CHAPTER 12

CARRYOVERS OF CORPORATE TAX ATTRIBUTES

A. INTRODUCTION

Code: § 381(a). Skim § 381(c).

The Internal Revenue Code contains a comprehensive statutory scheme governing the carryover of various corporate "tax attributes" (such as earnings and profits, net operating losses, and capital loss carryforwards) on corporate acquisitions and other major transactions involving a change of ownership of a corporation. As always, some brief historical background helps to put the current law into perspective.

The earliest versions of the Code contained few rules regulating the carryover of corporate tax attributes. The Supreme Court merely followed the lead of lower courts[1] in holding that a corporation's earnings and profits could not be eliminated by means of a reorganization but instead the acquiring corporation inherited the target's earnings and profits along with its assets.[2] Because any other approach would have allowed a profitable corporation to use a reorganization to sweep its earnings and profits account clean and diminish future dividends, the Court's decision was no more surprising than the reaction of the tax bar to the proposition that corporate attributes could survive a reorganization. They assumed, or at least hoped, that an acquiring corporation could inherit negative as well as positive tax attributes in a tax-free reorganization or liquidation. If that assumption proved true, profitable corporations could acquire the assets of their unprofitable brethren solely to succeed to the target's earnings and profits deficit and net operating losses (NOLs). The acquiring corporation thus could assure itself that future distributions would be sheltered by the newly acquired earnings and profits deficit and that future income would be effectively exempt from tax because of the newly acquired NOLs.

The Supreme Court responded by holding that earnings and profits deficits did *not* survive a reorganization[3] and that NOLs could be used only by the corporate entity that incurred them.[4] But tax advisors were not to be outdone. Shortly after these decisions, several reorganizations which followed a similar pattern appeared on the scene. Loss Corp., a

1 See, e.g., Commissioner v. Sansome, 60 F.2d 931 (2d Cir.1932), cert. denied, 287 U.S. 667, 53 S.Ct. 291 (1932).

2 Commissioner v. Munter, 331 U.S. 210, 67 S.Ct. 1175 (1947).

3 Commissioner v. Phipps, 336 U.S. 410, 69 S.Ct. 616 (1949).

4 New Colonial Ice Co. v. Helvering, 292 U.S. 435, 54 S.Ct. 788 (1934). But see Helvering v. Metropolitan Edison, 306 U.S. 522, 59 S.Ct. 634 (1939), where the Court held that these attributes did follow the target's assets in certain mergers.

corporation with NOLs but no current income to absorb them, would acquire the assets of Profit Corp., a successful company, in a tax-free reorganization. In the process, the Profit Corp. shareholders would receive more than enough Loss Corp. stock to control the continuing and expanded Loss Corp. Since Loss Corp. technically was the surviving entity, it retained its NOLs, which then were used to offset the gains generated by the new business. Once again, the Supreme Court was forced to respond to a device involving trafficking in tax attributes. In Libson Shops, Inc. v. Koehler,[5] the Court decided that even if a loss corporation survives a reorganization, NOLs incurred prior to the transaction only could be used to offset postacquisition gains if they were generated by substantially the same *business* as well as the same entity which had incurred the losses.

With the arrival of the Internal Revenue Code of 1954, the case law regulating the carryover of tax attributes was replaced by a comprehensive statutory scheme.[6] The principal provisions are: (1) Section 381, which generally provides that a target corporation's tax attributes follow its assets in tax-free reorganizations (other than B and E reorganizations) and tax-free liquidations of a subsidiary; (2) Sections 382 and 383, which restrict the carryforward of net operating losses and certain other losses and credits following a substantial change of ownership; (3) Section 384, which limits the use of loss carryforwards to offset certain gains following a corporate acquisition; and (4) Section 269, which allows the Secretary to disallow deductions, credits or other allowances in certain situations where one corporation's stock or assets were acquired for the principal purpose of obtaining the specific deductions, credits or allowances in question. This chapter first considers the general carryover rules and limitations in Section 381 and then turns to the more specialized limitations on loss carryforwards.

B. SECTION 381 CARRYOVER RULES

Code: § 381(a), (b). Skim § 381(c).

General Carryover Rules. Section 381(a) provides that in a tax-free liquidation of a subsidiary or a reorganization (other than a Type B or E reorganization), the acquiring corporation shall "succeed to and take into account" certain specified tax attributes of the target,[7] including earnings and profits, NOLs, accounting and depreciation methods, and capital loss, investment credit and charitable contribution carryovers.[8] In a Type

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5 353 U.S. 382, 77 S.Ct. 990 (1957).

6 Some commentators and courts have suggested that the *Libson Shops* doctrine survived the 1954 Code, but Congress intended specifically not to incorporate the doctrine into the new statutory scheme governing limitations on net operating loss carryforwards. H.R.Rep. No. 99–841, 99th Cong., 2d Sess. II–194 (1986).

7 I.R.C. § 381(c)(1)–(26).

8 Cf. I.R.C. § 312(h)(2), which requires a "proper allocation" of earnings and profits between the acquiring corporation and the target if less than 100 percent of the assets are acquired in a Type C or Type D reorganization.

B stock-for-stock acquisition and a Type E recapitalization, the acquired or recapitalized corporation remains intact after the transaction and thus no carryover mechanism is necessary. The regulations adopt a strict but simple approach for determining the "acquiring" corporation with respect to all tax attributes governed by Section 381. Only a single "acquiring" corporation may succeed to the target's tax attributes.[9] In a Section 332 liquidation of a subsidiary, the parent is the acquiring corporation.[10] In a Type A, C, D, F or G reorganization, the corporation that directly acquires the transferred assets is the acquiring corporation even if it ultimately retains none of those assets because all or part of them are dropped down to a controlled subsidiary.[11]

Earnings and Profits Deficits. Left unchecked, Section 381 would subject the revenue to some of the same abuses already discussed. As we have seen, one promising tax avoidance strategy is presented where Profit Corp. acquires Loss Corp.'s assets in a reorganization and inherits its earnings and profits deficit and NOL carryovers. To some extent, this abuse is limited by Section 381 itself. Section 381(c)(2) restricts Profit Corp.'s ability to rid itself of its own current or accumulated earnings and profits through a simple acquisition of Loss Corp. by providing that an earnings and profits deficit inherited from Loss Corp. may not be applied against any earnings and profits of Profit Corp. that existed prior to the acquisition. Loss Corp.'s deficit therefore only can be used to offset postacquisition accumulated earnings and profits. If a distribution is made in a postacquisition year in which there are current earnings and profits, any offsetting accumulated deficit acquired from Loss Corp. is irrelevant in any event, since the distribution will be deemed to come from the current earnings and profits of the taxable year and then from Profit Corp.'s own preacquisition accumulated earnings and profits.[12]

Net Operating Losses. Even though Profit Corp. receives little benefit from Loss Corp.'s earnings and profits deficit, Loss's NOL carryovers still might be used to eliminate Profit's own tax liability. Section 381(c)(1) provides complex rules governing the carryover of NOLs, but it does not prevent them from being misused by Profit Corp. Instead, Section 382, which is discussed later in this chapter, is the designated policing agent in this situation.

Rather than Profit Corp. acquiring the assets and tax attributes of Loss Corp., Loss might acquire Profit's assets in a Type A or C reorganization, maintaining Loss's earnings and profits deficit and NOLs without assistance from Section 381, and then might hope to use those negative tax attributes to offset Profit's past and future income. The basic

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9 Reg. § 1.381(a)–1(b)(2)(i). See also Reg. § 1.312–11(a) for the same rule for earnings and profits.

10 Reg. § 1.381(a)–1(b)(2)(i).

11 Id. See Reg. § 1.381(a)–1(b)(2)(ii) Example 2.

12 I.R.C. § 381(c)(2)(B). See Chapter 4, supra. Thus, an acquired earnings and profits deficit will do no more than prevent undistributed current earnings and profits from becoming accumulated earnings and profits in a subsequent year.

NOL rules in Section 172 operate to limit certain abuses in this situation. The Tax Cuts and Jobs Act modified the NOL deduction by (1) limiting it to 80 percent of the taxpayer's taxable income for the taxable year, and (2) providing that NOL carryforwards extend indefinitely into the future without expiration.[13] These rules are effective for losses arising in tax years beginning after December 31, 2017. The Act also generally disallows NOL carrybacks for tax years ending after 2017.[14] Thus, after 2017 Loss generally would be precluded from carrying back its NOLs to any prior years.[15] In addition, if Profit's shareholders receive sufficient Loss Corp. stock to control the combined company, the transaction in substance is identical to the acquisition of Loss Corp. by Profit. The future benefits of this transaction also are limited by both Sections 381(b) and 382.

PROBLEMS

1. Acquiring Corporation ("P") acquires the assets of Target Corporation ("T") in a valid Type C reorganization. Both corporations are calendar year taxpayers and the transactions are completed on December 31, Year 1.

(a) If P has accumulated earnings and profits of $30,000 and T has an earnings and profits deficit of $50,000, what result to the P shareholders in Year 1 if during that year P has $20,000 of current earnings and profits, T breaks even, and P distributes $20,000 cash?

(b) What result in (a), above, if P breaks even in Year 1 and makes no distributions during that year but distributes $20,000 in Year 2, a year when P also breaks even?

(c) What result in (b), above, if in Year 1, P has a $10,000 current earnings and profits deficit?

(d) What result in (b), above, if in addition in Year 3 P has a $10,000 current earnings and profits deficit and makes a $20,000 cash distribution?

(e) What result in (d), above, if in addition in Year 4, P has $20,000 of current earnings and profits and makes a $20,000 cash distribution?

(f) What result in (e), above, if P makes no distribution in Year 4, but distributes $40,000 in Year 5, a year in which P breaks even.

2. T Corporation merges into P Corporation two-thirds of the way through P's year. What are the results in the following situations:

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[13] I.R.C. § 172(a), (b)(1)(A)(ii).

[14] There are exceptions for farming losses and losses incurred by insurance companies. I.R.C. § 172(b)(1)(B) & (C).

[15] Section 381(b)(3) also contains a prohibition against an acquiring corporation carrying back an NOL incurred after the acquisition to a taxable year of a profitable target corporation. Given the general rule in Section 172 prohibiting carrybacks of NOLs, the rule in Section 381(b)(3) is now largely redundant.

(a) P has $30,000 of deficit earnings and profits for the entire year of the acquisition and T has $30,000 of accumulated earnings and profits at the date of the acquisition. The combined corporation makes a distribution of $20,000 in the succeeding year when it breaks even.

(b) Same as (a), above, except that P Corporation has $30,000 of current earnings and profits for the year and T has a $30,000 earnings and profits deficit at the time of the acquisition. The combined corporation again makes a distribution of $20,000 in the succeeding year, when it breaks even.

(c) Same as (b), above, except that the combined corporation makes a distribution of $30,000 on the last day of the year of acquisition.

3. T Corporation merges into P Corporation in a tax-free Type A reorganization in which T shareholders receive 51 percent of the outstanding P stock. Both corporations are calendar year, accrual method taxpayers and the merger occurs on December 31, Year 3. Both corporations have been in existence for two years, with T sustaining a $20,000 loss in each of those years and P earning a profit of $30,000 in each year.

(a) May the combined corporation carry back T's losses and apply them against P's profits for Year 1 and Year 2?

(b) Assuming that the loss and income patterns continue, determine the combined corporation's net income for Year 4 through Year 8.

(c) What results in (b), above, if T were a profitable corporation with net income of $20,000 in each of the prior and current years but P sustained a $100,000 loss in Year 4 followed by a return to the regular gain pattern in Year 5?

C. LIMITATIONS ON NET OPERATING LOSS CARRYFORWARDS: SECTION 382

1. INTRODUCTION

Code: Skim § 382(a), (b)(1), (g)(1), (i)(1).

Before examining the Section 382 limitations on carryovers of corporate NOLs, it is helpful to review the concept of a net operating loss. In general, a net operating loss, often identified by its "NOL" monogram, is the excess of business deductions allowed by the Code over the taxpayer's gross income in a single taxable period.[16] Generally, in taxable years before 2018, a net operating loss ordinarily could be carried back to the two taxable years preceding the loss year and carried forward to the 20 following years.[17] The Tax Cuts and Jobs Act modified the NOL for taxable years beginning after 2017 by (1) limiting it to 80 percent of

16 See generally I.R.C. § 172.

17 I.R.C. § 172(b)(1)(A) (pre-2018).

the taxable income for the taxable year, (2) providing that carryforwards of NOLs extend indefinitely into the future without expiration, and (3) generally ending carrybacks of NOLs.[18] The purpose of the carryover scheme is to serve as an averaging device that ameliorates the harsh consequences that would result for a business taxpayer with a fluctuating economic track record. As the Supreme Court has described NOL carryovers, "[t]hey were designed to permit a taxpayer to set off its lean years against its lush years, and to strike something like an average taxable income computed over a period longer than one year."[19] All of this works smoothly in the corporate setting if the owners of the entity remain unchanged during the future years in which the loss may be used. Section 382 addresses the problems that arise if the ownership of a loss corporation changes at a time that the company has unused net operating losses.

A profitable company seeking tax savings may be tempted to acquire a corporation with NOL carryovers to use those deductions to shelter its taxable income. To illustrate, assume that Mr. Loser forms Loss Co. to engage in the manufacture and sale of passing fads. The company is initially capitalized with $1,000,000, all represented by Mr. Loser's equity investment. Despite Loser's high hopes, Loss Co. incurs $999,999 in deductible expenses in the first two years of its operation and never earns a cent. At the end of two years, the company has nothing left except $1 in its checking account and a $999,999 NOL deduction that is useless because Loss Co. has no income to offset. At that point, the company is worth $1 plus the value, if any, of its deductions. If Loss Co. is liquidated, the sad story ends. If Loser infuses new property or cash into the corporation to keep the business afloat, then Loss Co. may deduct its loss carryforwards against any future income as long as Loser continues to own a controlling interest in the company.

But what if Profit Co., shopping around for tax deductions, learns of Loss Co.'s difficulties? If Profit wishes to acquire Loss, it has many options. It could: (1) acquire all of Loss Co.'s assets (i.e., $1) in exchange for Profit Co. stock in an acquisitive Type A or C tax-free reorganization, as a result of which Profit Co. would inherit all of Loss Co.'s tax attributes (i.e., its $999,999 NOL deduction);[20] (2) acquire the stock of Loss Co. in either a taxable purchase, a tax-free Type B reorganization, or reverse triangular merger, and later liquidate Loss Co. under Section 332, thereby inheriting its NOL carryforwards;[21] (3) acquire Loss Co.'s stock and then transfer its own assets into Loss Co. in a Section 351 exchange;

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18 I.R.C. § 172(a)(2), (b)(1)(A).

19 United States v. Foster Lumber Co., 429 U.S. 32, 97 S.Ct. 204 (1976).

20 I.R.C. § 381(a)(2).

21 I.R.C. § 381(a)(1). If the liquidation occurs immediately after a Type B reorganization, it would be treated as a Type C reorganization. See Rev. Rul. 67–274, 1967–2 C.B. 141; Chapter 9B3, supra. In addition, if Profit Co. acquires the Loss Co. stock and files a consolidated return, the availability of Loss Co.'s losses will be limited by the consolidated return regulations. See Section E3 of this chapter, infra.

in that case Loss Co., now a wholly owned subsidiary of Profit Co., can operate the Profit business while retaining its own NOLs; or (4) Loss Co. can acquire the assets of Profit Co. in an acquisitive tax-free reorganization by exchanging enough Loss Co. stock to give the Profit Co. shareholders virtually 100 percent ownership of Loss Co. The Profit Co. shareholders then will own Loss Co., which will own all of old Profit Co.'s assets plus a $999,999 NOL carryforward.

Is something wrong here? If Loss Co. lost money, should its NOLs be available to offset Profit's future income or should the use of those NOLs be limited to offsetting later income earned by Loss? Should Profit be able to avoid tax on $999,999 of its future income by acquiring (or being acquired by) the corporate shell of an unsuccessful business?

After pondering these questions for many years, and trying various statutory solutions, Congress eventually adopted the current version of Section 382,[22] which is the outgrowth of decades of study, most notably the Subchapter C Project of the American Law Institute and the Senate Finance Committee staff's Subchapter C report.[23]

When applicable, Section 382 limits the use of a loss corporation's NOL carryforwards when there is a change of ownership of more than 50 percent of the stock of that company over a period of three years or less.[24] Stating this general rule in the language of the Code, the loss limitations are triggered only after an "ownership change,"[25] which is either an "owner shift involving a 5-percent shareholder", or an "equity structure shift,"[26] coupled with a more than 50 percent increase in the stock ownership of "5-percent shareholders" which occurs during a three-year "testing period".[27] If Section 382 is triggered, it limits the use by a "new loss corporation" of any NOLs of an "old loss corporation" for any "post-change year" (i.e., any year after the ownership change).[28] In general, the taxable income of a new loss corporation that may be offset by preacquisition NOLs is limited to the value of the old loss corporation's stock on the date of the ownership change multiplied by a prescribed "long-term tax-exempt rate."[29] These and many other statutory terms will be explained in detail later in the chapter.

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22 See generally Jacobs, "Tax Treatment of Corporate Net Operating Losses and Other Tax Attribute Carryovers," 5 Va. Tax Rev. 701 (1986).

23 See American Law Institute, Federal Income Tax Project, Subchapter C (1986); Staff of the Senate Finance Committee, The Subchapter C Revision Act of 1985: A Final Report Prepared by the Staff, 99th Cong., 1st Sess. 32–35, 55–56, 68–71 (S.Prt. 99–47, 1985); Eustice, "Alternatives for Limiting Loss Carryovers," 22 San Diego L. Rev. 149 (1985).

24 I.R.C. § 382(g)(1), (i).

25 I.R.C. § 382(a), (g), (k)(3).

26 I.R.C. § 382(g), (k)(7).

27 I.R.C. § 382(g), (i), (k)(7).

28 I.R.C. § 382(a), (d)(2). The "new loss corporation" is the successor to Loss Co. in a merger or asset acquisition; it is Loss Co. itself in a stock acquisition. See I.R.C. § 382(k)(3). The "old loss corporation" is Loss Co. prior to the ownership change. I.R.C. § 382(k)(2).

29 I.R.C. § 382(b)(1).

The rationale of Section 382 is to allow a loss company's NOLs to offset only the future income generated by that company's business. If the section is triggered by an ownership change, its limitations apply in two different ways. First, if the Loss Co. business is not continued (or substantially all of its assets are not used) for at least two years after the change of ownership, all of its NOLs are disallowed.[30] Second, if the Loss Co. business is continued or if its assets are used for at least two years, the losses are allowable only to the extent of the income generated from the old Loss Co.'s assets. Because the transactions that trigger Section 382 may involve the combining of a loss company with a profitable company, it may be impossible to determine exactly what part of the combined company's income is generated by the Loss Co.'s business or assets. Section 382 solves this problem by adopting a method to approximate Loss Co.'s income. It irrebuttably assumes that the return on Loss Co.'s equity will be the rate of return payable on long-term tax-exempt bonds. Thus, in any year, Loss Co.'s NOLs can be used by the combined company only to the extent of the value of old Loss Co. multiplied by an assumed return on equity known as the long-term tax-exempt rate.[31] These basic rules are augmented by attribution rules, technical adjustments and a swarm of anti-avoidance provisions that give new dimension to Congressional paranoia.

Our study of Section 382 begins with an examination of the ownership change requirement and then turns to the effect of such a change on the ability to use Loss Co.'s NOL carryforwards.

2. THE OWNERSHIP CHANGE REQUIREMENTS

Code: § 382(g), (i), (k), (*l*)(3) & (4). See § 318.

In General. Since the economic burden of corporate losses falls on the persons who were shareholders when the corporation was losing money, the Section 382 limitations do not intercede as long as those investors continue as shareholders. After all, they suffered through the losses, so it is only fair to give them the benefit of the accompanying tax deductions. Consequently, Section 382 applies only if there is an "ownership change," which occurs if the percentage of Loss Co. stock owned by one or more "5-percent shareholders" increases by more than 50 percentage points[32] during the three-year "testing period."[33] Thus, if Profit Co. purchases 51 percent or more of Loss Co.'s stock within a three-year period, or if Loss Co. is acquired in a corporate reorganization and its ownership changes by more than 50 percent, the loss limitations will apply. Similarly, if ten unrelated investors each purchase six percent of the Loss Co. stock, Section 382 applies.

[30] I.R.C. § 382(c).

[31] I.R.C. § 382(b)(1).

[32] I.R.C. § 382(g)(1).

[33] Id. I.R.C. § 382(i)(1).

These various types of ownership changes are divided by the statute into two categories: an "owner shift involving a 5-percent shareholder" and an "equity structure shift."[34] An "owner shift" generally occurs upon any change in the stock ownership (either an increase or a decrease) of any 5-percent or more shareholder (e.g., the taxable purchases illustrated above).[35] An "equity structure shift" includes tax-free reorganizations, certain public offerings and reorganization-type transactions such as cash mergers.[36]

Owner Shift Involving 5-Percent Shareholder. An owner shift involving a 5-percent shareholder is any change in stock ownership (increase or decrease) that affects the percentage of stock owned by any person who is a 5-percent shareholder before or after the change.[37] Most owner shifts are purchases. Thus, if Profit Co. purchases 10 percent of Loss Co. stock from one shareholder, an owner shift has occurred. Apart from purchases, owner shifts can occur as a result of Section 351 exchanges, redemptions, issuances of stock, or recapitalizations.[38] However, the statute specifically excludes owner shifts as a result of a gift, death or divorce transfer.[39] Changes in proportionate ownership attributable solely to fluctuations in the market value of different classes of stock also are disregarded, except to the extent provided in regulations.[40]

Keep in mind that a single "owner shift" is not enough to trigger Section 382; there also must be a more than 50 percent change in ownership of Loss Co.[41] And while a more than 50 percentage point change in ownership is an essential ingredient in the Section 382 recipe, it is not the only one. Here is where the "5-percent shareholder" concept enters the scene. Consider, for example, the consequences of a simple 50 percent change in ownership rule to a publicly traded company that has loss carryforwards. Those NOLs might be limited as a result of random public trading if more than 50 percent of the company's shares happened to change hands during a three-year period. To preclude such a result, the type of "owner shift" required to trigger Section 382 occurs only if the percentage of stock of Loss Co. owned by one or more "5-percent shareholders" increases by the requisite 50 percent.[42]

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34 I.R.C. § 382(g)(2), (3).

35 I.R.C. § 382(g)(2).

36 I.R.C. § 382(g)(3). Regulations designating taxable reorganization-type transactions as equity structure shifts have not yet been issued. See Reg. § 1.382–2T(e)(2)(ii).

37 I.R.C. § 382(g)(2). A 5-percent shareholder is defined as any person holding 5 percent or more of the stock of the loss corporation at any time during the three year testing period. I.R.C. § 382(k)(7).

38 Reg. § 1.382–2T(e)(1).

39 I.R.C. § 382(*l*)(3)(B).

40 I.R.C. § 382(*l*)(3)(C).

41 I.R.C. § 382(g)(1).

42 I.R.C. § 382(g)(1)(A).

A rule that only counted the increased ownership of 5-percent shareholders might be easily circumvented. For example, a shareholder who held all the Loss Co. stock while the losses were incurred might sell four percent interests to 25 equal purchasers rather than to a single individual. In so doing, the owner would avoid selling any of his stock to a 5-percent shareholder despite an obvious sale and purchase of tax benefits. To assure that the loss limitations apply in these circumstances, Section 382 generally treats all less than 5-percent shareholders as a single 5-percent shareholder.[43] Thus, the sales to 25 four percent shareholders in the example are treated as sales to a single 5-percent shareholder, and the Section 382 limits apply because that 5-percent shareholder's ownership shifts from zero percent to 100 percent. But in the earlier publicly traded example, the group of less than 5-percent shareholders always would have held 100 percent both before and after the transfers, and thus Section 382 would not apply. Unfortunately, not all "owner shifts" are the result of such simple purchases. The problems at the end of this section explore some of these additional complications.

Equity Structure Shifts. Recall that Section 382 first must be triggered by either an "owner shift involving a 5-percent shareholder" or an "equity structure shift,"[44] either of which must result in an "ownership change." An "equity structure shift" is defined to include tax-free reorganizations[45] and certain taxable "reorganization-type" transactions, public offerings and similar transactions.[46] Consequently, if there is a shift in the ownership of Loss Co. stock in a reorganization, which when combined with any other stock transfers within the three-year period results in a more than 50 percent change of ownership, such an equity structure shift will bring the Section 382 limitations into play.[47]

Special Rules for Determining Change in Ownership. In determining whether a change in ownership has occurred, reorganizations involve some special complications. In a Type A or C reorganization, the acquiring company that inherits the loss is probably an entirely different company from Loss Co. In that event, what ownership is tested under Section 382? This question is answered indirectly by Section 382(k), which defines the "loss corporation" affected by Section 382 as the corporation entitled to use the loss after the ownership change.[48] Thus, in a Type A statutory merger or a Type C stock-for-assets reorganization involving a loss corporation and another corporation, the limits apply to

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[43] I.R.C. § 382(g)(4)(A).

[44] I.R.C. § 382(g)(1).

[45] I.R.C. § 382(g)(3)(A). Some reorganizations are excluded from the definition of "equity structure shift." Section 382(g)(3)(A) excludes a Type D or G reorganization, unless the requirements of Section 354(b)(1) are met, and a Type F reorganization.

[46] I.R.C. § 382(g)(3)(B). The regulations have not yet identified the reorganization-type transactions covered by this rule. See Reg. § 1.382–2T(e)(2)(ii).

[47] The regulations acknowledge that any equity structure shift affecting a 5-percent shareholder is also an owner shift. Reg. § 1.382–2T(e)(2)(iii).

[48] Section 382(k)(1) also defines a loss corporation as a corporation entitled to use a carryforward of disallowed business interest under Section 381(c)(20).

the survivor. In order to determine the extent of ownership change that has occurred, the ownership of the surviving corporation must be compared to the prereorganization ownership of the old Loss Co. In effect, the statute looks at the pre and postreorganization ownership of whatever company possesses the losses—whether this is the acquiring corporation or the target. For example, if Loss Co. is merged into Profit Co., Section 382 requires a comparison of the ownership of premerger Loss Co. and postmerger Profit Co. If the premerger Loss Co. shareholders own at least 50 percent of the postmerger Profit Co. (defined as "new loss corporation")[49] an ownership change within the meaning of Section 382(g) will not have occurred. On the other hand, if Loss Co. acquires the stock (in a Type B reorganization or reverse triangular merger) or assets (in a Type A or C reorganization, or a forward triangular merger) of Profit Co. in exchange for Loss Co. stock, Section 382 will apply unless at least 50 percent of the postreorganization Loss Co. stock continues to be owned by the prereorganization Loss Co. shareholders.

In order to assure proper results in the context of the fusion of two corporations, one more special rule is required. All shareholders who own less than five percent of a company's stock generally are treated as a single 5-percent shareholder[50]. In a reorganization (an "equity structure shift" for Section 382 purposes), there may be at least two groups of less than 5-percent shareholders—in our examples, the shareholders of Loss Co. and those of Profit Co. If these two groups were treated as a single shareholder, virtually all reorganizations of publicly held companies would escape Section 382. For example, assume that Loss Co. and Profit Co. are both public companies, with no shareholder owning stock of both and no individual owning (directly or indirectly) five percent of either company. If Profit Co. acquires the Loss Co. assets in a merger pursuant to which the old Loss Co. shareholders receive enough Profit Co. stock to become, as a group, 15 percent shareholders of Profit Co., it would appear that Section 382 should apply because the Profit Co. shareholders went from zero to 85 percent ownership of the "new loss corporation." But if all less-than-5-percent shareholders of Loss Co. and Profit Co. are treated as a single shareholder, 100 percent ownership of Loss Co. has remained within the exclusive ownership of that "single" shareholder—i.e., the group of less than 5-percent shareholders owned all of Loss Co. and all of Profit Co. and still owns all of Profit Co. In order to assure that Section 382 will apply in this and similar situations, the statute segregates public shareholders by providing that the group of less than 5-percent shareholders of Profit Co. and the group of less than 5-percent shareholders of Loss Co. are treated as separate shareholders.[51] In the

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49 I.R.C. § 382(k)(3).

50 I.R.C. § 382(g)(4)(A).

51 I.R.C. § 382(g)(4)(B)(i).

example, ownership of Loss Co. by the Profit Co. shareholders will have increased from zero to 85 percent and Section 382 therefore will apply.

Attribution Rules. The rules outlined above are buttressed by a set of attribution rules that borrows from and expands upon the attribution regime of Section 318.[52] In general, they treat all stock as owned by individuals, and only actual or constructive ownership by individuals is relevant in testing whether an ownership change has taken place under Section 382. As illustrated by the *Garber Industries* case, which follows, the attribution rules can raise challenging issues of statutory interpretation even in the simplest family settings.

Garber Industries Holding Co. v. Commissioner

United States Tax Court, 2005.
124 T.C. 1.

■ HALPERN, J.

By notice of deficiency dated June 21, 2001, respondent determined deficiencies in petitioner's Federal income taxes for petitioner's 1997 and 1998 taxable (calendar) years in the amounts of $4,916 and $301,835, respectively. The parties have settled all issues save one, leaving for our decision only the question of whether a 1998 stock sale between siblings that increased one sibling's percentage ownership of petitioner by more than 50 percentage points resulted in an ownership change for purposes of section 382, triggering that section's limitation on net operating loss (NOL) carryovers. That issue turns on the interpretation of section 382(*l*)(3)(A)(i), a matter of first impression for this Court.

Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for 1998, and all Rule references are to the Tax Court Rules of Practice and Procedure. For the sake of convenience, all percentages are rounded to the nearest full percent.

FINDINGS OF FACT

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At the time of petitioner's incorporation in December 1982, Charles M. Garber, Sr. (Charles), and his brother, Kenneth R. Garber, Sr. (Kenneth) (collectively, sometimes, the Garber brothers), owned 68 percent and 26 percent, respectively, of petitioner's common stock. The spouses, children, and other siblings of the Garber brothers owned the remaining shares of such stock. The Garber brothers' parents, who are deceased, never owned any of petitioner's stock.

On or about July 10, 1996, petitioner underwent a reorganization described in section 368(a)(1)(D) (the reorganization). Pursuant to the reorganization, petitioner canceled Charles's original stock certificate for 3,492.85 shares and issued a new certificate to him for 386 shares. As a

[52] I.R.C. § 382(*l*)(3).

result, Charles's percentage ownership of petitioner decreased from 68 percent to 19 percent, and Kenneth's percentage ownership of petitioner increased from 26 percent to 65 percent.

On April 1, 1998, Kenneth sold all of his shares in petitioner to Charles (the 1998 transaction). As a result of the 1998 transaction, Charles's percentage ownership of petitioner increased from 19 percent to 84 percent.

On its 1998 consolidated Federal income tax return, petitioner claimed an NOL deduction in the amount of $808,935 for regular tax purposes and $728,041 for alternative minimum tax (AMT) purposes. As one of the adjustments giving rise to the deficiencies here in question, respondent adjusted the amount of petitioner's 1998 NOL deduction, for both regular tax and AMT purposes, to $121,258 pursuant to section 382(b). Petitioner assigns error to that adjustment.

OPINION

I. Substantive Law

A. Overview of Section 382

Section 382(a) limits the amount of "pre-change losses" that a corporation (referred to as a loss corporation) may use to offset taxable income in the taxable years or periods following an ownership change. "Pre-change losses" include NOL carryovers to the taxable year in which the ownership change occurs and any NOL incurred during that taxable year to the extent such NOL is allocable to the portion of the year ending on the date of the ownership change. Sec. 382(d)(1). An ownership change is deemed to have occurred if, on a required measurement date (a testing date), the aggregate percentage ownership interest of one or more 5-percent shareholders of the loss corporation is more than 50 percentage points greater than the lowest percentage ownership interest of such shareholder(s) during the (generally) 3-year period immediately preceding such testing date (the testing period). Sec. 382(g)(1) and (2), (i); sec. 1.382–2(a)(4), Income Tax Regs.

B. Determining Stock Ownership for Purposes of Section 382

Section 382(*l*)(3)(A) provides that, with certain exceptions, the constructive ownership rules of section 318 apply in determining stock ownership. Under the first of those exceptions, set forth in section 382(*l*)(3)(A)(i), the family attribution rules of section 318(a)(1) and (5)(B) do not apply; instead, an individual and all members of his family described in section 318(a)(1) (spouse, children, grandchildren, and parents) are treated as one individual.

C. Regulations

The family aggregation rule of section 382(*l*)(3)(A)(i) is further addressed in section 1.382–2T(h)(6), Temporary Income Tax Regs., 52 Fed.Reg. 29686 (Aug. 11, 1987). Paragraph (h)(6)(ii) of that section repeats the general rule that, for purposes of section 382, an individual and all members of his family described in section 318(a)(1) are treated as one individual.[6] Paragraph (h)(6)(iv) provides further that, if an individual may be treated as a member of more than one family under paragraph (h)(6)(ii), such individual will be treated as a member of the family with the smallest increase in percentage ownership (to the exclusion of all other families).

II. Arguments of the Parties

A. Petitioner's Argument

Petitioner argues that, although siblings are not family members described in section 318(a)(1), Charles and Kenneth are nonetheless members of the same family when such determination is made by reference to their parents and grandparents. That is, as sons, they are both members of each family consisting of a parent and that parent's family members described in section 318(a)(1). Similarly, as grandsons, they are both members of each family consisting of a grandparent and that grandparent's family members described in section 318(a)(1). Accordingly, petitioner argues, Charles and Kenneth are treated as one individual under section 382(*l*)(3)(A)(i), with the result that transactions between them are disregarded for purposes of section 382.

B. Respondent's Argument

Respondent maintains that the family aggregation rule applies solely with reference to living individuals. Under that view, inasmuch as none of the parents and grandparents of the Garber brothers was alive at the commencement of the 3-year testing period immediately preceding the 1998 transaction, from that point forward there was no individual, within the meaning of section 382(*l*)(3)(A)(i), whose family members (as described in section 318(a)(1)) included both Charles and Kenneth. It follows, respondent argues, that Charles and Kenneth are not treated as one individual for purposes of section 382 and that the 1998 transaction resulted in an ownership change with respect to petitioner under section 382.

III. Analysis

A. General Principles of Statutory Construction

As a general matter, if the language of a statute is unambiguous on its face, we apply the statute in accordance with its terms, without resort to extrinsic interpretive aids such as legislative history. * * * Accordingly, our initial inquiry is whether the language of section 382(*l*)(3)(A)(i) is so plain as to permit only one reasonable interpretation insofar as the question presented in this case is concerned. * * * . That

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[6] The family aggregation rule does not apply, however, to any family member who, without regard to aggregation, would not be a 5-percent shareholder. Sec. 1.382–2T(h)(6)(iii), Temporary Income Tax Regs., 52 Fed.Reg. 29686 (Aug. 11, 1987). That exception in turn does not apply if the loss corporation has actual knowledge of such family member's stock ownership. *Id.;* sec. 1.382–2T(k)(2), Temporary Income Tax Regs., *supra* at 29694.

threshold determination must be made with reference to the context in which such language appears. Id.

B. Language of Section 382(*l*)(3)(A)(I)

Section 382(*l*)(3)(A)(i) provides as follows:

> (A) Constructive ownership.—Section 318 (relating to constructive ownership of stock) shall apply in determining ownership of stock, except that—
>
> > (i) paragraphs (1) and (5)(B) of section 318(a) shall not apply and an individual and all members of his family described in paragraph (1) of section 318(a) shall be treated as 1 individual for purposes of applying this section * * *

Respondent apparently would limit our textual analysis to a single word. According to respondent, Charles and Kenneth are not common members of any individual's family under section 382(*l*)(3)(A)(i) "[b]ecause the commonly used meaning of the term 'individual' does not include a deceased parent". We believe respondent's focus is too narrow. As stated by the Court of Appeals for the Fifth Circuit:

> However, even apparently plain words, divorced from the context in which they arise and in which their creators intended them to function, may not accurately convey the meaning the creators intended to impart. It is only, therefore, within a context that a word, any word, can communicate an idea.

Leach v. FDIC, 860 F.2d 1266, 1270 (5th Cir.1988). In our view, the question is not whether the noun "individual", standing alone, typically denotes a living person—typically it does. The question, rather, is whether the language of section 382(*l*)(3)(A)(i) as a whole definitively establishes, one way or the other, that the identification of a (living) individual whose family members are aggregated thereunder must be made, as respondent maintains (or need not be made, as petitioner maintains), coincident with the determination of stock ownership under section 382 (i.e., on a testing date or at any point during a testing period). Stated negatively, is the language of section 382(*l*)(3)(A)(i) so plain as to preclude either party's position, as so identified?

We are satisfied that the language of section 382(*l*)(3)(A)(i) can variably (and reasonably) be interpreted as being consistent with each party's position in this case. That is, there is nothing in the language of the statute that would make either party's position patently untenable. While a rule attributing stock owned by an individual on a measurement date to members of his family presupposes that the individual is alive, the same need not be said of a rule (such as that contained in section 382(*l*)(3)(A)(i)) that identifies (by reference to an individual) the members of a family that, on some measurement date, are to be treated as a single shareholder. By the same token, the language of section 382(*l*)(3)(A)(i) certainly does not *compel* the conclusion that the individual whose family members are so aggregated need not be alive on that measurement date.

Because the answer to our inquiry is not apparent from the face of the statute, we may look beyond the language of section 382(*l*)(3)(A)(i) for interpretive guidance.

C. Legislative History of Section 382(*l*)(3)(A)(I)

Congress enacted the family aggregation rule of section 382(*l*)(3)(A)(i) as part of its overhaul of section 382 included in the Tax Reform Act of 1986, * * * The rule first appeared in the conference committee bill. The conference committee report that accompanied that bill (the 1986 conference report) does not address the temporal aspect of family aggregation identified above: "The family attribution rules of sections 318(a)(1) and 318(a)(5)(B) do not apply, but an individual, his spouse, his parents, his children, and his grandparents are treated as a single shareholder." H. Conf. Rept. 99–841 (Vol.II), at II–182 (1986), 1986–3 C.B. (Vol.4) 1, 182.[10]

D. Other Considerations

1. Family Aggregation Under Pre-1986 Act Section 382

a. General Structure of the Statute

Prior to the amendment of section 382 by the 1986 Act, section 382 contained separate rules for ownership changes resulting from purchases and redemptions, see former sec. 382(a), and those resulting from corporate reorganizations, see former sec. 382(b). Under the "purchase" rules of former section 382(a), ownership changes were ascertained by reference to the holdings of the 10 largest shareholders at the end of the corporation's taxable year (as compared to their holdings at the beginning of such taxable year or the preceding taxable year). Former sec. 382(a)(1) and (2).

b. Family Attribution and Aggregation

Intrafamily sales were excluded from the operation of former section 382(a) by means of stock attribution (as opposed to shareholder aggregation) rules. Specifically, purchases of stock from persons whose stock ownership would be attributed to the purchaser under the family attribution rules of section 318 were ignored for purposes of determining whether an ownership change by "purchase" had occurred. See former sec. 382(a)(3) and (4). Although family members were potentially subject to aggregation for purposes of determining the 10 largest shareholders at year-end, that rule applied only if loss corporation stock owned by one was attributed to the other under the family attribution rules of section 318. Former sec. 382(a)(2) and (3). For that reason, the aggregation rule of former section 382(a)(2), unlike the aggregation rule of section 382(*l*)(3)(A)(i), necessarily applied as of the date on which stock ownership was measured (in the case of former section 382(a)(2), at year

[10] As noted *supra* part I.B., the members of an individual's family described in sec. 318(a)(1) (to which sec. 382(*l*)(3)(A)(i) refers) are his spouse, children, grandchildren, and parents. Regarding the possible significance of the conferees' reference to "grandparents" in lieu of "grandchildren", see *infra* part III.E.4.

end). Accordingly, no inference can be drawn from former section 382(a)(2) as to whether, as respondent maintains, the identification of the individuals whose family members are aggregated under section 382(*l*)(3)(A)(i) occurs as of the date on which stock ownership is measured.

2. Practical Consequences of Each Party's Interpretation of Section 382(*l*)(3)(A)(I)

a. Petitioner's Interpretation

Under petitioner's interpretation of section 382(*l*)(3)(A)(i), an individual would be aggregated with (and therefore could, without any section 382 consequences, sell loss corporation shares to) not only his spouse, children, grandchildren, and parents, but also his siblings, nephews, nieces, grandparents, in-laws, great-grandchildren, aunts, uncles, first cousins, and great-grandparents.[12] It is difficult to believe that Congress intended to expand the scope of exempted intrafamily sales so significantly (as compared to both the then-existing version of section 382, see *supra* part III.D.1.b., and the House and Senate versions of revised section 382, see *supra* note 9) with nary a mention of that objective in the 27 pages devoted to section 382 in the 1986 conference report.

b. Respondent's Interpretation

Respondent's interpretation of section 382(*l*)(3)(A)(i) is perhaps even more troubling than petitioner's. First, it has the potential for being just as expansive as petitioner's interpretation.[13] More importantly, respondent's interpretation leads to arbitrary distinctions. As relevant to this case, respondent would have us believe that the ability of siblings to sell loss corporation shares among themselves without any section 382 consequences is wholly dependent on the continued good health of their parents. We see no rational basis for Congress's having drawn a distinction in this context between siblings whose parents happen to be living and those whose parents happen to be deceased; the former are no more related than the latter.

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[12] As a member of each parent's family (i.e., in his capacity as a child of those parents), an individual would be aggregated with his parents' children (his siblings), grandchildren (his nephews and nieces), and parents (his grandparents). As a member of his spouse's family (i.e., in his capacity as her spouse), an individual would be aggregated with his spouse's parents (his mother-and father-in-law). As a member of each child's family (i.e., in his capacity as a parent of those children), an individual would be aggregated with each child's spouse (his sons-and daughters-in-law) and grandchildren (his great-grandchildren). As a member of each grandparent's family (i.e., in his capacity as a grandchild of those grandparents), an individual would be aggregated with his grandparents' children (his aunts and uncles), grandchildren (his first cousins), and parents (his great-grandparents). See secs. 382(*l*)(3)(A)(i), 318(a)(1).

[13] Respondent's interpretation of the statute differs from petitioner's in that respondent would require that the relevant parent, spouse, child, or grandparent of the individual in question be living when stock ownership is measured. See *supra* note 12.

E. A Third Interpretation

1. Introduction

Our own analysis of the legislative evolution of section 382(*l*)(3)(A)(i) leads us to believe that both parties have erroneously interpreted that provision. For the reasons discussed below, we conclude that Congress most likely intended the aggregation rule of section 382(*l*)(3)(A)(i) to apply solely from the perspective of individuals who are shareholders (as determined under the *attribution* rules of section 382(*l*)(3)(A)) of the loss corporation.[14] In practical terms, our conclusion dictates that we sustain respondent's determination in this case, even though we disagree with his interpretation of the statute.

2. 1986 Act Revisions to Section 382

a. Relevant Fundamental Changes to the Statute

Among other things, section 621(a) of the 1986 Act replaced the "purchase" rules of former section 382(a) with the concept of the "owner shift", defined broadly to include any change in the respective ownership of the stock of a corporation. Sec. 382(g)(2)(A). The occurrence of an owner shift involving a 5-percent shareholder, see sec. 382(g)(2)(B), (k)(7), is one of two occasions for opening the corporation's stock transfer books to determine whether the aggregate percentage ownership interest of one or more such shareholders has increased by more than 50 percentage points within the relevant "lookback" (testing) period.[15] See sec. 382(g)(1), (i). While the owner shift "trigger" presupposes some type of transaction in the stock of the loss corporation, see H. Conf. Rept. 99–841 (Vol.II), supra at II–174, 1986–3 C.B. (Vol.4) at 174, the requisite increase in stock ownership within the resulting testing period need not be attributable to a purchase, redemption, or, indeed, any transaction in which shares actually change hands, see sec. 382(g)(1)(A) and (B).

b. Consequences for Family Attribution: Changes in Family Status

Under a system in which an increase in one's percentage ownership of a corporation need not be associated with a transaction in which shares actually change hands, a straightforward application of the family attribution rules of section 318(a) could produce "artificial" ownership increases; i.e., ownership increases solely attributable to changes in family status. For instance, under the attribution rules, the ownership percentage of an individual who marries the sole shareholder of a loss corporation would thereby increase from zero to 100 percent. If the wedding occurred during a testing period (which could be triggered, for instance, by the subsequent issuance of a relatively small number of additional shares to a key employee), then the increase in the

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[14] In other words, composite shareholders are to be constructed only around individuals who directly or indirectly (through an entity or by means of an option) own shares of the loss corporation.

[15] The other such occasion is the occurrence of an equity structure shift (in general, most corporate reorganizations). See sec. 382(g)(1), (3).

nonshareholder spouse's deemed ownership percentage would result in an ownership change. A similar result presumably would occur if the shareholder legally adopted someone during a testing period. See sec. 318(a)(1)(B).

c. House Bill Provision Regarding Changes in Family Status

The House version of revised section 382 provided that the family attribution rule of section 318(a)(1) would apply "by assuming that the family status as of the close of the testing period was the same as the family status as of the beginning of the testing period". H.R. 3838, 99th Cong., 1st Sess. sec. 321(a) (1985) (provision designated as sec. 382(n)(3)(A)). Although the report of the Committee on Ways and Means accompanying the House bill provides no additional insight, see H. Rept. 99–426, at 266 (1985), 1986–3 C.B. (Vol.2) 1, 266, the practical effect of that provision would have been to eliminate the possibility that a change in family status during a testing period could, in and of itself, contribute to an ownership change.[17] The conference committee, in addition to substituting family aggregation for family attribution, dropped the provision in the House bill regarding changes in family status.[18]

d. Observations

In the context of the parties' arguments in this case, the conference committee's excision of the House bill provision regarding changes in family status is somewhat puzzling. Specifically, under each party's interpretation of section 382(*l*)(3)(A)(i), the family aggregation rule adopted by the conferees would produce the same "artificial" ownership increases that the House bill provision eliminated in the context of attribution. In terms of our marriage hypothetical, the addition of the shareholder spouse to the nonshareholder spouse's family unit during the testing period would increase the ownership percentage of that family unit by 100 percentage points during that period. If, however, the family aggregation rule applies solely from the perspective of shareholders of the loss corporation, there would be no separate family unit headed by the nonshareholder spouse in our hypothetical and, consequently, (1) no increase in ownership attributable to the marriage, and (2) no need for the remedial provision contained in the House bill. Under that interpretation of the family aggregation rule, the conference committee's excision of the House bill's family status provision makes perfect sense.

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17 Returning to our marriage hypothetical, under the House bill's provision, the couple's relationship on the testing date would have been deemed to be the same as it was at the beginning of the testing period (i.e., not married), with the result that the nonshareholder spouse's ownership percentage would have been deemed to be zero throughout the testing period.

18 The Senate version of the bill contained no such provision, providing instead for the application of the family attribution rules of sec. 318 without modification. H.R. 3838, 99th Cong., 2d Sess. sec. 621(a) (1986) (provision designated as sec. 382(k)(3)(A)).

3. Revisiting the Language of the Statute

That our interpretation of section 382(*l*)(3)(A)(i) provides a cogent explanation for the conference committee's action is of no consequence if a plain reading of the statute does not permit that interpretation. See *supra* part III.A. The use of the term "individual" in section 382(*l*)(3)(A)(i), however, does not preclude a contextual interpretation pursuant to which the set of individuals contemplated by Congress (i.e., individuals who own shares of the loss corporation) is smaller than the universe of all possible individuals (i.e., all living beings). More importantly, we are satisfied that our interpretation proceeds from an entirely natural reading of the statute. Given a stock ownership rule that operates by reference to an individual and other persons who are defined in terms of their relationship to that individual, it is hardly a stretch to surmise that the rule presupposes the shareholder status of the referenced individual.

4. Revisiting the 1986 Conference Report

Having concluded that our interpretation of section 382(*l*)(3)(A)(i) does not do violence to the plain language of the statute, we return to the legislative history to determine whether it is any more supportive of our view than it is of the views of the parties. As indicated above, see *supra* part III.C. and note 10, the 1986 conference report contradicts the statutory language by including an individual's grandparents (rather than his grandchildren) among the family members who are aggregated for purposes of section 382. If that disconnect were attributable to a simple typographical error, one might reasonably expect that the subsequently issued report of the Joint Committee on Taxation explaining the 1986 Act (the so-called Blue Book) would point out the error. See, e.g., Staff of Joint Comm. on Taxation, General Explanation of Tax Legislation Enacted in the 104th Congress at 81 n.59 (J. Comm. Print 1996), (noting that the conference report accompanying H.R. 3448, the bill eventually enacted as the Small Business Job Protection Act of 1996, mistakenly refers to the lessee rather than the lessor in the context of new section 168(i)(8)). The Blue Book for the 1986 Act, however, retains the reference in the 1986 conference report to "grandparents" in the context of section 382(*l*)(3)(A)(i). Staff of Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1986 at 311 (J. Comm. Print 1987).

As is the case with the conference committee's excision of the family status provision of the House bill, see *supra* part III.E.2.d., the substitution of "grandparents" for "grandchildren" in the 1986 conference report makes perfect sense if the family aggregation rule applies solely from the perspective of individuals who are shareholders of the loss corporation. Section 318(a)(1) (to which section 382(*l*)(3)(A)(i) refers) is phrased in terms of the family members (spouse, children, grandchildren, and parents) *from whom* shares are attributed. The converse of that rule is that shares owned by an individual are attributed *to* that individual's spouse, parents, grandparents, and children. The substitution of "grandparents" for "grandchildren" in the 1986 conference report (reiterated in the 1986 Blue Book) therefore suggests that Congress intended individuals to be aggregated with the same family members to whom their shares would otherwise be attributed under section 318(a)(1), which in turn suggests that Congress intended the family aggregation rule to apply from the perspective of individuals who are shareholders of the loss corporation.[20]

5. Revisiting the Regulations

Having concluded that our interpretation of the family aggregation rule (1) does not violate the plain meaning rule, and (2) arguably finds support in the legislative history of section 382(*l*)(3)(A)(i), we would nonetheless be hard pressed to adopt that interpretation if it were inconsistent with respondent's 17-year-old "legislative" regulations. See, e.g., Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 843–844, 104 S.Ct. 2778, 81 L.Ed.2d 694 (1984); see also sec. 382(m) (directing the Secretary to "prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section"). As is the case with the statute, see *supra* part III.E.3., the language of the relevant regulation presents no such obstacle. See sec. 1.382–2T(h)(6), Temporary Income Tax Regs, *supra* at 29686.

Nor does our interpretation of the statute render superfluous the "tiebreaker" rule of paragraph (h)(6)(iv) of the above-cited regulation. See *supra* note 19. To the contrary, that rule serves the useful purpose of precluding purely "vicarious" ownership increases that could otherwise occur under our interpretation of the statute (as well as those of the parties). For instance, if a husband and wife each own shares of a loss corporation, and the husband purchases additional shares from his mother, the ownership percentage of the family unit centered on the wife would increase as a result of the otherwise exempt transaction.[21] The tiebreaker rule precludes that result by treating the wife as a member of the family unit centered on her husband rather than a member of the family unit centered on her, since such inclusion would result in the smallest increase (zero) in percentage ownership.[22] See *supra* part I.C.; *supra* note 21.

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20 We do not mean to suggest that sec. 382(*l*)(3)(A)(i) should be interpreted as incorporating a modified version of sec. 318(a)(1) (i.e., one that substitutes grandparents for grandchildren); such an interpretation presumably would violate the plain meaning rule. See *supra* part III.A.

21 Since the purchased shares would be included in the holdings of the family unit centered on the husband both before and after the sale, the percentage ownership of the husband-centric family unit would remain unchanged. However, since the purchased shares would not be included in the holdings of the family unit centered on the wife until after the sale, the percentage ownership of the wife-centric family unit would increase as a result of the sale. A similar result would occur if the purchaser's child (rather than his wife) were a shareholder.

22 As is the case with changes in family status, see *supra* note 16, this problem did not arise under former sec. 382(a), since the "vicarious" ownership increase would not have been attributable to a purchase by the wife. See former sec. 382(a)(1)(B)(i).

IV. Conclusion

We hold that the family aggregation rule of section 382(*l*)(3)(A)(i) applies solely from the perspective of individuals who are shareholders (as determined under the attribution rules of section 382(*l*)(3)(A)) of the loss corporation. Inasmuch as an individual shareholder's family consists solely of his spouse, children, grandchildren, and parents for these purposes, sibling shareholders are not aggregated under section 382(*l*)(3)(A)(i) if none of their parents and grandparents is a shareholder of the loss corporation.[23] Since Kenneth and Charles were not children or grandchildren of an individual shareholder of petitioner at any relevant time, they are not aggregated for purposes of applying section 382 to the facts of this case. It follows that Charles's purchase of shares from Kenneth in 1998 resulted in an ownership change with respect to petitioner as contemplated in section 382(g).

PROBLEMS

J sh ↑ 5% sh during testing period.
J ✓ ownership change to 100%.

each own 4 sh.

1. Loss Co. has 100 shares of common stock outstanding and is owned equally by Shareholders 1 through 25, who are not related to one another. Loss Co. has assets worth $1,000,000 and net operating loss carryovers of $8,000,000. Will the Section 382 loss limitations apply in the following situations?

(a) All shareholders sell their stock to Ms. Julie ("J")? → ✓ ownership change.

(b) Shareholders 1 through 13 sell their stock to J? 0% → 52% ~~>50~~ enough ownership change

(c) Shareholders 1 through 12 sell their stock to J? ✗

Ownership change → 看3yr period ∴ 少了 2 4sh, stock outstanding: 100 → 92. ∴ J ownership: 48% → 52%

(d) What result in (c), above, if Loss Co. redeems the stock of Shareholders 13 and 14 two years later?

(e) What result in (c), above, if Shareholder 13 sells his stock to New Shareholder 26? — 持 4 stock, 0% → 4%

(f) What result in (e), above, if Shareholder 14 also sells her stock to New Shareholder 26? 5% sh ! ∴ 0% → 8% sh. ∴ % sh in total: J & 26.

(g) What result if Shareholders 1 through 25 sell their stock to New Shareholders 26 through 50? ✗ 8% + 48% = 56%

2. Loss Co. is owned 40 percent by Bill and 60 percent by the general public. Loss Co.'s stock is worth $10,000,000. Loss Co. acquires all the assets of Gain Co. (net worth—$10,500,000) in a Type C reorganization in exchange

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[23] We recognize that our interpretation of the statute suggests a distinction between siblings who are the children or grandchildren of a shareholder and those who are not, a distinction that is arguably just as arbitrary as the distinctions resulting from respondent's interpretation of the statute. See *supra* part III.D.2.b. That problem would not arise if the tiebreaker rule of sec. 1.382–2T(h)(6)(iv), Temporary Income Tax Regs., *supra* at 29686, were inapplicable in any instance in which such application would have the effect of exempting a transaction (such as a sale between siblings) that otherwise would have increased the percentage ownership of the purchaser's family unit. Cf. sec. 1.382–4(d)(6)(i), Income Tax Regs. (rules treating an option as exercised do not apply if a principal purpose of the option is to avoid an ownership change by having it treated as exercised); T.D. 9063, 2003–2 C.B. 510, 511 (discussing the need for additional regulations dealing with changes in family composition in the context of sec. 382).

(10.5K Corp asset + 10k loss corp stock)

from 20.5m FMV Loss Co. where Gain Corp has 10.5/20.5m ownership & 75%!

Both & general public has

for $10,500,000 worth of Loss Co. voting stock. If no shareholders of Gain Co. owned any Loss Co. stock prior to the transaction, has there been an ownership change? Loss corp is the "loss corp" both before & after the acquisition.

3. Whale Co. and Minnow Co. (which has loss carryovers) are both publicly held companies, neither of which has any 5-percent shareholder. Whale Co. purchases all the stock of Minnow Co. for cash. Does § 382 apply?

3. RESULTS OF AN OWNERSHIP CHANGE

Code: § 382(a)–(f), (h), (*l*)(1) & (4).

In General. If an ownership change occurs, the Section 382 loss limitations then must be applied. Before considering any further details, the function of the limitations must be examined. We have seen that Congress designed Section 382 to prevent taxpayers from selling and purchasing tax deductions. If that were the only relevant consideration, the rest would be easy—whenever there is an ownership change, simply eliminate all loss carryforwards. But our study of Subchapter C has revealed one other salient factor—a corporation is treated as a separate entity for tax purposes. Although the individual shareholder may bear the ultimate burden or reap the ultimate benefit of a corporation's losses or profits, it is the corporation itself that is the focus of the corporate income tax.

In Section 382, Congress has adopted a principle of "neutrality" toward a loss company. While the Section 382 limitations restrict trafficking in deductions, they permit the purchaser of a loss corporation to use that corporation's net operating losses to offset the old loss corporation's own subsequent income. What Section 382 seeks to prevent is the use of a corporation's losses to offset another taxpayer's income after an ownership change. It is from this policy that the two limitations in Section 382 directly flow.

Continuity of Business Enterprise Limit. The first limit is found in Section 382(c),[53] which incorporates the continuity of business enterprise doctrine[54] by disallowing all net operating loss carryovers if the old loss corporation business is not continued for at least two years after the ownership change.[55] As described in the reorganization regulations, continuity of business enterprise requires either that the historic business of the loss corporation be continued for at least two years or that a significant portion of its assets are used in some other business carried on by the new loss corporation.[56] As a result, a corporation that runs afoul of this first limit in the second year following an ownership change may

[53] This limitation is inapplicable to the extent of any built-in gains or gains resulting from a Section 338 election as well as any Section 382(b)(2) carryovers related to such gains. See I.R.C. § 382(c)(2) and p. 586, infra.

[54] See Chapter 9B1f, supra.

[55] I.R.C. § 382(c)(1).

[56] Reg. § 1.368–1(d).

be required to amend its tax return for the earlier year and remove any inherited NOL deductions that had been applied against taxable income.

The Section 382 Limitation. A second, more complex limitation is "the Section 382 limitation," under which losses can be used in any "post-change year" only to the extent of the value of the old loss corporation multiplied by the "long-term tax-exempt rate."[57] To illustrate, assume Loss Co. has a value of $200,000 and has losses of $800,000 at a time when the long-term tax-exempt rate is 6 percent. After an ownership change, New Loss Co. may use its loss carryforwards only to the extent of $200,000 multiplied by 6 percent, or $12,000 per year.

The theory of this limit is to allow the loss carryforwards to offset any income earned by the old loss business. But since many of the acquisitions that will trigger the limit involve combining a loss business with some other more profitable enterprise, it is impossible to determine exactly how much income will be generated by the old company. To solve this problem, Section 382 irrebuttably presumes that the old loss business will generate income on its assets at a predetermined rate—the long-term tax-exempt rate. Because the amount of available loss carryforwards depends on the value of the old loss company, the greater the value (and cost) of that company, the more loss carryforwards may be used each year. Again, the objective is to defer use of the loss carryforwards by limiting their use in any one year to an approximation of the income produced in the year by the old loss business.

Carryforwards of Unused Limitation. The Section 382 limitation results in some further complexity if it exceeds a corporation's taxable income in a given post-change year. To illustrate, if Loss Co. in the example above, with a value of $200,000, had at least $12,000 of taxable income (disregarding its NOL carryover), the full $12,000 of NOLs that were available in each year after the change of ownership would be used. But if the combined taxable income of the new loss company were only $4,000, the full amount available under the Section 382(b)(1) limitation would not be utilized. In that situation, the $8,000 of available but unused NOLs may be carried forward and the limitation in the following year would be $20,000 (the sum of the regular $12,000 limitation plus the $8,000 carryover).[58]

Mid-Year Ownership Change. Another special rule applies if the "change date"[59] occurs on a date other than the last day of a year. In that event, the Section 382 limitation for the portion of the year after the change is a prorated amount derived by applying a ratio of the remaining days in the year to the total days in the year.[60] Thus, if the change occurs

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[57] I.R.C. § 382(b)(1), (f). "Post-change year" is any taxable year ending after the "change date"—i.e., in the case of an owner shift, the date on which the shift occurs and, in the case of an equity structure shift, the date of the reorganization. I.R.C. § 382(d)(2), (j).

[58] I.R.C. § 382(b)(2).

[59] I.R.C. § 382(j).

[60] I.R.C. § 382(b)(3)(B).

two-thirds of the way through the year, the limitation for that year is one-third of what otherwise would be available—i.e., $12,000 × ⅓, or $4,000 in the example above.[61]

The Long-Term Tax-Exempt Rate. Returning to the basic Section 382 limitation, recall that it is the value of the old loss corporation multiplied by the long-term tax-exempt rate. The use of this measure to predict the expected return on Loss Co.'s assets is the product of substantial Congressional debate.[62] Loss Co. presumably can generate earnings on its assets at a rate at least equal to the higher federal long-term taxable rate. Indeed, if it could not do so some other way, Loss Co. simply could sell its assets and invest the proceeds in long-term federal obligations. Use of the lower tax-exempt rate to predict Loss Co.'s earnings is intended to offset the fact that the amount against which this rate is applied will exceed the real value of Loss Co.'s income-generating assets. How so? Because under Section 382(e)(1), the value of Loss Co. is the value of its stock immediately before the ownership change. Since Loss Co. has loss carryforwards to offset any income it earns in the near future, that income will be essentially tax-free. Loss Co.'s after-tax return will equal its before-tax profit, and the value of its stock will reflect not only the value of its income-generating assets but also the fact that the income which is generated will be tax free.

The Value of the Company. The second component of the Section 382 limitation is the value of the stock of the old loss corporation immediately preceding the ownership change.[63] Congress included several special rules to guard against predictable efforts to abuse this rule by inflating the value of the loss company.

One obvious technique to increase the available NOLs after an ownership change would be for the shareholders to increase the value of the loss company just prior to the change by contributing cash or other property to the corporation. Congress attacked this maneuver with an "anti-stuffing" rule, under which the value of any pre-change capital contribution received by the loss company as part of a plan to increase the Section 382 limitation is disregarded.[64] Any contribution received within two years before an ownership change is generally treated as part of such a plan.[65]

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61 In addition, the limitation is inapplicable to the days of the year prior to the change date. I.R.C. § 382(b)(3)(A).

62 The long-term tax-exempt rate is defined by Section 382(f) as the highest federal long-term rate determined under Section 1274(d) in effect for the three-month period ending with the month of the ownership change, adjusted to reflect differences between returns on long-term taxable and tax-exempt obligations.

63 I.R.C. § 382(b)(1), (e)(1). For purposes of determining the value of the loss corporation, all stock is counted, even preferred stock that would be ignored in determining whether an ownership change has occurred. I.R.C. §§ 382(e)(1), (k)(6)(A); 1504(a)(4).

64 I.R.C. § 382(*l*)(1).

65 I.R.C. § 382(*l*)(1)(B). Exempted from this presumption are any contributions to be specified in regulations. The Conference Report instructs the Treasury that the regulations should generally exempt contributions only if they occurred prior to the accrual of the losses or

Even without "stuffing" in anticipation of a planned ownership change, shareholders of a loss company may be tempted to transfer cash or income-producing investments to the company. If there is a later ownership change, the allowable losses then would be greater; and if there is not a change, the investment income could be accumulated tax-free at the corporate level because it would be offset by the loss carryforwards. If the shareholders do not wish to transfer portfolio investments to the loss company, they at least might be tempted to prevent the company's profits (assuming it later becomes profitable) from being taken out of the company in order to reinvest these profits in portfolio investments which can accumulate tax-free at the corporate level and be available to increase the Section 382 limit in the event of a subsequent ownership change.

These possibilities did not go unnoticed by an ever suspicious Congress. If at least one-third of a loss corporation's assets consist of nonbusiness (i.e., investment) assets, the value of the corporation for purposes of Section 382 includes only the percentage of its actual net value that represents the percentage of its gross assets which are business assets.[66] To illustrate, if Loss Co. has $2,000,000 of investment assets, $3,000,000 of business assets and $1,000,000 of debt, it has a net value of $4,000,000, but only 60 percent of that value is taken into account for purposes of the Section 382 limitation because only 60 percent of its gross assets are business assets.[67]

If taxpayers are unable to increase useable NOLs by inflating the value of the loss corporation prior to an ownership change, they might be tempted to at least enable a profitable corporation to more easily avail itself of these losses by decreasing the value of the loss corporation after an ownership change. To illustrate, assume Loss Co. has a value of $1,000,000 and loss carryforwards of $1,000,000 and the tax-exempt rate is 6 percent. Profit Co. could acquire Loss Co. for $1,000,000 and use loss carryforwards at the rate of $60,000 per year, which probably would be enough only to offset Loss Co.'s own income. But what if Profit Co. pays $510,000 for 51 percent of Loss Co., and then Loss Co. redeems the remaining 49 percent of its outstanding shares? Loss Co.'s value has decreased by 49 percent (the amount paid to redeem its stock), and its revenues presumably will decrease by the same 49 percent. Profit Co. will have paid only $510,000, but the smaller New Loss Co. may deduct its loss carryovers to the extent of 6 percent times $1,000,000, or $60,000 per year. Once again, Congress cuts off a promising strategy at the pass.

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if they were contributions of necessary operating capital. H.R.Rep. No. 99–841, supra note 6, II–182.

[66] I.R.C. § 382(*l*)(4).

[67] When it applies, Section 382(*l*)(4) specifically requires that the value of the loss corporation shall be reduced by the excess of the value of its nonbusiness assets over an amount of the corporation's debt which bears the same ratio to all the company's debt which the nonbusiness assets bear to all the company's assets. I.R.C. § 382(*l*)(4)(A). See § 382(*l*)(4)(D). The net result is as described in the text above.

Section 382(e)(2) provides that if a redemption or other corporate contraction occurs in connection with an ownership change, the value of the loss corporation is determined only after taking the redemption or contraction into account.[68]

Limit on Built-in Losses. Finally, a corporation generally is subject to the Section 382 limitations only if it has loss carryforwards or carryovers of disallowed business interest.[69] A prospective buyer of deductions might be tempted to avoid the section by simply acquiring an asset that did not have the carryforwards themselves but rather the ability to produce them. Specifically, instead of acquiring a corporation that had loss carryforwards, a taxpayer could acquire a corporation that had substantial unrealized losses and other deductions built into its assets. Assuming a buyer is in the market for deductions, a company with assets having an aggregate basis of $1,000,000 and a value of $100,000 may be as attractive as a company with a $900,000 loss carryforward. Once the company is acquired, the profitable company could sell those assets and use the losses against its own profits.

In its eternal race to stay one step ahead of the taxpayer, Congress has extended the limitations in Section 382 to certain built-in unrealized losses and deductions that economically accrue prior to an ownership change but are not recognized until after the change.[70] If a corporation has assets whose aggregate bases exceed their total value—i.e., a "net unrealized built-in loss"[71]—then any built-in losses which are recognized within five years[72] of an ownership change are treated as loss carryforwards of the old loss corporation and are subject to the Section 382 deduction limits.[73] Depreciation, amortization or depletion deductions during the five-year recognition period are treated as recognized built-in losses for purposes of this rule unless the corporation establishes that such amounts are not attributable to the excess of the adjusted basis over the fair market value of the asset on the change date.[74] To the extent that the new loss corporation establishes that a loss recognized during the five-year period accrued after the ownership change, the loss may be deducted without limitation.[75] Even if the new loss company is unable to establish when any particular loss was accrued, the total amount of loss subject to this rule may not exceed the net

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68 The legislative history suggests that the "in connection with" standard should be broadly construed to include any redemption that is contemplated at the time of the ownership change. See H.R.Rep. No. 99–841, supra note 6, II–187.

69 I.R.C. § 382(k)(1).

70 I.R.C. § 382(h)(1)(B).

71 I.R.C. § 382(h)(3)(A).

72 This is known as the "recognition period." I.R.C. § 382(h)(7).

73 I.R.C. § 382(h)(1)(B).

74 I.R.C. § 382(h)(2)(B). For example, depreciation deductions attributable to capital improvements made with respect to an asset after the change date would not be subject to the limitation.

75 I.R.C. § 382(h)(2)(B)(i).

unrealized loss built into the old loss corporation's assets.[76] A special de minimis rule provides that a corporation's net unrealized built-in loss is considered to be zero if it does not exceed the lesser of (1) 15 percent of the fair market value of the assets of the corporation, or (2) $10 million.[77]

Special Rules for Built-in Gains. On occasion, Congress is as eager to be fair as it is to be vigilant. In that spirit, the Section 382 limitation is increased to reflect built-in gains and other income items that accrued prior to the ownership change but are recognized within five years after the change. If on the change date the aggregate fair market value of a loss corporation's assets exceeds the aggregate adjusted basis of those assets—i.e., the corporation has a "net unrealized built-in gain"[78]—the Section 382 limitation is increased by any built-in gain (up to total net unrealized built-in gain) which is recognized during the five-year "recognition period" following an ownership change.[79] As a result, the new loss company can use its loss carryforwards (in addition to otherwise allowable post-change losses) to offset any built-in gains which it recognizes either on a disposition of an asset of the old loss corporation[80] or because of a Section 338 election made with respect to the loss corporation.[81] The corporation must be able to prove that the built-in gains accrued prior to the change date;[82] and the total increase in the Section 382 limitation may not exceed the net unrealized built-in gain as of the change date.[83] Once again, a de minimis rule provides that net unrealized built-in gains do not increase the Section 382 limitation if they do not exceed the lesser of (1) 15 percent of the fair market value of the corporation's assets, or (2) $10 million.[84]

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[76] I.R.C. § 382(h)(1)(B)(ii).

[77] I.R.C. § 382(h)(3)(B)(i). For purposes of this test, cash, cash equivalents and marketable securities with a value not substantially different from their bases generally are disregarded. § 382(h)(3)(B)(ii).

[78] I.R.C. § 382(h)(3)(A).

[79] I.R.C. § 382(h)(1).

[80] Id. If a taxpayer sells a built-in gain asset prior to or during the recognition period in an installment sale under Section 453, the provisions of Section 382(h) continue to apply to gain recognized from the sale (including a disposition of the installment obligations) after the recognition period. I.R.S. Notice 90–27, 1990–1 C.B. 336.

[81] I.R.C. § 382(h)(1)(C). If an ownership change and Section 338 qualified stock purchase occur simultaneously, the target is treated as selling its assets to itself ("new T") at the close of the acquisition date. I.R.C. § 338(a). In that situation, the Section 382 limit does not apply to the Section 338 deemed sale gain because the losses do not carry over to a "post-change year." I.R.C. § 382(a), (d)(2). When an ownership change takes place prior to a qualified stock purchase (i.e., a creeping qualified stock purchase), Section 382(h)(1)(C) provides special rules when the Section 382(h)(3)(B) de minimis threshold is not satisfied and the corporation's built-in gains are considered to be zero.

[82] I.R.C. § 382(h)(2)(A).

[83] I.R.C. § 382(h)(1)(A)(ii).

[84] I.R.C. § 382(h)(3)(B).

PROBLEMS

value. 8m. 10m.

1. Loss Co. has net operating loss carryforwards of $10,000,000. It has assets worth $10,000,000 and liabilities of $2,000,000. Profit Co. is a publicly held company worth $100,000,000. 92m

(a) On January 1, Year 1, Profit Co. acquires all of the Loss Co. assets in a merger of Loss Co. into Profit Co. where Loss Co. shareholders receive Profit Co. stock worth $8,500,000. The long-term tax-exempt rate at that time is 5 percent. Assuming the Loss Co. business is continued, to what extent can Profit Co. deduct Loss Co.'s loss carryforwards in Year 1? 425K. Stock for asset Type A. 8500×5%

(b) What result in (a), above, if Profit Co. instead purchases all of the Loss Co. stock for $8,500,000? taxed trans.

(c) What result in (a), above, if Profit Co.'s taxable income, disregarding any loss carryforward, is $300,000 in Year 1? ✓ 300K offset by NOL ↳ 125K carrying forward to next Next yr limitation 550K

(d) What result in (a), above, if Profit Co. discontinues the Loss Co. business and disposes of its assets in Year 1? COBE.

(e) What result in (a), above, if the merger occurs on June 30, Year 1? Assume the date is halfway through each corporation's taxable year. → only use half of § 382 limitation → $212,500.

2. Loss Co. has loss carryforwards of $10,000,000. It has the following assets, all of which have been held for more than two years unless otherwise indicated:

Asset	Adj. Basis	F.M.V.
Equipment	$2,000,000	$4,500,000
Land	$6,000,000	$3,000,000
IBM stock	$2,000,000	$2,000,000
Cash	$ 500,000	$ 500,000

Loss Co. has liabilities of $2,000,000. Profit Co. is a publicly held company worth $100,000,000. On January 1, Year 2, Profit Co. acquires all of the Loss Co. assets in exchange for Profit Co. stock worth $8,500,000 and then Loss Co. liquidates. The long-term tax-exempt rate is 5 percent.

(a) Assuming that the business conducted by Loss Co. is continued, to what extent can Profit Co. deduct Loss Co.'s loss carryforwards in Year 2?

(b) What result in (a), above, if the stock and cash had been contributed to the capital of Loss Co. in November, Year 1?

(c) What result in (a), above, if the IBM stock had a value and basis of $5,000,000?

(d) What result in (c), above, if IBM were a wholly owned subsidiary of Loss Co.?

(e) What result in (a), above, if Profit Co. acquires 70 percent of the Loss Co. stock for Profit Co. stock on January 1 and the

IBM stock and the cash are distributed to Joe, a 30 percent shareholder of Loss Co., on March 1 in redemption of all of his stock?

(f) Will the result in (a), above, change if Profit Co. sells the equipment in February? Would the answer be different if the land had a basis of zero?

(g) Assume in (a), above, that the land had a basis of $8,000,000 and that Profit Co. sells the land for $3,000,000 two years later. Is the loss deductible? What if Profit Co. sells the land for $2,700,000?

D. LIMITATIONS ON OTHER TAX ATTRIBUTES: SECTION 383

Code: § 383.

Section 383 is a brief section that is easily mastered if one understands the operation of Section 382. It essentially calls for the Treasury to issue regulations that will adopt the principles of Section 382 (i.e., the continuity of business enterprise requirement and ownership change rules coupled with limitations) to limit corporate attributes other than loss carryforwards. Section 383 applies to the Section 39 carryforward of the general business credit,[85] the Section 53 carryforward of the alternative minimum tax credit,[86] and the Section 904(c) carryforward of the foreign tax credit.[87] Section 383 also calls for regulations to employ Section 382 principles to limit capital loss carryforwards of a loss company.[88] In addition, the regulations must provide that any permitted use of a capital loss carryforward in any year will reduce the Section 382 limitation on loss carryforwards for that year.[89]

E. OTHER LOSS LIMITATIONS

1. ACQUISITIONS MADE TO EVADE TAX: SECTION 269

Code: § 269.

If a corporation surmounts the hurdles of Section 382, it still may find its losses limited by Section 269. The subjective approach of Section 269 is fundamentally different from the objective tests of Section 382. Section 269 applies to a transaction only if the principal purpose of the acquisition was "evasion or avoidance of Federal income tax by acquiring the benefit of a deduction, credit, or other allowance" which the taxpayer otherwise might not enjoy. Section 269(a) potentially applies to Type A

[85] I.R.C. § 383(a)(2)(A).

[86] I.R.C. § 383(a)(2)(B).

[87] I.R.C. § 383(c).

[88] I.R.C. § 383(b).

[89] I.R.C. § 383(b). For regulations implementing Section 383, see Reg. § 1.383–1.

and C reorganizations and forward triangular mergers and to Type B reorganizations or stock purchases where the acquiring corporation previously owned less than 50 percent of the target.[90] Section 269(b) applies to liquidations which occur within two years after a corporation makes a stock purchase which would have qualified for a Section 338 election but only if no such election was made.[91]

If Section 269 applies, the Commissioner has the power to deny any "deduction, credit or allowance." In theory, Section 269 thus has a potentially broader reach than Section 382. Although Congress has indicated that Section 269 should not be applied to a transaction where carryovers were limited by the prior versions of Section 382,[92] the proposed regulations make it clear that current Sections 382 and 383 do not limit the Service's ability to invoke Section 269.[93] Thus, if a tax avoidance device or scheme is detected, Section 269 can deny even those NOLs that otherwise slip by the limits of Section 382. It is expected, however, that Section 269 will be applied more sparingly now that the objective limits on loss carryovers have been strengthened.

2. LIMITATIONS ON USE OF PREACQUISITION LOSSES TO OFFSET BUILT-IN GAINS: SECTION 384

Code: § 384.

Section 384 restricts an acquiring corporation from using its preacquisition losses to offset built-in gains of an acquired corporation. The policy and operation of Section 384 can best be illustrated by an example. Assume that Loss Corporation ("L") has $100,000 of net operating loss carryforwards. At the beginning of the current year, profitable Target Corporation ("T") merges into L in a tax-free Type A reorganization. L and T are owned by unrelated individual shareholders, and the merger does not result in a Section 382 ownership change to L. T's only asset, Gainacre, has a value of $200,000 and an adjusted basis of $125,000 which will transfer to L under Section 362(b). Assume that L sells Gainacre for $200,000 shortly after the merger, realizing a $75,000 gain.

Unless Section 269 or Section 382 applied, L could apply its preacquisition losses to shelter any gains recognized on the disposition of the assets acquired from T. Thus, L could use its net operating loss carryforwards to offset the $75,000 gain on the sale of Gainacre. Because it was not clear that Section 269 would effectively deter this strategy,

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90 I.R.C. § 269(a)(2).

91 See Chapter 8C2, supra.

92 See, e.g., S.Rep. No. 94–938, 94th Cong., 2d Sess. 206 (1976), reprinted in 1976–3 C.B. (Part 1) 244; S.Rep. No. 1622, 83d Cong., 2d Sess. 284 (1954).

93 Reg. § 1.269–7 provides that Section 269 may be applied to disallow a deduction, credit or other allowance when the item is limited or reduced under Section 382 or 383. The fact that an item is limited under Section 382(a) or 383 is relevant to the determination of whether the principal purpose of the acquisition is evasion or avoidance of federal tax.

Congress became concerned that loss corporations would become vehicles for "laundering" the built-in gains of profitable target companies. Section 384—yet another attack on the real and perceived abuses flowing from corporate acquisitions—is the legislative response. Its purpose is to preclude a corporation from using its preacquisition losses to shelter built-in gains of another (usually, a target) corporation which are recognized within five years of an acquisition of the gain corporation's assets or stock. In the example above, L would be prevented from using its preacquisition net operating loss as a deduction against the $75,000 "recognized built-in gain" on the disposition of Gainacre.

Section 384 is triggered in two situations: (1) stock acquisitions, where one corporation acquires "control" (defined by reference to the 80-percent-of-vote-and-value benchmark in Section 1504(a)(2)) of another corporation, and (2) asset acquisitions in an acquisitive Type A, C or D reorganization, if either corporation is a "gain corporation"—i.e., a corporation having built-in gains.[94] As originally enacted, Section 384 applied only when a loss corporation acquired the stock or assets of a gain corporation, but Congress later expanded the provision to apply regardless of which corporation acquired the other. If applicable, Section 384(a) provides that the corporation's income, to the extent attributable to "recognized built-in gains," shall not be offset by any "preacquisition loss" other than a preacquisition loss of the gain corporation. This punishment occurs during any "recognition period taxable year," which is any taxable year within the five-year period beginning on the "acquisition date."[95]

Understanding the operation of Section 384 requires a mastery of its glossary, much of which is borrowed from Section 382. The essential terms are as follows:

(1) The "acquisition date" is the date on which control is acquired, in the case of a stock acquisition, or the date of the transfer, in the case of an asset acquisition.[96]

(2) A "preacquisition loss" is any net operating loss carryforward to the taxable year in which the acquisition date occurs and the portion of any net operating loss for the

[94] I.R.C. § 384(a), (c)(4) and (5). Section 384 does not displace any of the other Code provisions limiting loss carryovers—e.g., Sections 269, 382, and certain provisions in the consolidated return regulations. Congress has indicated that the limitations of Section 384 apply independently of and in addition to the limitations of Section 382. Staff of the Joint Committee on Taxation, Description of the Technical Corrections Bill of 1988, 100th Cong., 2d Sess. 421 (1988). In contrast to Section 269, the application of Section 384 is not dependent on the subjective intent of the acquiring corporation.

[95] See I.R.C. §§ 384(c)(8); 382(h)(7). The Section 384 limitation also applies to any "successor" corporation to the same extent it applied to its predecessor. I.R.C. § 384(c)(7).

[96] I.R.C. § 384(c)(2).

taxable year of the acquisition to the extent the loss is allocable to the period before the acquisition date.[97]

(3) A "recognized built-in gain" is any gain recognized on the disposition of any asset during the five-year recognition period except to the extent that the gain corporation (in the case of an acquisition of control) or the acquiring corporation (in the case of an asset acquisition) establishes that the asset was not held by the gain corporation on the acquisition date, or that the gain accrued after the acquisition date.[98] Income items recognized after the acquisition date but attributable to prior periods are also treated as recognized built-in gain.[99] This definition should be familiar; it is similar to the definition of the same term in Section 382(h)(2)(A) except that the burden of proof is different. Under Section 382, the burden is on the taxpayer to establish that the asset was held by the old loss corporation before the change date and the recognized gain does not exceed the appreciation in the asset on that date. Under Section 384, it is presumed that a gain recognized during the recognition period is a built-in gain unless the corporation establishes that the asset was not held on the acquisition date or that the recognized gain exceeds the built-in gain at the time of the acquisition.

(4) The amount of recognized built-in gain for any taxable year is limited to the "net unrealized built-in gain" reduced by recognized built-in gains for prior years in the recognition period which, but for Section 384, would have been offset by preacquisition losses.[100] For this purpose, the definition of "net unrealized built-in gain" is borrowed from Section 382(h)(3), substituting the acquisition date for the ownership "change date."[101] Thus, it is the excess of the aggregate fair market value of the assets of the "gain corporation" over the aggregate adjusted bases of those assets, except that the net unrealized built-in gain will be deemed to be zero unless it is greater than the lesser of (1) 15 percent of the fair market value of the corporation's assets other than cash and certain marketable securities or (2) $10 million.[102]

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97 I.R.C. § 384(c)(3)(A). In the case of a corporation with a net unrealized built-in loss, as defined by Section 382(h)(1)(B), the term "preacquisition loss" also includes any built-in loss recognized during the five-year recognition period. I.R.C. § 384(c)(3)(B).

98 I.R.C. § 384(c)(1)(A).

99 I.R.C. § 384(c)(1)(B).

100 I.R.C. § 384(c)(1)(C).

101 I.R.C. § 384(c)(8).

102 I.R.C. §§ 384(c)(8); 382(h)(3)(B).

The limitations in Section 384(a) do not apply to the preacquisition loss of any corporation that was a member of the same "controlled group" that included the gain corporation at all times during the five-year period ending on the acquisition date. For this purpose, the definition of controlled group is borrowed from Section 1563 (as modified to generally require more than 50 percent common ownership of both voting power and value).[103]

As if the foregoing rules were not enough, Section 384(f) authorizes the Treasury to promulgate regulations as may be necessary to carry out the anti-abuse mission of the section.[104]

PROBLEM

Gain Corp., which is wholly owned by individual A, has the following assets and no liabilities:

Asset	Adj. Basis	F.M.V.
Inventory	$150,000	$300,000
Machinery	$300,000	$200,000
Gainacre	$100,000	$350,000

Loss Corp., which is wholly owned by unrelated individual B, has $500,000 in net operating loss carryforwards.

Unless otherwise indicated below, assume that Loss Corp. acquired all the assets of Gain Corp. in a tax-free Type A reorganization on January 1, Year 1. After the acquisition, B owned 80% and A owned 20% of the Loss Corp. stock. To what extent, if any, may Loss Corp. use its preacquisition net operating loss carryforwards against the gains recognized in the following alternative transactions?:

(a) Loss Corp. sells Gainacre for $500,000 in Year 2.

(b) Same as (a), above, except that Loss Corp. acquired all of Gain Corp.'s stock from A for cash (not making a § 338 election) on January 1, Year 1, after which it liquidated Gain Corp. under § 332.

(c) Same as (a), above, except Loss Corp. also sells the inventory for $400,000 in Year 2.

(d) Instead of (a)–(c), above, Loss Corp. sells Gainacre for $900,000 in Year 7.

(e) Same as (a), above, except that Loss Corp. has no net operating loss carryforwards at the time of the acquisition but its only asset is Lossacre, which had a fair market value of $300,000 and an adjusted basis of $500,000. In Year 2, Loss Corp. sells

[103] I.R.C. § 384(b). The common control testing period would be shortened if the gain corporation was not in existence for the full five-year preacquisition date period by substituting its period of existence. I.R.C. § 384(b)(3).

[104] As of early 2019, no regulations had been issued.

Lossacre for $200,000 at the same time that it sells Gainacre for $500,000.

3. CONSOLIDATED RETURN RULES

C corporations generally determine their taxable income and tax liability without regard to the income and losses of other affiliated entities. The consolidated return rules are an exception to this separate entity principle. Section 1501 permits an "affiliated group of corporations" to elect to file a consolidated tax return in which their separate taxable income and losses are aggregated.[105] An "affiliated group" is defined as a chain of corporations linked by specific levels of stock ownership. The common parent of the group must own at least 80 percent of the total voting power and value of at least one corporation in the chain, and every corporation in the chain must be 80 percent owned (based on voting power and value) by other members of the group.[106]

When computing the consolidated taxable income or loss of an affiliated group of corporations, each member of the group first determines its separate taxable income or loss.[107] The separate taxable income or loss figures of the members of the group are then combined, and the Section 11 tax rates are applied to the aggregate figure to arrive at the group's tax liability.

Because the consolidated return rules permit aggregation of the separate taxable income and loss of the members, the potential exists for one member of the group to offset its taxable income with the losses of another member. For example, without a specific limitation, a profitable corporation could acquire the requisite ownership of a corporation with a large net operating loss, the two corporations could elect to file a consolidated return, and the joint tax liability of the corporate family would be reduced as the net operating losses of one member are deducted against the income of the other. A multi-layer of statutes and regulations limit the use of net operating losses by corporations filing a consolidated return. First, all of the statutory limitations on the use of NOLs studied earlier in this chapter (i.e., Sections 382, 383, 384 and 269) potentially apply to a consolidated group.[108] If any loss somehow should survive these statutory gatekeepers, the consolidated return regulations contain an additional rule to patrol abuse: the "separate return limitation year" ("SRLY") limitation.[109] The operation of these rules should be familiar

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105 See generally Chapter 1D2, supra, and Chapter 13, infra.

106 I.R.C. § 1504(a)(1), (2). In general, preferred stock is not counted for purposes of the ownership tests and certain corporations subject to special tax regimes, such as tax-exempt and foreign corporations, are not permitted to be part of an affiliated group. I.R.C. § 1504(a)(4), (b).

107 Reg. §§ 1.1502–2, 1.1502–11(a)(1), 1.1502–12.

108 See Reg. § 1.1502–90 through Reg. § 1.1502–99, which apply Section 382 to a consolidated group of corporations.

109 The regulations also include limitations on the use of built-in losses and capital loss carryovers and carrybacks. See Reg. §§ 1.1502–15; 1.1502–22(c), (d). These items are also subject to the SRLY limitation.

because they reflect many of the same policies embodied in the generally applicable statutory limitations.

The SRLY limitation is designed to prevent the use by an affiliated group of net operating losses arising in a separate return limitation year of a member of the group. A separate return limitation year is a taxable year in which the member filed either its own separate tax return or filed as part of another affiliated group.[110] In general, the aggregate net operating losses of a member of an affiliated group arising in separate return years only may be carried over and used to offset the aggregate consolidated income attributable to that member.[111] Thus, if a profitable corporation ("P") acquires a target corporation ("T") with large net operating losses, and the two corporations file a consolidated tax return, preacquisition losses and built-in losses of T may not be used to reduce the postacquisition tax liability on consolidated taxable income attributable to P.

The regulations include an important exception that restricts the application of the SRLY limitation. Generally, the SRLY limitation does not apply in any case where a corporation becomes a member of a consolidated group (where the limitation otherwise would apply) within six months of the change date of a Section 382(g) change of ownership.[112] As a result, in many acquisitions the SRLY limitation relinquishes jurisdiction over NOLs to Section 382.[113]

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110 Reg. § 1.1502–1(e), (f).

111 Reg. § 1.1502–21(c).

112 Reg. § 1.1502–21(g)(1) & (2).

113 A similar rules applies in the case of recognized built-in losses. See Reg. § 1.1502–15(g).