- disallowed business interest under section 163(j) of the Code,
- net capital losses under section 1212 of the Code,
- excess foreign taxes under section 904(c) of the Code (i.e., taxes eligible for foreign tax credit),
- general business credits under section 39 of the Code,
- minimum tax credit under section 53 of the Code, and
- RBILs.

IRC § 382(d)(1), (3); Treas. Reg. § 1.382-2(a)(2). 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).

On September 27, 2018, the House of Representatives passed the American Innovation Bill of 2018, HR 6756, 115<sup>th</sup> 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 115<sup>th</sup> Congress. The bill has not been introduced in the 116<sup>th</sup> Congress, but could be in the future.

Section 168(k)(4) (as in effect for property placed in service after March 31, 2008 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). ILM 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).

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); Prop. Treas. Reg. § 1.163(j)-5(b)(2) (excess 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). 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 is uncertainty as to whether this ameliorative rule applies to tax attributes other than NOLs.

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) Ex. (1) (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% or 10% depending upon the taxable year). The proposed regulations state that the application of BEAT is not a limitation on tax attributes that affects the application or absorption of sections 382 or 383. Prop. 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) Ex. (1); TD 8264, 1989-2 CB 73. The regulations have not yet been revised to advise as to where a business interest carryforward under section 163(j) would be placed under the above-list.

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) Ex. (4).

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) Ex. (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). In addition, if the old loss corporation has a NUBIL for ACE purposes (before its repeal by the TCJA), the basis of the assets of the loss corporation are generally marked-to-market for ACE purposes. IRC § 56(g)(4)(G).

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. ILM 201309013 (Nov. 21, 2012); ILM 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.

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.

Before the enactment of the TCJA, there was uncertainty as to whether the NUBIL rules applied (and how they applied) to foreign corporations that do not have a U.S. trade or business. It seemed clear that if the NUBIL rules did apply to such a foreign corporation, the base annual section 382 limit was zero (and any RBILs would not be deductible). IRC sec. 382(e)(3); ILM 200238025 (June 14, 2002). In at least one ruling, the IRS has treated a foreign corporation without a U.S. trade or business as potentially subject to the NUBIL rules. 1997 FSA Lexis 17.

There is 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 U.S. 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 U.S. shareholder’s consequences related to ownership of a CFC’s stock relate to determinations of the earnings and profits (“E&P”) of a CFC. Positive E&P is necessary to have subpart F income or an inclusion under sections 956 and 965. 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* Prop. Reg. § 1.163-4(c)(1) (effect of section 163(j), as amended by the TCJA, on E&P); *Weyerhaeuser v. Commissioner*, 33 BTA 594, 597 (excess charitable contributions); IT 3758, 1945 CB 159, 160 (same); IT 3764, 1945 CB 188, 191 (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. § 1.952-2(b)(1); Prop. Reg. § 1.951A-2(b), (c)(2). However, as discussed above, there is uncertainty as to how to compute the section 382 limitation.

Treasury and the IRS have listed as a priority guidance project for the current fiscal, guidance under section 382(h)(6) in response to the TCJA. Office of Tax Policy, and the IRS, 2018-2019 Priority Guidance Plan (April 5, 2019). It is not clear what this guidance relates to. Regardless, it is possible that this guidance will

be issued shortly as the website for the Office of Management and Budget's (OMB) Office of Information and Regulatory Affairs (OIRA) indicates receipt of proposed guidance on April 11, 2019 as "Pending Review." <https://www.reginfo.gov/public/jsp/EO/coDashboard.myjsp>

#### **A. Notice 2003-65**

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.

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 *Vail Resorts Inc. v. United States*, 2011-2 USTC ¶ 50,520 (D. Colo.), *vacated by*, 2015 US Dist. LEXIS 58701, a district court held that a taxpayer could adopt the section 338 approach to taxable years before the Notice 2003-65 was issued even though those taxable years were the subject of a closing agreement. The closing agreement referred to the amount of the NOLs in the results section (but not the determination section) of the agreement (but did not refer to the section 382 limitation or any approaches or elections thereto). The court held the amount and usability of the NOL was not an item that was subject to the closing agreement. The case was subsequently vacated and dismissed. As a result, the precedential value of the case is limited.

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 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) of the Code (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.

In Notice 2003-65, the IRS announced that it intends to publish proposed regulations providing for a single approach. The project is no longer on the list of priority guidance projects. Office of Tax Policy and the IRS, 2018-2019 Priority Guidance Plan (April 5, 2019).

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 National Co. v. Welch*, 304 US 191 (1938); *J.E. Riley Inv. Co. v. Commissioner*, 311 US 55 (1940); *Grynberg v. Commissioner*, 83 TC 255, 261 (1984); *Hodel v. Commissioner*, TC Memo. 1996-348; FAA 20105101F (Nov. 19, 2010). *But see Bayley v. Commissioner*, 35 TC 288, 298 (1960) (taxpayer permitted to change to installment method where gain originally reported on amended return).

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 is 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.

## **B. NUBIG and NUBIL**

The determination of NUBIG and NUBIL is relevant to determine whether the NUBIG or NUBIL rule applies and the limitation on the effect of such 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 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 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).

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% or more of the stock of the loss corporation (by value) is acquired in a single transaction (or a series of related transactions over any 12-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 acquires stock that it did not already own (directly, or indirectly by attribution). Stock is acquired for section 382(h)(8) purposes with respect to the issuance of stock to creditors, including the issuance to holders of convertible debentures. A stock-for-stock exchange can be ignored for this purpose if the stock exchanged has the same value. However, stock acquired in a section 1032 transaction is taken into account (i.e., shares issued for cash or property). Stock acquired 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 acquired before the beginning of the testing period can count 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.

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. No. 795, 100<sup>th</sup> Cong. (1988); S. Rep. No. 445, 100<sup>th</sup> Cong. (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 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.

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 times 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 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) of the Code (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.

There is some uncertainty as to how to determine the NUBIG or NUBIL of a foreign corporation for regular tax purposes. For purposes of determining the base annual section 382 limit of a foreign corporation, only assets and liabilities that are effectively connected with a U.S. 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 U.S. trade or business. Thus, it would appear that NUBIG or NUBIL is computed by taking into account the fair market value and U.S. tax basis of the worldwide assets of a

foreign corporation that undergoes an ownership change. ILM 200238025 (June 14, 2002); 1997 FSA Lexis 17. It should be noted that determining the U.S. tax basis of the assets of a foreign corporation can be a daunting task.

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).

Section 338 and 1374 Approaches. 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. It is possible that forthcoming regulations (or other guidance) may not be as generous.

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, 1980-2 CB 620, 625 (“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. ILM 201629007 (Feb. 29, 2016).

Any RBIL that would result in a disallowed 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.

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.

### **C. RBIG and RBIL**

The determination of RBIG and RBIL are relevant for the determination of the application of the NUBIG rule and the NUBIL rule. However, RBIGs are only relevant to the NUBIG rule and RBILs are only relevant to the NUBIL rule.

An RBIG is a gain recognized during the recognition period on the disposition of any 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 recognized during the recognition period on the disposition of any 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 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 regulatory 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 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 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, forthcoming regulations will allow 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.

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 controlled foreign corporation 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 a 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 treat the capital loss as an RBIL that does not reduce the section

382 and 383 limitations 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. Commissioner*, 39 F.2d 540, 543-44 (2d Cir. 1930) (business deductions); *Nitto v. Commissioner*, 13 TC 858, 866 (1949) (gross income); *Serianni v. Commissioner*, 80 TC 1090, 1093 (1983) (allocation of legal expenses), *aff'd*, 765 F.2d 1051 (11th Cir. 1985); 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).

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.

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 in a hypothetical section 338 election. 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.

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). For 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%. 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 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.

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) 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. For 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 an RBIL. 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%. 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.

#### **D. 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.

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). Nonexclusive examples of prepaid income include income that is deferred under section 455 of the Code (subscription income), section 1.451-5 of the Treasury regulations (sale of goods and long-term contracts), and Revenue Procedure 2004-34, 2004-1 CB 991 (services and intellectual property). Treas. Reg. § 1.382-7(a). These regulations apply with respect to change dates that occur on or after June 11, 2010. Treas. Reg. § 1.382-7(b). Similar rules apply to change dates that occur on or after June 14, 2007 and before June 11, 2010. Temp. Reg. § 1.382-7T.

It is possible that income and deductions that are deferred under a provision of the Code or regulations would be treated as built-in income or deduction items. Examples of deferred items include (i) section 267

of the Code (related party deductions and losses), (ii) section 1.1502-13 of the Treasury regulations (intercompany transactions), and (iii) section 465 of the Code (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. Notice 87-79 cannot be relied upon for change dates that occur on or after September 12, 2003, if the loss corporation chooses to adopt the section 338 or 1374 approach. Notice 2003-65, §§ III.B.2.b, IV.D.

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 earnings and profits (“E&P”) purposes. *See* IRC § 312(l)(1) (excluded COD income included in E&P except to the extent of basis reduction).

In 2008, the IRS issued controversial guidance as to the application of the built-in deduction rules to banks. In Notice 2008-83, 2008-2 CB 905, the IRS announced that any deduction otherwise allowable to a bank with respect to losses on loans or bad debts (including an addition to reserve for bad debts) is not treated as an RBIL or a built-in deduction. Notice 2008-83 appears to be retroactive.

Notice 2008-83 only applies to a corporation that is a “bank” within the meaning of section 581 of the Code. For this purpose, a “bank” is a “bank or trust company” that generally is incorporated in, doing business under the laws of, and regulated by the United States, the District of Columbia, or any state if a substantial part of the business consists of defined banking practices. IRC § 581. A bank also includes a domestic building and loan association, a domestic savings and loan association, or a Federal savings and loan association which meets the requirements of section 7701(a)(19) of the Code. IRC §§ 581, 7701(a)(19). As a result of the application of the section 581 definition of banks, Notice 2008-83 does not appear to apply to foreign banking institutions or foreign or domestic investment banking institutions.

Many commentators were critical of Notice 2008-83 as inconsistent with the statute. In February 2009, legislation was enacted that terminated the application of the notice prospectively. As a result, Notice 2008-83 now only applies to ownership changes occurring on or before January 16, 2009 (or after that date pursuant to a written agreement entered into on or before the date if other requirements are met). For ownership changes for which the notice is effective, the notice has the “force and effect of law.” American Recovery and Reinvestment Tax Act of 2009, PL No. 111-5, § 1261(b).

The Congress did not stop there. In addition to terminating Notice 2008-83, they made specific findings that (i) the Treasury Department does not have the authority to issue section 382 regulations that provide specific exemptions or special rules for particular industries or classes of taxpayers, (ii) the notice is

inconsistent with congressional intent in granting regulatory authority, and (iii) the legal authority for the IRS to issue the notice is doubtful. However, the Congress found that taxpayers should generally be able to rely on IRS guidance. As a result, it found that legislation was necessary to clarify the force and effect of Notice 2008-83 and the proper application of the NUBIL rules. PL No. 111-5, § 1261(a). Based on these findings it is possible that the IRS and the Treasury Department may be more circumspect in providing guidance in general and particularly where the provision only applies to a single industry or class of taxpayers.

Some taxpayers have taken the position that the benefits of Notice 2008-83 apply to the computation of NUBIG and NUBIL, as well as the RBILs. In other words, in computing NUBIG and NUBIL, built-in losses with respect to loans were not taken into account. The IRS has challenged this position on several occasions. They maintain that the computations of NUBIG/NUBIL and RBIG/RBIL do not apply the same rules and the Notice only excludes losses and bad debt deductions from the calculation of RBIL. *See* ILM 201326013 (Mar. 19, 2013); ILM 201308029 (July 24, 2012); ILM 201308026 (Apr. 18, 2012).

An issue that was not addressed by Notice 2008-83 was the application of the ACE NUBIL rule. As described above, the adjusted basis for ACE purposes is generally marked-to-market after an ownership change if the loss corporation has a NUBIL. The IRS has taken the position in ILM 201444040 (July 17, 2014) that the notice does not provide any special relief for ACE purposes. The notice allows a taxpayer to take a bad debt deduction (free of section 382 limitations) for regular tax and AMT purposes. For ACE purposes, the IRS view is that the basis of the loan was reduced to fair market value for ACE purposes and that the subsequent bad debt deduction was similarly reduced. The taxpayer in the ruling agreed that the basis was reduced for ACE purposes, but that ACE basis is not applied for purposes of determining gain or loss under ACE. ILM 201444040.

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, temporary regulations have been issued with respect to the treatment of prepaid income. They apply to change dates that occur on or after June 14, 2007. For earlier change dates, there is uncertainty as to how prepaid income is treated under the section 338 approach.

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. For change dates before September 12, 2003,



loss corporations can either apply Notice 87-79 with respect to taxable COD income or the rule under Notice 2003-65 described in the previous sentence.

If a loss corporation realizes COD income that is excluded under section 108 of the Code, 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 of the Code 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 of the Code 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. There is uncertainty as to whether this section 481 adjustment is treated as an RBIG with respect to change dates that occur on or after June 14, 2007. *See* Temp. Reg. § 1.382-7T(a).

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 law suit 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) of the Code (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 12 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 12 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 12 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 12 month period. For change dates before September 12, 2003, loss corporations can either apply Notice 87-79 with respect to taxable COD income or the rule under Notice 2003-65 described in this paragraph.

If a loss corporation realizes COD income that is excluded under section 108 of the Code, 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 of the Code 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 of the Code 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) of the Code (DISC terminations) and the completed contract method of accounting. *See* Treas. Reg. § 1.1374-4(e), (g).

## **E. 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 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); Notice 2003-65, § IV.E. These rules apply to determine the effect on RBIGs and RBILs of a distributive share of partnership items.

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) of the Code. 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 under the section 338 and 1374 approaches can be found in section 1.1374-4(i)(8) of the Treasury regulations.

## F. ACE NUBIL Rule

The AMT is a tax regime that is an alternative to the regular income tax. ACE is a tax regime that is an alternative to both the regular income tax and the AMT. However, technically, ACE is only a component of the AMT.

Generally, a corporation pays the higher of the AMT or the regular tax in any taxable year. The AMT is a tax at a lower rate (20%) on a higher tax base. To the extent, a corporation pays the AMT in any taxable year, the excess over the regular tax is generally allowed as a credit to offset future year's regular tax liability. (The minimum tax credit generally can only be used to offset regular tax in later years to the extent the regular tax exceeds the AMT in that year.) From an economic standpoint, the AMT is generally only a timing difference (i.e., a prepayment of the regular tax liability).

The AMT tax regime starts with regular taxable income and requires various adjustments. One such adjustment is for ACE. AMT taxable income includes 75% of the excess of a corporation's ACE over its alternative minimum taxable income (computed without regard to ACE or NOL deductions). IRC § 56(c)(1), (g)(1). Taxpayers are allowed a deduction for AMT purposes when the timing differences represented by prior year ACE adjustments reverse.

Essentially, ACE is a tax at a lower effective rate (15%) on a higher tax base than AMT and regular tax. The effective 15% rate is based on the 20% AMT rate times the 75% inclusion adjustment. From an economic standpoint, ACE, like AMT, is generally only a timing difference (i.e., a prepayment of the regular tax liability).

The computation of ACE starts with alternative minimum taxable income (computed without regard to ACE or NOL deductions) and requires various adjustments. IRC § 56(g)(3). One such adjustment is for a corporation undergoing a section 382 ownership change with a NUBIL. IRC § 56(g)(4)(G).

Essentially, regular tax, AMT, and ACE are separate but parallel tax regimes. *See* Treas. Reg. §§ 1.55-1, 1.56(g)-1(a)(5); *Merlo v. Commissioner*, 126 TC 205 (2006), *aff'd*, 492 F.3d 618 (5<sup>th</sup> Cir. 2007); *Palahnuik v. Commissioner*, 127 TC 118 (2006), *aff'd*, 544 F.3d 471 (2d Cir. 2008); *Kadilak v. Commissioner*, 127 TC 184 (2006), *aff'd*, 534 F.3d 1197 (9<sup>th</sup> Cir. 2008); ILM 201444040 (July 17, 2014). *But see Allen v. Commissioner*, 118 TC 1 (2002) (deduction reduced for AMT purposes for targeted jobs credit); *Ventas v. United States*, 57 Fed. Cl. 411 (2003), *aff'd*, 381 F.3d 1156 (Fed. Cir. 2004).

A corporation will have a NUBIL for ACE purposes, if the aggregate basis of the corporation's assets (for ACE purposes) exceeds the FMV of such assets. The determination as to whether a corporation has a NUBIL is generally made immediately before the ownership change. IRC § 382(h)(3)(A)(i); Treas. Reg. § 1.56(g)-1(k)(3). Presumably, the section 338 or 1374 approach must be used to determine ACE NUBIL if it was used for regular tax purposes.

The NUBIL (for ACE purposes) will generally be zero if the amount of the NUBIL would otherwise be less than or equal to the lesser of (i) 15% of the FMV of the corporation's assets (immediately before the ownership change), or (ii) \$10 million. IRC § 382(h)(3)(B)(i); Treas. Reg. § 1.56(g)-1(k)(3). It should be

noted that the above-described threshold rule is applied separately for regular tax and ACE purposes. Treas. Reg. § 1.56(g)-1(k)(4) Ex.

A special rule applies for determining the FMV of a corporation's assets if 80% or more of the stock of the corporation (by value) is acquired in one transaction (or a series of related transactions over a 12-month period). In such instance, the FMV will be limited to the grossed up amount paid for the stock, adjusted for indebtedness and other relevant items. IRC § 382(h)(8), *compare with*, IRC § 338(b), (d)(3); Treas. Reg. § 1.56(g)-1(k)(3).

In general, the NUBIL adjustment rule will not apply if the corporation is not a "loss corporation." Treas. Reg. § 1.56(g)-1(k)(2). For this purpose, a loss corporation is a corporation that has a tax attribute that is potentially subject to limitation by either section 382 or section 383. Treas. Reg. § 1.382-2(a)(1). One such tax attribute is a NUBIL. In determining whether a corporation is a "loss corporation," the NUBIL is determined by using the aggregate adjusted basis of the assets for regular tax purposes and not the adjusted basis of such assets for ACE purposes. Treas. Reg. § 1.56(g)-1(k)(2). Accordingly, if a corporation is not a loss corporation because it does not have an NOL or credit carryforward, it will be a loss corporation if it has a NUBIL computed using the aggregate basis of its assets for regular tax purposes. Treas. Reg. § 1.56(g)-1(k)(4) Ex. This exception to the NUBIL adjustment rule is unlikely to be available to many taxpayers.

The ACE regulations are silent as to whether the NUBIL adjustment applies to a loss corporation that undergoes an ownership change under section 382(l)(5) (the "bankruptcy exception" to section 382). From a technical standpoint, the provision could apply. However, the legislative intent behind section 382(l)(5) was to allow the corporation to use its tax attributes free of limitations (other than those imposed by section 382(l)(5)). The IRS appears to be of the view that the NUBIL adjustment rule applies in the context of section 382(l)(5). CCA 200444002 (July 22, 2004).

The NUBIL adjustment, where it applies, adjusts the corporation's asset basis (for ACE purposes) to reflect FMV at the time of the ownership change. The basis of each of the corporation's assets (immediately after the ownership change) will equal the proportionate share of the FMV (for NUBIL purposes) of the aggregate assets of the corporation (immediately before the ownership change). IRC § 56(g)(4)(G). It should be noted that the basis can be adjusted upward or downward.

The ACE basis (as adjusted by the NUBIL adjustment), is used (for among other purposes) to determine the ACE gain or loss upon a subsequent sale or exchange of property. IRC § 56(g)(4)(H); Treas. Reg. § 1.56(g)-1(a)(5)(ii) Ex.; ILM 201444040 (July 17, 2014) (bad debt deduction).

The statute and regulations allocate the basis of the assets using the proportionate method. IRC § 56(g)(4)(G); Treas. Reg. § 1.56(g)-1(k)(1), (4). This is an unusual treatment since the residual method (allocate to tangible assets first, with remainder to intangibles) is used in most analogous tax provisions. *See* IRC § 1060(a); Treas. Reg. §§ 1.338-6, 1.1060-1. For most taxpayers, the proportionate method will produce the same result as marking-to-market. *See* Treas. Reg. § 1.56(g)-1(k)(4)(iii). However, in a negative goodwill situation (i.e., FMV of the business is less than the FMV of individual assets), a strange and potentially costly result could occur. Under the proportionate method required by the Code and regulations, the negative goodwill appears to be allocable to all assets pro rata (including inventory and receivables). This should be contrasted to the residual method (used under both section 338 and 1060 of the Code) where the negative goodwill would reduce the basis of inventory and receivables only after the basis of other assets is reduced to zero. *See* Treas. Reg. § 1.338-6(b)(2).

The ACE regulations state that the allocation of basis rules of the section 338 regulations applies, “if otherwise applicable to the transaction.” Treas. Reg. § 1.56(g)-1(k)(1). This rule appears generally to apply to an ownership change caused by a qualified stock purchase for which a section 338(g) election is made. This rule could also apply to a transaction for which a section 338(h)(10) election is made if the option attribution rule applies to push forward the change date. For example, Corporation A purchases an option to acquire 100% of the stock of Lossco. Corporation A exercises the option four months later. A section 338 election is made for the stock acquisition. The option was structured with a principal purpose of tax avoidance and the option attribution rule applies. As a result, Lossco has an ownership change on the date the option is sold. If Lossco has a NUBIL, the ACE basis of the assets are allocated under the section 338 regulations. Treas. Reg. § 1.56(g)-1(k)(1). Lossco is treated as selling its assets four months after the ownership change pursuant to the section 338 election. For ACE purposes, there will only be gain or loss to the extent of changes in the value of assets during the four months. There will not be gain or loss resulting from different allocation schemes being used for section 338 and ACE purposes.

The ACE NUBIL adjustment is complicated and not very well known. Where it applies it can result in the need to produce time-consuming calculations. In many cases, it will be the only reason, the taxpayer will have to give thought to ACE.

## **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. 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) 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 of the Code. S. Rep. No. 1035, 96<sup>th</sup> Cong., at 35, n.3 (1980). Section 371 was effective for proceedings begun on or before September 30, 1979, IRC § 370(a), 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.

Some taxpayers are taking the position that a proceeding authorized by Delaware corporate law qualifies as a title 11 or similar case. *See* M. Ginsburg J. Levin, D. Rocap “Mergers Acquisitions, and Buyouts,” § 1210.2.1.5(3) (2013 ed.) (Delaware proceeding “should” qualify). 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. To become effective, the court of equity must sanction the compromise or arrangement. Del. Code Ann. tit. 8, § 102(b)(2).

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.”

## **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” 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).

Alternatively, 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). 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).

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% of more of the stock (by vote and value) after the ownership change. PLR 201322032.

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. No. 795, 100<sup>th</sup> Cong., p. 51 (1988).

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); ILM 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 Code provides 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 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 results in a person not owning stock if the stock is attributed to someone else does not apply. 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 still 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.

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 of the Code 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 some reason, that the statement cannot be relied upon if known to be false. *Compare* Temp. Reg. § 1.382-2T(k)(1)(ii).

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) Ex. (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) Ex. (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 B’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) Ex. (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 found 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). 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 this 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 participating in formulating the plan.

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.

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) of the Code);
- 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) of the Code (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 of the Code), 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 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.

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 (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 were 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 current 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) of the Code) 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 value 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 of the Code), an insurance company (as defined in section 1.801-3(a) of the Treasury regulations), or a qualified trust under section 401(a) of the Code (a U.S. 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 value-less if a second ownership change occurs within two years. Third, the ACE NUBIL rule may apply. Fourth, 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).

Where section 382(l)(5) applies to an ownership change, the interest haircut rule applies. In such case, the NOLs (and other tax attributes) 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. Commissioner*, 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 FSA 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.

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 in the section entitled “Defensive Measures.”

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 September 15, 2009 (the extended due date of the 2008 tax return). At that time, 14 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.

There is some uncertainty as to whether the ACE NUBIL rules can apply where section 382(l)(5) applies. Both the ACE and section 382(l)(5) regulations are silent as to whether the ACE NUBIL rule applies to a loss corporation that undergoes an ownership change under section 382(l)(5). From a technical standpoint, the provision could apply. However, the legislative intent behind section 382(l)(5) was to allow the corporation to use its tax attributes free of limitations (other than those imposed by section 382(l)(5)). The IRS appears to be of the view that the ACE NUBIL adjustment rule applies in the context of section 382(l)(5). CCA 200444002 (July 22, 2004).

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 of the Code 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(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 avoidance of U.S. 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).

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 avoidance of U.S. 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 avoidance 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. Rev. Rul. 80-46, 1980-1 CB 62.

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).

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 U.S. 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 U.S. 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. 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. 91 TNT 9-6.

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 the Congress. Taking advantage of the provision is not tax avoidance. *Modern Home Fire and Casualty Insurance v. Commissioner*, 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 the 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) of the Bankruptcy Code provides that 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. 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., Inc.*, 227 BR 596, 603-04 (Bankr. D. Conn 1998). *But see In re Scott Cable Commun., Inc.*, 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., Inc.*, 376 BR 881, 893-94 (Bankr. ND Ill. 2007) (objection by U.S. trustee acting in is administrative capacity), *aff’d*, 421 BR 456 (ND Ill. 2009), *aff’d*, 606 F.3d 366 (7<sup>th</sup> Cir. 2010); *In re Maxim Industries.*, 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., Inc.*, 349 BR 80 (Bankr. D. Nev. 2006) (trustee not permitted to object).

The 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, <https://www.solyndra-info.com/CourtFilings-Download.aspx?Docket=1193>, 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 Liflind, 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 Liflind 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.

### **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 elect 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 ownership change. Treas. Reg. § 1.382-9(j)(1). As a result, any increase in value from the surrender or cancellation of creditors' 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 (as well as the ACE NUBIL rule) 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 U.S. trade or business. Treas. Reg. § 1.382-9(k)(3).

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 U.S. trade or business. Treas. Reg. § 1.382-9(l)(3).

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. Federal Stimulus Legislation**

In attempts to deal with extraordinary economic problems caused by the 2008 financial crises, the U.S. Federal government has implemented several programs to help large corporations in key industries stay in business. In many cases, the form of relief was in the form of investments by the U.S. Federal government (or an agency or subdivision thereof) in the troubled companies. Without special rules, these investments could have caused an ownership change with a low base annual section 382 limitation. To avoid these potentially negative results, the Congress has enacted ameliorative legislation and the IRS has issued several pieces of guidance.

In Notice 2008-76, 2008-2 CB 768, the IRS issued guidance with respect to acquisitions made under section 1117 of the Housing and Economic Recovery Act of 2008, PL 110-289. Section 1117 authorizes the Federal government to acquire stock and debt obligations of Fannie Mae and Freddie Mac. Special rules apply for purposes of determining whether these corporations have an ownership change, if the United States (or any agency or instrumentality thereof) acquires stock (including pure preferred stock) or an option to acquire stock under section 1117. In such case, the corporation issuing the stock or option will not have a testing date on the date of the acquisition (or thereafter). The notice applies on or after September 7, 2008. Notice 2008-76. Since there are no testing dates on or after the date the United States acquires stock of Fannie Mae and Freddie Mac, it appears that the corporation issuing stock under section 1117 cannot have a subsequent ownership change. The IRS and the Treasury Department have announced that they intend to issue regulations that implement the rules described in Notice 2008-76.

In Notice 2008-84, 2008-2 CB 855, the IRS issued guidance with respect to acquisitions (other than those described in Notice 2008-76) in which the United States (or any agency or instrumentality thereof) becomes the owner (directly or indirectly, including through an option) of more than 50% of the stock of a loss corporation (by vote or value, excluding pure preferred stock). In such case, the corporation issuing the stock or option will not have a testing date on any date the United States holds a more than 50% interest. The loss corporation is required to determine whether there is a testing date (and whether there is an ownership change) once the United States' interest drops to 50% or less. The notice applies to any taxable year ending on or after September 26, 2008. Notice 2008-84. The IRS and the Treasury Department have announced that they intend to issue regulations that implement the rules described in Notice 2008-84.

In February 2009, the Congress enacted section 382(n) with respect to ownership changes caused by a restructuring plan pursuant to the Emergency Economic Stabilization Act of 2008, PL 110-343. These restructuring plans include certain plans under the TARP. The limitations of section 382 do not apply to an ownership change pursuant to a plan that is under a loan agreement (or commitment for a line of credit) entered into with the Treasury Department that is "intended to result in a rationalization of the costs, capitalization, and capacity with respect to the manufacturing workforce of, and suppliers to, the taxpayer and its subsidiaries." IRC § 382(n)(1)(B).

The exemption from section 382 does not apply if immediately after the ownership change any person (other than a voluntary employees' beneficiary association ("VEBA")) owns 50% or more of the stock of the loss corporation (by vote or value). IRC § 382(n)(3)(A). For this purpose, all related persons are treated as a single person. Two or more persons are related if they bear a relationship described in section 267(b) or 707(b) of the Code. IRC § 382(n)(3)(B). 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, two or more persons are treated as related if they are members of a group or persons acting in concert. IRC § 382(n)(3)(B)(ii)(II).

If a loss corporation has a subsequent ownership change after undergoing an ownership change that is exempt from section 382, the subsequent ownership change is generally subject to section 382. However, if the subsequent ownership change also qualifies for exemption, then the subsequent ownership change is also exempt. IRC § 382(n)(2).

The exemption from section 382 for restructuring plans under the Emergency Economic Stabilization Act only applies to ownership changes after February 17, 2009. American Recovery and Reinvestment Tax Act of 2009, PL 111-5, § 1262(b).

In Private Letter Ruling 201114004 (Sept. 20, 2010), *as modified by*, PLR 201229004 (Aug. 10, 2011), the IRS dealt with the exemption under section 382(n). The taxpayer in the ruling entered into a loan agreement with the Treasury Department under the Emergency Economic Stabilization Act of 2008. The taxpayer was required to submit a restructuring plan before receiving any loan proceeds from the government. The restructuring plan was required to provide for (i) repayment of any government loans or other funding, (ii) rationalization of costs, capitalization, and capacity with respect to workforce and suppliers, and (iii) modification of the healthcare and pension obligations with respect to retirees. The Treasury Department subsequently approved the taxpayer's restructuring plan and agreed to provide funds to support the plan.

As part of the plan described in Private Letter Ruling 201114004, the taxpayer transferred substantially all of its assets to a newly-formed successor corporation in an acquisitive reorganization. This implementation of the restructuring plan resulted in an owner shift (i.e., certain lenders received stock). After the restructuring plan transaction, the successor corporation planned to issue stock in a public offering (initial, secondary, or combination). The taxpayer stated that it believed that the shifts attributable to the restructuring plan and the public offering would result in an ownership change. The IRS ruled that the restructuring plan met the requirements for exemption under section 382(n). It also ruled that section 382(n) applied to an ownership change that occurs pursuant to the public offering if the ownership change would not have occurred if stock acquired in the restructuring plan were to be ignored. PLR 201114004.

In Notice 2010-2, 2010-1 CB 251, the IRS provided guidance regarding the application of section 382 (and other provisions) to instruments acquired by the Treasury Department pursuant to the Troubled Asset Relief Program ("TARP") established under sections 101(a)(1) and 102(a) of the Emergency Economic Stabilization Act of 2008, PL 110-343. Notice 2010-2 supersedes prior guidance issued in Notice 2009-38, 2009-1 CB 901, Notice 2009-14, 2009-1 CB 516, and Notice 2008-100, 2008-2 CB 1081.

Notice 2010-2 applies to corporate issuers with respect to eight TARP programs. The eight programs are (i) the Capital Purchase Program for publicly-traded issuers ("Public CPP"), (ii) the Capital Purchase Program for private issuers ("Private CPP"), (iii) Capital Purchase Program for S corporations ("S Corp CPP"), (iv) the Targeted Investment Program ("TARP TIP"), (v) the Asset Guarantee Program, (vi) the Systemically Significant Failing Institutions Program, (vii) the Automotive Industry Financing Program ("TARP Auto"), and (viii) the Capital Assistance Program for publicly-traded issuers ("TARP CAP"). The notice does not apply to instruments issued under other programs. Where the notice does not apply, the U.S. Federal income tax consequences are determined based upon specific facts and circumstances. Notice 2010-2, § IV. It appears that these "facts and circumstances" apply to state, local, and foreign stimulus programs, as well as other Federal programs. *See* Letter from Michael F. Mundaca, Acting Assistant Secretary (Tax

Policy), Treasury Department, to Lawrence R. Uhlick, Chief Executive Officer, Institute of International Bankers, 2010 TNT 22-15 (Notice 2010-2 will not be expanded to cover foreign stimulus plans); Letter from Michael F. Mundaca, Assistant Secretary (Tax Policy), Treasury Department, to Lawrence R. Uhlick, Chief Executive Officer, Institute of International Bankers, 2010 TNT 76-14 (same).

The notice provides guidance on the characterization of instruments issued to the Treasury Department under TARP (other than TARP CAP). Such instruments are treated as debt obligations if denominated as debt. Similarly, such instruments are treated as pure preferred stock if denominated as preferred stock. The treatment as debt or pure preferred stock applies for all U.S. Federal income tax purposes (including section 382) and applies to subsequent holders (as well as the Treasury Department). As a result, debt obligations or shares of preferred stock issued under a TARP program are not treated as stock for ownership change purposes. (Preferred stock issued under a TARP program; however, is treated as stock for purposes of determining the base annual section 382 limitation.) Notice 2010-2, § III.A.

The notice does not provide guidance as to the appropriate classification of instruments issued to the Treasury Department pursuant to TARP CAP. The classification of such instruments are determined based upon general tax principles. Notice 2010-2, § III.A.

Any warrant to purchase stock issued to the Treasury Department pursuant to a TARP program (other than Private CPP or S Corp CPP) is treated as an option (and not as stock). The treatment as an option applies for all U.S. Federal income tax purposes (including section 382) and applies to subsequent holders (as well as the Treasury Department). While owned by the Treasury Department, such a warrant is not to be deemed to be exercised under the option attribution rules. Notice 2010-2, § III.B. It appears that the warrant can be deemed to be exercised under the option attribution rules once the Treasury Department transfers it to a third party.

Any warrant to purchase stock issued to the Treasury Department pursuant to the Private CPP program is treated as an ownership interest in the underlying stock. The underlying stock is itself treated as pure preferred stock. The treatment as a pure preferred stock applies for all U.S. Federal income tax purposes (including section 382). Notice 2010-2, § III.B. It does not appear that the treatment as pure preferred stock applies to subsequent holders.

Any warrant issued to the Treasury Department pursuant to the S Corp CPP program is treated as an ownership interest in the underlying debt obligation. The treatment as a debt obligation applies for all U.S. Federal income tax purposes (including section 382). Notice 2010-2, § III.B. It does not appear that the treatment as debt applies to subsequent holders.

The notice treats amounts received by an issuer in exchange for instruments issued to the Treasury Department under a TARP program as received solely as consideration for such instrument. Notice 2010-2, § III.C. As a result, it appears that the issuer will not realize gross income as a result of amounts paid by the Treasury Department for instruments (even if the amounts received exceed the value of the obligations issued). In addition, any capital contribution made by the Treasury Department does not result in a negative adjustment to the base annual section 382 limitation under the capital contributions adjustment (i.e., the contribution is not for a principal purpose of tax avoidance). Notice 2010-2, § III.F.

Any stock issued to the Treasury Department (other than pure preferred stock) pursuant to a TARP program (directly or upon exercise of a warrant) receives special treatment for ownership change purposes. On any testing date, the Treasury Department's ownership in the issuing corporation is not considered to have

increased for ownership change purposes. Such stock is considered to be outstanding for purposes of determining the percentage stock interest of other 5% shareholders on the testing date. Notice 2010-2, § III.D. As a result, an acquisition of stock by the Treasury Department will generally not cause (or contribute to) an ownership change. This special treatment does not appear to apply to subsequent 5% shareholders.

Special rules apply if a loss corporation redeems stock held by the Treasury Department that was originally issued pursuant to a TARP program (directly or upon exercise of a warrant). The redeemed stock is treated as if it had never been outstanding for ownership change purposes. This treatment applies for testing dates occurring on or after the date of the redemption. Notice 2010-2, § III.D. As a result, a redemption of stock held by the Treasury Department will generally not cause (or contribute to) an ownership change.

Notice 2010-2 added controversial rules for the treatment of stock sold by the Treasury Department to public shareholders. These rules had not been included in prior guidance. The new rules apply if the Treasury Department sells stock that was originally issued pursuant to a TARP program (directly or upon exercise of a warrant) and the sale creates a new public group under the segregation rules. In such case, the new public group's percentage ownership interest is not treated as having increased solely as a result of the sale. The new public group's percentage ownership interest is treated as increasing to the extent it increases as a result of other transactions (e.g., a stock issuance or redemption). The stock held by the new public group is considered to be outstanding for purposes of determining the percentage stock interest of other 5% shareholders on the testing date. Notice 2010-2, § III.E.

The rules for sales of stock to new public groups have been controversial. Senator Grassley has suggested that the notice may have resulted in an inappropriate tax benefit to certain banks for which the Treasury Department owns shares. Letter from Chuck Grassley, Ranking Member, Senate Finance Committee, to Timothy F. Geithner, Secretary, Treasury Department, and Douglas Shulman, Commissioner, IRS, 2009 TNT 245-29.

In 2013, the segregation rules were amended so that a new public group was not treated as created when a 5% shareholder sold shares to public shareholders. Treas. Reg. § 1.382-3(j)(13). This change created some uncertainty as to how Notice 2010-2 applies since the special rule in the notice only comes into play if a sale by the Treasury Department creates a new public group. This glitch was corrected by changing the applicability date of the change to the segregation rules. As a result, the old segregation rules (i.e., a new group is created) continue to apply with respect to a sale of stock by the Treasury Department that was originally issued pursuant to a TARP program. Temp. Reg. § 1.382-3T(j)(17). As before the segregation rules were changed, a sale of TARP stock results in a new public group which is treated as not having an owner shift (except to the extent other transactions create an increase).

The notice extends some of the above-described rules to certain instruments acquired by the Treasury Department in exchange for instruments that were issued to the Treasury Department under a TARP program (a "covered instrument"). A covered instrument also includes an instrument that is acquired by the Treasury Department in exchange for a covered instrument. The rules described in Notice 2010-2 generally apply to covered instruments as though the instruments were issued directly to the Treasury Department under a TARP program. One exception to the rule described in the previous sentence is that no guidance is given as to character of any covered instrument. The character of a covered instrument is determined under general tax principles. Notice 2010-2, § III.G.

Taxpayers are permitted to rely on the rules set out in Notice 2010-2 pending the issuance of further guidance. Future contrary guidance will not apply to obligations issued to (or covered instruments acquired

by) the Treasury Department prior to (or, after, if pursuant to prior binding contract) publication of that guidance. Notice 2010-2, § IV.

The IRS and the Treasury Department have announced that they intend to issue regulations that implement the rules described in Notice 2010-2.

The IRS had announced that section 597 of the Code will not apply to amounts furnished by the Treasury Department to a financial institution pursuant to the TARP. Notice 2008-101, 2008-2 CB 1082. The regulations under section 597 apply special rules for determining ownership changes of certain financial institutions. *See* Treas. Reg. § 1.597-4(c). As a result, it appears that the section 382 provisions of the section 597 regulations will not apply to restructuring plans pursuant to the TARP. Taxpayers are permitted to rely on the rules set out in Notice 2008-101 pending the issuance of further guidance. Future contrary guidance will not apply to transactions with (or to securities issued by financial institutions to) the Treasury Department prior to (or after, if pursuant to a prior written binding contract) publication of that guidance. Notice 2008-101.

### **E. FDIC Receiverships**

Over the years the Federal Deposit Insurance Corporation (the “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 U.S. 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. Final amended regulations were recently issued to provide guidance on loss guarantees and loss sharing agreements. Treas. Reg. § 1.597-5(f) Ex. 4, 5 (generally effective on or after October 19, 2017).

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 appears to be included in the definition of a Bankruptcy Case. IRC § 368(a)(3)(D).

The IRS has announced that section 597 will not apply to amounts furnished by the Treasury Department to a financial institution pursuant to the TARP. Notice 2008-101, 2008-2 CB 1082. As a result, it appears that the section 382 provisions of the section 597 regulations will not apply to restructuring plans pursuant to the TARP.

## **VIII. Consolidated Groups**

Special 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).

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.

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).

The consolidated NOL can be carried forward to subsequent 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).

If a member of a consolidated group departs from the group, the member’s share of any unused consolidated NOL carryforward is 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 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). It appears that the SRLY limitation generally applies if the ownership change that occurred within six months qualifies for exemption from limitation under section 382(l)(5).

Similar concepts apply with respect to the tax attributes that are limited by section 383 and to charitable contribution deductions. Treas. Reg. §§ 1.56(g)-1(n) (consolidated ACE rules), 1.1502-3 (consolidated general business credit), -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. §§ 1.163(j)-5(b)(3) (business interest expense), 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).

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 appears to apply to capital losses and charitable contributions, as well as NOLs. 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)(4)(ii).

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.)

The IRS and the Treasury Department have proposed regulations that, if finalized, would expand the choices with respect to relinquishing the carryback period. The split waiver election described in the previous paragraph would still be available. However, the proposed regulations would expand the existing election to cover any member that joins a consolidated group (even if the member was not previously a



member of a consolidated group). In addition, the proposed regulations would expand the split waiver election to waive the entire carryback period (not just the carrybacks to the former group). Prop. Reg. § 1.1502-21(b)(3)(ii)(B)(1), (3). The proposed effective date for the changes to the split waiver election is for acquisitions that occur on or after the proposed regulations are finalized (unless the acquisition is pursuant to a written agreement that is binding on such date). Prop. Reg. § 1.1502-21(h)(5).

In addition, the proposed regulations would offer two additional choices. The three choices that are described in the proposed regulations are mutually exclusive. Prop. Reg. § 1.1502-21(b)(3)(ii)(B)(1). The proposed regulations would allow an acquiring group to relinquish the ability to carry back a single taxable year's NOL (the "annual election"). The annual 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. Prop. Reg. § 1.1502-21(b)(3)(ii)(B)(1), (2). The proposed effective date for the annual election is for acquisitions that occur on or after the proposed regulations are finalized (unless the acquisition is pursuant to a written agreement that is binding on such date). Prop. Reg. § 1.1502-21(h)(5).

The 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).

If a member joins a consolidated group and has a NUBIL on the day it joined the group, any RBILs can be subject to the SRLY limitation. Unlike with respect to the section 382 NUBIL rule, the amount of the NUBIL does not serve as a cap on the amount of deductions that can be treated as RBILs during the recognition period. Treas. Reg. § 1.1502-15(a), (b). However, 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. § 1.1502-15(g).

## **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 U.S. 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.

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) Ex. 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) Ex. (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.

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) Ex., (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) Ex.

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, (iii) a transferor or distributor of assets on or after June 25, 1999, if the successor receives a transferred basis in the assets, or (iv) a transferor or distributor of assets before June 25, 1999, if the successor receives a transferred basis in the assets and the difference between the basis and the value of the assets, in the aggregate, is material. In each such case, the successor corporation is the corporation that received the assets from the transferor or distributor. For transactions occurring before June 25, 1999 only one member may be considered a predecessor and only one member may be considered a successor. 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), and (ii) any ownership change pursuant to the separate subsidiary approach (described below). 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) 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 and capital losses) 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, (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. As an example, 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)

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).

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).

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.

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 when 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 uncertainty as to how to apply the ACE NUBIL rules in the event of a switch in regimes. For example, if a loss group switches from NUBIL to NUBIG, do the previous basis adjustments (to the extent not taken into account in depreciation or gain or loss) get reversed? There is also 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 of the Code 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 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).

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.

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-subsidary 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).

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 of the Code 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) Ex. 10(b). 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) Ex. 10(c).

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).

ACE NUBIL Rule. The consolidated section 382 and the consolidated ACE rules provide limited guidance as to how to apply the ACE NUBIL rule to a consolidated group. As a result, there is some uncertainty as to how to apply the rules.

The consolidated ACE regulations provide that ACE is computed on a consolidated basis. Consolidated taxable income is adjusted on a consolidated basis to arrive at consolidated pre-adjustment alternative minimum taxable income. Consolidated pre-adjustment alternative minimum taxable income is adjusted on a consolidated basis to arrive at consolidated ACE. The positive ACE adjustment is determined by taking into account 75% of the excess of consolidated ACE over consolidated pre-adjustment alternative minimum taxable income. The negative ACE adjustment (subject to limitations that are computed on a consolidated basis) is determined by taking into account 75% of the excess of consolidated pre-adjustment alternative minimum taxable income over consolidated ACE. Treas. Reg. § 1.56(g)-1(n).

An ACE NUBIL is determined by applying the rules that are used to determine a NUBIL for regular tax purposes, but taking into account ACE basis in the assets (instead of regular tax basis). Treas. Reg. § 1.56(g)-1(k)(3). Presumably, this means that a consolidated ACE NUBIL is determined by taking into account the separate ACE NUBIGs and NUBILs of the members of the group and excluding from the computation certain members that have not been members of the consolidated group for five years. *See* Treas. Reg. § 1.1502-91(g)(1), (2)(ii).

For section 382 purposes, UBIG or UBIL with respect to stock of a member of the consolidated group or intercompany obligations is not taken into account in determining consolidated NUBIG or NUBIL. Treas. Reg. § 1.1502-91(g)(1). No authority has been found as to whether (or how) to apply the ACE mark-to-market rules to either item.

It appears that the ACE basis of stock of a member should generally be adjusted by the ACE NUBIL rules. The consolidated regulation generally ignore built-in gains or losses with respect to stock in determining NUBIG or NUBIL, but take such gains or losses, if recognized, into account in determining RBIGs or RBILs. Treas. Reg. § 1.1502-91(h)(2). There is some uncertainty as to how to recompute the basis for ACE purposes. One approach would be to mark the basis to market. The other approach would be to change the stock basis pursuant to the investment adjustment rules of section 1.1502-32 of the Treasury regulations by the adjustments made to the asset basis of the member. *See* Treas. Reg. § 1.1502-32(b)(3)(ii)(D), (iii)(B); Prop. Reg. § 1.1502-55(g). These two approaches generally come to the same result if there is no disconformity between inside and outside basis.

It is possible that the basis of intercompany obligations does not need to be marked-to-market for ACE purposes. The consolidated regulations do not treat gain or loss on an intercompany obligation as an RBIG or an RBIL unless the transaction affects consolidated taxable income. Treas. Reg. § 1.1502-91(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) Ex.

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 of the Code 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. §§ 1.1502-36(d)(7) (applicable to worthlessness determinations on or after September 17, 2008), -35(f) (applicable to worthlessness determinations on or after March 10, 2006 and before September 17, 2008); Temp. Reg. § 1.1502-35T(f)(1) (applicable to worthlessness determinations after March 18, 2004 and before March 10, 2006 and optionally available for worthlessness determinations on or after March 7, 2002).

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 carrybacks 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 U.S. 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. New rules 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 will 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, are not taken into account in determining NUBIG or NUBIL, and are not treated as RBIGs or RBILs. Prop. Reg. § 1.1502-76(b)(1)(ii)(D); Notice of Proposed Rulemaking 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 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 of 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. New rules 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 will 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, are not taken into account in determining NUBIG or NUBIL, and are not treated as RBIGs or RBILs. Prop. Reg. § 1.1502-76(b)(1)(ii)(D); Notice of Proposed Rulemaking 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) 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 harsher (but not reduced) limitation. 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 times 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).) 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) (effective for transactions on or after December 16, 2008), -36(d)(7) (effective for transactions on or after September 17, 2008); *see also* Treas. Reg. § 1.1502-35(f) (more limited provision applicable to transactions on or after March 10, 2006), Temp. Reg. § 1.1502-35T(f) (transactions on or after March 7, 2002 and before March 10, 2006).

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 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, remaining consolidated (or subgroup) NUBIL 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 times 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) (effective for transaction on or after December 16, 2008), -36(d)(7) (effective for transactions on or after September 17, 2008); *see also* Treas. Reg. § 1.1502-35(f) (more limited provision applicable to transactions on or after March 10, 2006); Temp. Reg. § 1.1502-35T(f) (transactions on or after March 7, 2002 and before 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). 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 Industries 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 (1)(5) and (1)(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(1)(5) and section 1.269-3(d) of the Treasury regulations applied on a consolidated basis).

Section 382(1)(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(1)(5). Many taxpayers take the position that where the parent change method applies, all of the members of the group qualify for section 382(1)(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(1)(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(1)(5)(A)(ii); Treas. Reg. § 1.382-9(b)(2). A separate approach would necessarily result in exclusion from section 382(1)(5) for members that are not in bankruptcy.

For members that do not qualify for section 382(1)(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(1)(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(1)(6). The issues under section 382(1)(6) in the consolidated context are similar to those under section 382(1)(5). However, there seems to more comfort that section 382(1)(6) can be applied on a consolidated basis than there is for section 382(1)(5). Section 382(1)(6) only adjusts the amount of the base annual section 382 limitation and does not provide an exemption from section 382. Applying section 382(1)(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(1)(6) on a consolidated basis if the consolidated group elected to apply section 382(1)(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 Section 383 Rules**

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 first sentence of 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. The remainder of the regulation 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. 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.

## **J. Unified Loss Rules**

In September 2008, the IRS and the Treasury Department issued final unified loss rules. 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 unified loss rules generally apply to transfers of subsidiary stock on or after September 17, 2008. Treas. Reg. § 1.1502-36(h).

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) of the Code. 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 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. No. 795, 100<sup>th</sup> Cong. (1988); S. Rep. No. 445, 100<sup>th</sup> Cong. (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. The 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. No. 391, 100<sup>th</sup> Cong. (1987). Section 384 is generally effective with respect to acquisitions after December 15, 1987. PL 100-203, § 10226(c).

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. Generally, the 1988 changes to the statute are effective as if included in the original 1987 legislation. For acquisitions that occurred before March 31, 1988, the taxpayer could elect to apply the 1987 statutory language instead of the 1988 statutory language. PL 100-647, § 2004(m).

Since 1988, the 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 twenty 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).

### **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) 780-3<sup>rd</sup>, 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) of the Code (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). 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) of the Code, 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 of the Code,
- net capital losses under section 1212 of the Code,
- general business credits under section 39 of the Code,
- minimum tax credit under section 53 of the Code, and
- RBILs.

IRC. § 384(c)(3), (d). Section 384 does not appear to limit the use of foreign tax credits, charitable contribution deductions, or excess 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).

Section 168(k)(4) (as in effect for property acquired after March 31, 2008 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. Rev. Proc. 2009-16, 2009-1 CB 449, § 2.09, *mod. by*, Rev. Proc. 2009-33, 2009-2 CB 150. The guidance is silent as to

whether the credits remain subject to section 384, if applicable. Presumably, the election does not increase any section 384 limitation.

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).

### **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.

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 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. No. 391, 100<sup>th</sup> Cong. (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 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) of the Code. The regulations which expand section 384 were not intended to be effective prior to the issuance of guidance. H. Conf. Rep. No. 495, 100<sup>th</sup> Cong. (1987). 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.

Notice 2003-65. 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.

Notice 2003-65 is 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 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, 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 Notice 2003-65 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, 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 of the Big four 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.

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.

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, there is currently uncertainty as to whether a taxpayer can change approaches after applying an approach on a tax return.

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. 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. No. 795, 100<sup>th</sup> Cong. (1988); S. Rep. No. 445, 100<sup>th</sup> Cong. (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. No. 795, 100<sup>th</sup> Cong. (1988); S. Rep. No. 445, 100<sup>th</sup> Cong. (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.

The dual consolidated loss regulations provide for the section 384 treatment of potential recapture amounts with respect to a dual consolidated loss. 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). These regulations generally apply to taxable years beginning on or after April 18, 2007. Treas. Reg. § 1.1503(d)-8(a).

## **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 or 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. §§ 1.1502-3(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), Prop. Reg. § 1.163(j)-5(f) (excess business interest).

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 1.1502-1(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. *See also* Prop. Reg. § 1.163-5(d) (excess business interest).

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. The current rules are generally effective for taxable years for which the due date (without extensions) of the consolidated return is after June 25, 1999. Treas. Reg. §§ 1.1502-15(h)(1), -21(h)(1), -22(h)(1).

Since 1999, the IRS and Treasury Department have not revised the language of the SRLY limitation rules. Despite the amount of time the current rules have been in place (over ten years), there have only been a few rulings (and no cases) that interpret the rules.

### **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 carryback rules are not discussed in this paper.)

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. ILM 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). The exception generally applies to a taxable years 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 transferred 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 of the Code,
- net capital losses under section 1212 of the Code,
- general business credits under section 38 of the Code,
- minimum tax credits under section 53 of the Code, 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.

Proposed regulations would expand the SRLY limitation rules to cover excess business interest under section 163(j) (as amended by the TCJA). Prop. Reg. § 1.163(j)-5(d). These proposed regulations are proposed to apply to taxable years ending after the date they are finalized. However, taxpayers (and their related parties) may rely on the section 163(j) proposed regulations in their entirety before then. Prop. Reg. § 1.163(j)-5(h).

Section 168(k)(4) (as in effect for property acquired after March 31, 2008 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. §§ -21(b)(1) (NOLs), -22(b)(2) (net capital losses); Prop. Reg. §§ 1.163(j)-5(b)(2), 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) Ex. 2(vi) (NOLs).

Sections 382 and 384 have rules that apply 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) Ex. 2.

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) Ex. (1) (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) Ex. 5.

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) Ex. 5.

### **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. §§ 1.1502-15(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); Prop. Reg. § 1.163(j)-5(f). 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 majority stock 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) Ex. 3.

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) Ex. 1, 8(iii) (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) Ex. 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) Ex. 4, -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) Ex. 8.

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 NOLs and Capital Losses**

In this subsection, we will discuss the determination of the SRLY limitation on NOL and capital loss carryforwards, as well as the proposed rules for excess 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).

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 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).

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).

Under a rule to transition from the old SRLY regime to the present one, consolidated return years beginning before January 1, 1997 are not generally taken into account in determining the SRLY register. Treas. Reg. § 1.150-21(h)(2). However, if the consolidated group had made an election to retroactively apply the new SRLY rules, consolidated return years beginning before January 29, 1991 are not taken into account in determining the SRLY register instead. Treas. Reg. § 1.150-21(h)(3).

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. sec. 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. ILM 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. ILM 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).

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) Ex. 5.

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).

Under a rule to transition from the old SRLY regime to the present one, consolidated return years beginning before January 1, 1997 are not generally taken into account in determining the capital loss SRLY register. Treas. Reg. § 1.150-21(h)(2). However, if the consolidated group had made an election to retroactively apply the new SRLY rules, consolidated return years beginning before January 29, 1991 are not taken into account in determining the SRLY register instead. Treas. Reg. § 1.150-21(h)(3).

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) Ex. 5(ii).

Excess Business Interest. Proposed regulations would expand the SRLY limitation rules to cover excess business interest under section 163(j) (as amended by the TCJA). Prop. Reg. § 1.163(j)-5(d). These proposed regulations are proposed to apply to taxable years ending after the date they are finalized. However, taxpayers (and their related parties) may rely on the section 163(j) proposed regulations (in their entirety) before then. Prop. Reg. § 1.163(j)-5(h).

The SRLY limitation on excess 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). Prop. Reg. § 1.163(j)-5(d)(1). Unlike with respect to NOLs and other tax attributes, the proposed regulations do not apply a register concept. SRLY-limited deductions are deductible on a pro rata basis with non-SRLY limited carryforwards from the same taxable year. Prop. Reg. § 1.163(j)-5(d)(2).

## 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 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) Ex. 4, -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 not 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) times 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).

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 of the Code 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 \$17.5 million (\$50 million times 35%). The full \$17.5 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 \$70 million (\$200 million times 35%). Under the percentage method, S1's share of the consolidated net regular tax liability would be increased to \$70 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 \$52.5 million (\$70 million less \$17.5 million). Treas. Reg. § 1.1502-33(d)(6) Ex. 2.

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 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). 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. § 1.1502-3(d)(3)(i)(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).

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 times 35%) and a consolidated tentative minimum tax of \$80 million (\$400 million times 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 times 35%) and a consolidated tentative minimum tax of \$30 million (\$150 million times 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 times 35%). Sub's share of consolidated tentative minimum tax equals \$16 million (\$80 million times 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 times 35%). Sub's share of consolidated tentative minimum tax equals negative \$4 million (negative \$20 million times 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. 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).

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. Notice of Proposed Rulemaking 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. 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 carryforwards subject to the SRLY limitation rules under the principles that apply to NOLs. Treas. Reg. §§ 1.1502-3(d)(2)(iii) (general business credits), -22(c) (capital losses), -55(h)(4)(iii)(B)(4) (minimum tax credits), Prop. Reg. § 1.163(j)-5(d)(1). 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.

NOL (and other) Carryforwards. In the case of an NOL (or other) carryforward, 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).

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 SRLY subgroup may exist only for a carryforward 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) Ex. 1(iii), Ex. 2(ii). The subgroup rule could apply to Target and its subsidiaries with respect to the Holdco consolidated group if the overlap exception applied to the Parent’s acquisition of Target. Treas. Reg. § 1.1502-21(c)(2)(viii) Ex. 1(vi), (vii).

A separate SRLY subgroup is determined for each carryforward. 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) Ex. 3.

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).

A member remains a member of a SRLY subgroup until it ceases to be affiliated with a loss member. Treas. Reg. § 1.1502-21(c)(2)(i), (viii) Ex. 4. 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 determining the members of a SRLY subgroup, a successor of a member is treated as a member of the group. Treas. Reg. sec. 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), -21(c)(2)(viii) Ex. 1(vi), (vii).

If a SRLY subgroup exists, the SRLY limitation is computed on a subgroup basis. With respect to an NOL carryforward, 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) Ex. 2. 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) Ex. 4.

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 the 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) Ex. 1(vii).

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) Ex. 1(vi), (vii), (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 corporation to be a member of more than one SRLY subgroup. For example, if the 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) Ex. 3.

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 each of the first two consolidated 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) Ex. 3(iii).

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 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 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 subgroup 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) Ex. 3.

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 is 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). Treas. Reg. sec. 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). 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) Ex. 1(vi), (vii).

It is possible for 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 group 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. §§ 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-(c)(4), -91(h)(2).

If a loss is deferred (for example under section 267 of the Code 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) Ex. 4, -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 applicable 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 same members (i.e., coextensive subgroups). Treas. Reg. § 1.1502-21(g)(5) Ex. 5, 6.

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) Ex. 6.

The applicable 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.

## Definitions & Acronyms

	The following definitions and acronyms are used in this outline.
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.
ACE	Adjusted Current Earnings
AMT	Alternative Minimum Tax
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)
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.
Change date	A testing date on 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 taxable 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.
Amended Segregation Rules	Prop. Reg. § 1.382-3(i), (j).
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) of the Code.
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
TARP	Troubled Asset Relief Program
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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