REPORT # 579

TAX SECTION

New York State Bar Association

SUPPLEMENTAL REPORT

ON SECTION 382

by the

Committee on Net Operating Losses

February 22, 1988

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REPORT # 579

TAX SECTION
New York State Bar Association

February 22, 1988

Hon. Lawrence B. Gibbs
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 3000
Washington, D.C. 20224

Dear Larry:

I am pleased to forward to you the enclosed Supplemental Report on Section 382 (Including Temporary Regulations) prepared by our, Committee on Net Operating Losses. The report supplements the report of that Committee on section 382 that was submitted in 1986, prior to the enactment of the Tax Reform Act. The report was written by James M. Peaslee and Matthew A. Rosen, Co-Chairs of the Committee, Robert Rothman and Shlomo Cohen. Helpful comments on the report were received from Dale Collinson, Arthur A. Feder, Andrew Feiner, Stuart Goldring, Carol Goldstein, Leslie Hoffman, Robert Jacobs, Donald Schapiro and Michael Schler.

The two principal topics of the report are the Temporary Regulations under section 382 issued last August and the application of section 382 to affiliated groups. In addition to numerous technical comments on the Regulations, the Report recommends changes relating to the definition of 5-percent shareholder, the treatment of “stock” as “non-stock” and vice versa, and the rules governing options. The Report includes a summary of the Regulations. In the area of affiliated groups, the Report makes recommendations relating to the definition of ownership change, the calculation and application of the section 382 limitation, the treatment of

built-in gains and losses, and the application of the continuity of business enterprise test, the “anti-stuffing rules”, the SRLY and CRCO rules, and the bankruptcy exception in section 382(1)(5). It also comments on the allocation of income for the year in which an ownership change occurs in a case where some group members have short taxable years, and the treatment of affiliated groups that do not file consolidated returns.

In addition to these topics, the Report comments on the built-in gain and loss rules in section 382(h), additional issues relating to the valuation of stock, and corporate contractions.

Although many of the suggestions in the Report can be implemented through regulations, technical corrections to the statute are suggested in the discussion of built-in gains and losses (part III of the report), the discussion of the bankruptcy exception (part IV.H.) and with respect to effective dates, the discussion of corporate contractions in part VI.

We understand that there may be aspects of section 382 not addressed in either of our reports that are proving to be troublesome for practitioners and the Service, We plan to prepare a further report on that and would appreciate your suggestions as to specific areas where you believe that additional comments would be helpful.

Sincerely,

Herbert L. Camp

cc: William Nelson, Esq.
Peter K. Scott, Esq.
D. Kevin Dolan, Esq.
Mr. Donald E. Osteen
Mr. Keith Stanley

REPORT # 579

TAX SECTION
New York State Bar Association

February 22, 1988

Hon. O. Donaldson Chapoton
Assistant Secretary for Tax Policy
Department of the Treasury
Main Treasury Building
15th and Pennsylvania Avenue, N.W.
Room 3120
Washington, D.C. 20220

Dear Don:

I am pleased to forward to you the enclosed Supplemental Report on Section 382 (Including Temporary Regulations) prepared by our, Committee on Net Operating Losses. The report supplements the report of that Committee on section 382 that was submitted in 1986, prior to the enactment of the Tax Reform Act. The report was written by James M. Peaslee and Matthew A. Rosen, Co-Chairs of the Committee, Robert Rothman and Shlomo Cohen. Helpful comments on the report were received from Dale Collinson, Arthur A. Feder, Andrew Feiner, Stuart Goldring, Carol Goldstein, Leslie Hoffman, Robert Jacobs, Donald Schapiro and Michael Schler.

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Sincerely,

Herbert L. Camp

cc: Dennis Ross, Esq.
Tom Wessel, Esq.

REPORT # 579

TAX SECTION

New York State Bar Association

February 22, 1988

William Wilkins, Esq.
Majority Staff Director and
Chief Counsel
Senate Finance Committee
205 Dirksen Building
Washington, D.C. 20510

Dear Bill:

I am pleased to forward to you the enclosed Supplemental Report on Section 382 (Including Temporary Regulations) prepared by our, Committee on Net Operating Losses. The report supplements the report of that Committee on section 382 that was submitted in 1986, prior to the enactment of the Tax Reform Act. The report was written by James M. Peaslee and Matthew A. Rosen, Co-Chairs of the Committee, Robert Rothman and Shlomo Cohen. Helpful comments on the report were received from Dale Collinson, Arthur A. Feder, Andrew Feiner, Stuart Goldring, Carol Goldstein, Leslie Hoffman, Robert Jacobs, Donald Schapiro and Michael Schler.

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Sincerely,

Herbert L. Camp

REPORT # 579

TAX SECTION

New York State Bar Association

February 22, 1988

Mr. Randall W. Weiss
Deputy Chief of Staff
Joint Committee on Taxation
1010 Longworth House Office
Building
Washington, D.C. 20515

Dear Randall:

I am pleased to forward to you the enclosed Supplemental Report on Section 382 (Including Temporary Regulations) prepared by our, Committee on Net Operating Losses. The report supplements the report of that Committee on section 382 that was submitted in 1986, prior to the enactment of the Tax Reform Act. The report was written by James M. Peaslee and Matthew A. Rosen, Co-Chairs of the Committee, Robert Rothman and Shlomo Cohen. Helpful comments on the report were received from Dale Collinson, Arthur A. Feder, Andrew Feiner, Stuart Goldring, Carol Goldstein, Leslie Hoffman, Robert Jacobs, Donald Schapiro and Michael Schler.

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Sincerely,

Herbert L. Camp

cc: Dennis Ross, Esq.

REPORT # 579

TAX SECTION
New York State Bar Association

February 22, 1988

Robert J. Leonard, Esq.
Chief Counsel
House Ways and Means Committee
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

I am pleased to forward to you the enclosed Supplemental Report on Section 382 (Including Temporary Regulations) prepared by our, Committee on Net Operating Losses. The report supplements the report of that Committee on section 382 that was submitted in 1986, prior to the enactment of the Tax Reform Act. The report was written by James M. Peaslee and Matthew A. Rosen, Co-Chairs of the Committee, Robert Rothman and Shlomo Cohen. Helpful comments on the report were received from Dale Collinson, Arthur A. Feder, Andrew Feiner, Stuart Goldring, Carol Goldstein, Leslie Hoffman, Robert Jacobs, Donald Schapiro and Michael Schler.

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Sincerely,

Herbert L. Camp

Tax Report #579

SUPPLEMENTAL REPORT
ON SECTION 382

Prepared by the
Committee on Net Operating Losses
New York State Bar Association
Tax Section

February 22, 1988

New York State Bar Association, Tax Section

Committee on Net Operating Losses[*]

Supplemental Report on Section 382

(Including Temporary Regulations)

I. Introduction

In June of 1986, this Committee submitted a report (the “1986 Report”)[**] on proposed amendments to section 382[***] contained in H.R. 3838, as passed by the House of Representatives the preceding December. Subsequent to the filing of that report, the Tax Reform Act of 1986 (“TRA 1986”) was enacted, including, in section 621 of TRA 1986, amendments to section 382. Amendments to section 382 were also included in the Revenue Act of 1987, which was enacted in December, 1987. In addition, bills providing for technical corrections to TRA 1986, including amendments to

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* This report was prepared by James M. Peaslee and Matthew A. Rosen, Co-Chairs of the Committee on Net Operating Losses, Robert Rothman and Shlomo Cohen. Helpful comments were received from Dale Collinson, Arthur A. Feder, Andrew Feiner, Stuart Goldring, Carol Goldstein, Leslie Hoffman, Robert Jacobs, Donald Schapiro and Michael Schler.

** The 1986 Report was reprinted in Tax Notes, June 23, 1986 at 1217.

*** Except where otherwise specified, all section references herein are to the Internal Revenue Code of 1986 (the "Code"), and all paragraph references are to paragraphs of section 1.382-2T of the Regulations (as hereinafter defined).

section 382, are currently pending. On August 5, 1986, temporary and proposed regulations under section 382 (the “Regulations”) were issued. The Regulations are concerned mostly with the definition of “ownership change” found in section 382(g).

This report comments on the Regulations and other aspects of section 382. Part II below comments on the Regulations. Part III suggests amendments to section 382 relating to built-in gains and losses. Part IV considers how the section should apply to affiliated groups of corporations. Part V discusses certain other issues related to the valuation of stock in applying section 382. Finally, Part VI comments on the treatment of redemptions and other corporate contractions.

II. Temporary Regulations

A. Summary of Regulations

1. Ownership Changes Generally.
-2T(a).

Paragraph (a) sets forth the general rules concerning ownership changes. An ownership change will have occurred if (i) a corporation is a “loss corporation,” (ii) on a “testing date,” and (iii) immediately after the close of such testing date, the percentage of stock owned by 5-percent shareholders has increased by more than fifty percentage points over the lowest percentage of stock owned by such shareholders at any time during the "testing period."

A "testing date" occurs (and accordingly a loss corporation is required to test percentage changes in ownership) if:

(i) there is an "owner shift" (as defined below);

(ii) there is an "equity structure shift" (as defined below);

(iii) an option is transferred by or to a 5-percent shareholder; or

(iv) an option is issued by the loss corporation or by an entity which, directly or by attribution, owns 5-percent or more of the loss corporation.

The Regulations also require loss corporations to keep records necessary to apply section 382, and to file an information statement relating to the occurrence of testing dates, the identity of 5-percent shareholders, and the holdings of such 5-percent shareholders.

-2T(c).

Paragraph (c) sets forth the general rule for computing increases in percentage ownership. On each testing date, a loss corporation must (i) identify each 5-percent shareholder, (ii) identify which 5-percent shareholders experienced an increase in percentage interest on the testing date as compared to any other time during the testing period, and (iii) add together such increases for all such shareholders. Stock owned by a 5-percent shareholder whose percentage ownership on the testing date does not exceed his percentage ownership on some other date during the testing period is not taken into account.

-2T(d).

Paragraph (d) provides rules for determining testing periods. Generally, the testing period for any testing date is the three-year period ending on such testing date. Special rules provide that (i) after an ownership change, a subsequent testing period shall not begin prior to the first day after such ownership change, and (ii) a testing period generally does not begin prior to the first day of the first taxable year from which there is a loss or credit carryover, or in which there “accrues” a net unrealized built-in loss.

-2T(e).

Paragraph (e) defines “owner shift” and “equity structure shift.” An owner shift is any change in stock ownership that affects the percentage of stock owned by any 5-percent shareholder. A non-exclusive list of examples is provided, including purchases, dispositions, section 351 transactions, redemptions, recapitalizations, and new issuances of stock. An equity structure shift is any reorganization other than “F” reorganizations and divisive “D” or “G” reorganizations.

2. Definitions.

Paragraph (f) provides definitions for a number of terms used in the Regulations, including a number of terms that are used in applying the attribution, aggregation and segregation rules (discussed below). The major substantive provision in this paragraph is the special definition of “stock”, which is authorized by section 382(k)(6)(B). Under paragraph (f)(18), an interest otherwise not considered stock is treated as stock for purposes of section 382 if it “offers a potential significant participation in the growth of the corporation,” and an interest otherwise treated as stock is not treated as stock if its “likely participation. . . in future corporate growth is disproportionately small when compared to the value of such stock." In each case, the above rule only applies where (i) the effect of applying such rule would be to cause an ownership change, and (ii) the amount of the corporation's pre-change loss is, generally, more than twice the amount that would be the annual section 382 limitation if there were an ownership change.

3. Attribution Rules.

Paragraph (h) provides rules relating to the constructive ownership of stock. In general, the rules of section 318 apply, with certain modifications. However, stock owned by an entity is attributed to its owners regardless of the percentage interest they hold and stock attributed from an entity to its owners is no longer considered to be owned by the entity. The general effect of these rules is to trace stock ownership through entities to the ultimate individual beneficial owners of a loss corporation. Stock that is treated as non-stock under the rule described above (and other similar equity interests in unincorporated entities) is ignored in applying the attribution rules.

Paragraph (h)(4) provides detailed rules for determining when an option is deemed exercised for purposes of section 382. In general, for purposes of determining whether there is an ownership change (but not for purposes of calculating the "value" of a loss corporation that is used in determining the section 382 limitation if an ownership change occurs), any option is treated as being exercised on any testing date if the effect of so treating it is to cause an ownership change, regardless of whether the option is currently exercisable or whether exercise of the option makes economic sense. If an option that was deemed to have been exercised subsequently expires unexercised, it is treated as if it had never been issued, and, subject to the statute of limitations, the loss corporation may file amended returns for previously affected years. The option rule applies not only to interests that are commonly viewed as options but also to other similar interests (including purchase contracts).

A number of exceptions apply to the option rule, including the following:

> (i) the rule does not apply if the amount of pre-change losses is, generally, less than twice the annual section 382 limitation that would apply if an ownership change did occur;
>
> (ii) options for publicly traded stock, which

have been held by the same person for at least three years, are subject to the rule only if they are “in the money”;

(iii) the rule does not apply to a right upon maturity of a debt instrument (or possibly before maturity) to receive a fixed dollar value of stock (as opposed to a specified number of shares);

(iv) a right or obligation to redeem stock is not treated as an option, to the extent that (a) such right or obligation is issued at the same time such stock is issued, and (b) such stock was not issued to 5-percent shareholders (determined immediately before such issuance);

(v) options that are exercisable only upon death, complete disability, mental incompetency or retirement and are between owners of an entity (or between an entity and one of its owners) are not subject to the rule, except that in the case of options exercisable upon retirement, the exception is available only if (a) the parties to the option actively participate in management, and (b) the option is entered into when the corporation is not a loss corporation;

(vi) interest or dividends payable in stock of the issuer are not subject to the rule; and

(vii) rights to acquire stock upon default under a loan agreement, where the lender is one of certain enumerated types of financial institutions and where the loan is made in the ordinary course of business, are not subject to the rule.

4. Definition of 5-percent Shareholder and Aggregation and Segregation Rules.

-2T(g).

Paragraph (g) provides general rules for determining whether an individual is a 5-percent shareholder and for computing percentage ownership interests. The basic rule is that an individual is a 5-percent shareholder of a loss corporation if he owned, at any time during the testing period (not necessarily on the testing date) directly or by attribution, five percent or more of the stock of the corporation.

The Regulations go on to provide detailed rules for determining which indirect interests are to be taken into account in making this determination. Central to these rules are the definitions of “first tier entity” and “higher tier entity.” A “first tier entity” is defined in paragraph (f)(9) as an entity (i.e., not an individual) that directly owns five percent or more of the stock of a loss corporation. A “higher tier entity” is defined in paragraph (f)(14) as an entity that directly owns five percent or more of a first tier entity or of another higher tier entity.

The general rule for taking into account indirect interests in determining a shareholder’s percentage ownership is that stock is attributed to an individual from an entity only if (i) the entity is a first tier entity or higher tier entity, and (ii) the individual directly owns at least five percent of the entity. In addition, a direct interest of an individual in a loss corporation, or an indirect interest owned through any entity, is taken into account (i.e., added with other direct or indirect interests of such individual) only to the extent that each interest constitutes at least five percent of the loss corporation.

The net effect of these rules is that ownership attribution will only be applied through a continuous chain of five percent holdings, and will be broken if any entity in the chain owns less than five percent of the next lower entity.

Moreover, any attributed ownership through an entity that constitutes less than five percent of the loss corporation is generally disregarded and treated as part of a public group (see discussion below).

Exceptions to the above rules are provided for cases where (i) a corporation has actual knowledge of an ultimate shareholder's interests, or (ii) “a principal purpose” for creating an ownership structure is circumventing the section 382 limitation.

-2T(j).

Paragraph (j) sets forth rules pursuant to which groups of less than 5-percent shareholders (“public groups”) are aggregated and treated as separate 5-percent shareholders. In general, absent actual knowledge to the contrary, there is a presumption of no cross-ownership among public groups.

Under the general aggregation rule, an entity-by-entity analysis is performed to determine the public group of each highest tier entity. If any such group indirectly owns at least five percent of the loss corporation, it is treated as a separate 5-percent shareholder; otherwise, it is treated as part of the public group of the next lower tier entity. The same test is then applied to that public group and so on down the chain of ownership until the loss corporation is reached. The public group of the loss corporation is treated as a separate 5-percent shareholder regardless of how much stock it owns.

Paragraph (j)(2) provides rules pursuant to which the group of all direct public owners of the loss corporation may be segregated into more than one 5-percent shareholder. Generally, these rules apply in the case of (i) reorganizations described in section 381(a)(2), (ii) new issuances of stock, (iii) redemptions, and (iv) issuances of stock upon the deemed exercise of options.

In general, paragraph (j)(3) segregates the direct public owners of a loss corporation following a disposition of stock to the public by a 5-percent shareholder or first tier entity. It also extends the segregation rules that apply to the direct public shareholders of a loss corporation to the owners of any entity that owns directly or indirectly at least five percent of the loss corporation's stock.

5. Effective Date Provisions.

The effective date provisions of the Regulations focus on three dates: January 1, 1987 (the general effective date of the TRA 1986 amendments to section 382), May 6, 1986 (the earliest “look-back” date under the statute), and September 4, 1987 (30 days after the date the Regulations were published).

(a) General Rule. The general effective date rule, set forth in paragraphs (m)(1),(2) and (3), is that the Regulations apply to ownership changes occurring after December 31, 1986 (except that for this purpose, equity structure shifts that occur pursuant to plans of reorganization adopted on or prior to such date are treated as occurring on the date of adoption of the plan). Thus, except where special rules apply, as discussed below, the Regulations are subject to the same effective date rules as the statute.

(b) Aggregation and Segregation Rules. Special rules apply to the aggregation and segregation rules of paragraph (j). These rules differ depending on whether or not the testing date occurs before September 4, 1987. In the case of testing dates before September 4, 1987, (i) the aggregation rules of paragraph (j)(1) apply only to stock of the loss corporation acquired after May 5, 1986, (ii) the segregation rules of paragraph (j)(2) apply only to multi-party transactions (and not, for example, to redemptions or to public offerings of stock), and (iii) the segregation rules of paragraph (j)(3) apply only to multi-party transactions and to dispositions of stock acquired after May 5, 1986. In the case of testing dates on or after September 4, 1987, paragraph (j) applies without limitation, except that paragraphs (j)(2) and (j)(3) are subject to the same effective date rules as apply to pre-September 4 testing dates where the transaction giving rise to the application of any such paragraph occurred before September 4.

(c) Definition of Stock. The rules of paragraph (f)(18), which can reclassify stock as non-stock interests, and other interests as stock, apply only to interests that are either issued or transferred to or by a 5-percent shareholder on or after September 4, 1987.

(d) Information Statement. The section 382 information statement required by the Regulations is not required to be filed for any taxable year for which the due date of the income tax return (including extensions) is on or before October 5, 1987.

(e) Options. In the case of an option issued prior to May 6, 1986, the rules of paragraph (h)(4), which under certain circumstances deem options to be exercised, apply only if such option is transferred by or to a 5-percent shareholder after such date (although the actual exercise of the option may be taken into account). In the case of an option issued on or after

May 6, 1986 and prior to September 18, 1986, such rules apply in their entirety. In the case of an option issued on or after September 18, 1986 and before January 1, 1987, such rules apply except that the option is ignored if it either lapses unexercised or, on the issue date, there was no significant likelihood that it would be exercised within five years and a purpose of such issuance was to cause an ownership change prior to the January 1, 1987 effective date of the statute.

B. Major Conceptual Comments on Regulations

In general, the Committee believes that the Regulations represent a very thoughtful and successful attempt to implement an extremely complex conceptual structure.

The Committee believes there are three major areas in which a somewhat different conceptual approach than has been taken in the Regulations should be followed. These three areas are (i) the definition of 5-percent shareholder, (ii) the rules relating to the treatment of various interests as stock or as non-stock interests, and (iii) the treatment of options.

1. Definition of 5-percent Shareholder and Aggregation and Segregation Rules.

Although we disagree with some of the results reached in the Regulations in defining a 5-percent shareholder and applying the aggregation and segregation rules, our principal comment in this area is that the Regulations need to be simplified to make them more readily understandable. We believe that this could be accomplished by adopting the following rules:

1. A 5-percent shareholder would be defined as an individual who owns five percent or more of the stock of the loss corporation, or a public group (whether or not the group owns five percent of the stock of the loss corporation).

2. If an entity owns stock directly in the loss corporation, then:

a. Identify all of the individuals who own stock in the loss corporation through that entity. For purposes of these rules and the other provisions of the Regulations, any entity that owns directly or indirectly (disregarding paragraph (h)(2)) less than five percent of the stock of the loss corporation would be treated as an individual who is presumed to be unrelated to any other person owning stock of the loss corporation.

b. Aggregate the stock owned indirectly through an entity by all individuals identified in a. above who own individually less than five percent of the loss corporation and treat such stock as owned by a public group. That public group would be segregated from any other public group of the loss corporation.

3. Direct public groups of the loss corporation would be aggregated or segregated in accordance with the first sentence of paragraph (j)(1)(iv)(C) and paragraphs (j)(2) and (j)(3). Subject to the discussion below, changes in ownership of any entity that owns stock in the loss corporation would be measured by segregating public groups of that entity in the same manner as if it were the loss corporation.

4. Each public group identified in the Regulations would be presumed to include no shareholder who owns any other stock of the loss corporation.

5. The presumptions in 2.a. and 4. above would not apply to the extent the loss corporation has actual knowledge to the contrary.

Perhaps the best way to explain how these rules would simplify the Regulations is to compare them with their counterparts in the Regulations, and to suggest some of the specific changes that would be made if these rules were adopted. This is done in Appendix A to this Report. We will consider here the two substantive differences that we have identified between the rules proposed above and the Regulations, both of which relate to the segregation of public groups that own stock in L through an entity.

The first difference concerns public shareholders who own less than five percent of the stock of L through an entity that itself owns directly more than five percent of the stock of L. The Regulations, at paragraphs (j)(1)(iv)(A) and (C), would aggregate those shareholders with the direct public shareholders of L. Our proposed rule 2.b. would treat the entity's public shareholders as a separate public group.

To illustrate the difference in approaches, suppose L is owned entirely by public shareholders and that P purchases ten percent of the stock of L. P is owned sixty percent by A and forty percent by the public. Under the Regulations, the purchase would be treated as only a six percent increase in the ownership of L stock by a 5-percent shareholder because the P public shareholder, which owns less than five percent of the L stock, would be aggregated with the L public shareholder. On the other hand, if P were owned entirely by public shareholders, those shareholders would be treated as a separate public group and the full ten percent purchase would be counted. We do not think that this distinction makes sense. The principal purpose of the 5-percent shareholder rules is to relieve loss corporations of the burden of keeping track of changes in the holdings of small shareholders. However, the burden on L of keeping track of the holdings of P is not affected by whether P is owned forty percent or one hundred percent by public shareholders; the key point in terms of the burden on L is that P owns directly at least five percent of L. Thus, we would segregate the P public group, regardless of whether it is deemed to own five percent of the L stock, in any case where P owns at least five percent of L.

The second substantive difference between the proposed rules and the Regulations relates to the application of the segregation rules of paragraph (j)(2) to entities that own stock in L.

In the case of direct stock holdings in the loss corporation, the Regulations distinguish between transfers of stock between shareholders and changes in ownership that result from a transaction (a “segregation transaction”) listed in paragraph (j)(2) that results in the creation of a new public group. A transfer of stock between shareholders is not counted unless the percentage ownership of a shareholder that directly owns five percent or more of the L stock is affected. By contrast, changes in ownership that result in the creation of a new public group are counted regardless of the size of the new public group. Presumably, the reason for this difference is that segregation transactions involve direct participation by the loss corporation as a party to the transaction, so that it should be held to have knowledge of any resulting change in ownership.

The Regulations adopt three rules for measuring changes in ownership of L that result from changes in the ownership of an entity that owns stock of L. First, if the entity does not own directly or indirectly at least five percent of L, then it is treated as an individual and changes in the ownership of the entity are not counted as changes in the ownership of L.

Second, if the entity does own at least five percent of L, then transfers of interests in the entity between owners of such interests are counted only if the transferor or transferee owns five percent or more of L stock (not a five percent interest in the entity). Thus, in order for a transfer of an ownership interest in the entity to count as a change in the ownership of L, the interest that is transferred must represent a larger percentage interest in the entity the smaller the entity's holdings in L. At the extreme, if the entity owns only five percent of L, a transfer of stock of the entity would count only if the transfer involved a one hundred percent change in the ownership of the entity. This is true even if L could potentially identify changes in ownership of the entity that exceeded five percent of the interests in the entity by monitoring Schedule 13d filings with respect to the entity.

The third rule for measuring changes in the ownership of L resulting from changes in the ownership of another entity relates to entities that own directly or indirectly at least five percent of the stock of L and that participate in segregation transactions. Under the Regulations, the segregation rules in paragraph (j)(2) are applied to such an entity as if it were a loss corporation. Under those rules, changes in ownership that do not involve any 5-percent shareholder of the entity, much less of L, must be counted. As noted above, the apparent reason for counting all changes in ownership resulting from segregation transactions that affect L is that L is a party to those transactions and should have knowledge of any resulting changes in ownership; however, L would not necessarily be a party to segregation transactions affecting entities that own stock in L, and would not have any special knowledge of those transactions. Thus, the rationale for the rule would seem not to apply.

To illustrate how the rule in the Regulations would operate, suppose that five percent of the stock of L is owned by P, and that the stock of P is owned ten percent by C and forty-five percent each by A and B. Under the Regulations, A and B would be treated as part of the public group consisting of all of the shareholders of P. If A sold all of his stock to B, the transaction would not count as a change in ownership of L stock because A and B are members of the same public group. On the other hand, if P redeemed the stock owned by A, the increase in B's and C's combined interest in L from 2.75 percent to five percent would be counted because the public shareholders who participated in the redemption (namely, A) would be segregated from the other share-holders (B and C) under paragraph (j)(2)(iii)(C). However, there is no reason to believe that L would be more aware of the redemption than the sale.

We believe that the segregation rules should be restricted as they apply to entities that own stock in L. One approach would be to provide that those rules will not apply to a segregation transaction affecting such an entity, at least in the absence of actual knowledge of that transaction by L (without a duty of inquiry). Another approach, which we think is less desirable, would be to provide that the segregation rules will not apply to such an entity unless that entity owns a higher percentage than five percent (e.g., thirty percent) of the stock of L. Neither of these limitations would affect the results in the examples at paragraph (j)(3)(iv) illustrating the segregation rules as they apply to entities owning stock in L because all of those examples involve entities that own 100 percent of L.

2. Treatment of Interests as Stock or Non-stock.

Paragraph (f)(18)(ii) treats an ownership interest that otherwise would be stock as not stock if (A) as of the time of its issuance or transfer to (or by) a 5-percent shareholder, the likely participation of such interest in future corporate growth is disproportionately small when compared to the value of such stock as a proportion of the total value of the outstanding stock of the corporation, (B) treating the interest as not stock would result in an ownership change and (C) the amount of the pre-change loss exceeds a prescribed de minimis amount. Under paragraph (f)(18)(iii), instruments that would not otherwise be stock are treated as stock if (A) as of the time of issuance of the interest or its transfer to (or by) a 5-percent shareholder, such interest offers a potential significant participation in the growth of the corporation, (B) treating the interest as stock would result in an ownership change and (C) the same de minimis test is met. It is interesting to note that the rules treating stock as non-stock and non-stock as stock are not parallel. Non-stock is treated as stock if it has a potentially significant participation right. However, stock is treated as non-stock not only where it lacks a potentially significant participation right but also where it has a significant participation right but that right is disproportionately small compared with value.

These rules are necessary as anti-abuse measures. For example, in the absence of a rule treating stock as non-stock, it might be possible to transfer substantially all of the “true” equity ownership of L and avoid an ownership change by having the transferor retain voting preferred stock having no participation features but representing at least fifty percent of the value of L.*

Based on the discussion below, we are concerned that paragraph (f)(18)(ii) in its present form is overly broad. As an alternative, we recommend that stock be treated as non-stock only where it lacks a significant open-ended participation right. One of the factors that might be taken into account in determining whether a participation right is significant is the portion of the value of the stock attributable to that right. We believe that such a rule would be comparatively easy to apply and would adequately address the true abuse cases. Such a rule would be similar to the approach adopted in the 1976 version of section 382** and also analogous to the rules used to distinguish

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* See 1986 Report at 1229.

** The 1976 version of section 382 imposed limitations on NOL carryovers based on changes in ownership of either "stock" or "participating stock”. The former was defined in section 382(c) as stock other than straight preferred stock (defined in a manner similar to section 1504(a)(4) as amended by the Tax Reform Act of 1984). "Participating stock” was defined in section 382(c)(2) as "stock (including common stock) which represents an interest in the earnings and assets of the issuing corporation which is not limited to a stated amount of money or property or percentage of paid-in capital or par value, or by any similar formula."

preferred stock from other types of stock in Treasury Regulation section 1.305-5.*

As a less desirable substitute rule to limit the overbreadth of paragraph (f)(18)(ii), the paragraph could be changed so that it would treat stock as non-stock only to the extent that the stock's proportionate value exceeds its participation rights. This rule is less desirable in our view than the one described in the immediately preceding paragraph for two reasons. First, it would apply whenever participation rights were disproportionate to value, even if the stock possessed a significant participation right. As a result, the rule might extend beyond the types of abusive transactions that necessitate the existence of the rule. Second, developing rules for assigning

* This regulation defines "preferred stock" as stock that is not merely privileged in some fashion but also does not participate in corporate growth to any significant extent. The regulation makes it clear that a participation right that lacks substance will be disregarded.

a number to the degree of participation of a stock might be difficult in the case of stocks having unusual terms or that are issued by corporations with complex capital structures.

Whatever substantive rule is adopted in final regulations, we strongly recommend that it be illustrated with a number of examples, both of cases which are described in the rules and of cases not so described. This is an area where concrete illustrations are particularly necessary to add content to the words of a definition.

As noted above, we believe that paragraph (f)(18)(ii) in its present form is overly broad. In order to see why, consider a case where L has outstanding two classes of common stock (and no other stock) designated A and B. The two classes are identical, except that class B has two votes per share and class A has only one. The class A stock has a slightly lower per share value than the class B stock because of its reduced voting power. Suppose that there are ninety-five shares of class B outstanding and five shares of class A and that Q, a 5-percent shareholder, purchases the five shares of class A stock. Given that the class B stock has a right to substantially all of the earnings and assets of L and (if relevant) a controlling vote, it makes no sense to conclude that an ownership change has occurred as a result of the purchase by Q. However, that would arguably be the result under the Regulations as presently formulated, because the proportionate participation rights of the class B stock are smaller than its proportionate value.* The oddity of the result in this case is all the more apparent when it is considered that the non-stock rule would not apply if the class A stock had the same voting rights as class B, even though in that case Q would have acquired a more significant stake in L as a result of its purchase of class A stock because of the greater voting power of that stock.

Another common case where the Regulations may have questionable consequences involves the interplay between the definition of stock and the ownership attribution rules. Suppose that one hundred percent of the stock of L is owned by a limited partnership, LP. The general partner of the partnership performs services in exchange for a right to one percent of the profits of the partnership. The limited partners contributed all of the

* It is not clear whether the phrase "disproportionately small" was intended to require that the discrepancy between value and participation exceed some de minimis amount.

capital of LP and are entitled to ninety-nine percent of the profits. If a new general partner is substituted for the old one, there would arguably be an ownership change under the Regulations. The limited partners' interests may be said to have characteristics similar to corporate stock that would be treated as non-stock under paragraph (f)(18)(ii) because those interests have a profit share that is lower than their proportionate value. In that event, those interests would be disregarded under-paragraph (h)(2)(ii)(C), and the new general partner would be considered to have acquired one hundred percent of the stock of L.

More plausible results would be achieved under the alternative rules proposed above. The class B stock in the first example and the limited partnership interests in the second example would not be disregarded if the non-stock rule applied only to equity interests that did not have significant open-ended participation rights. In addition, under an approach that treated an equity interest as non-stock only to the extent its proportionate participation rights were smaller than its proportionate value, the class B stock and the limited partnership interests would be treated as non-stock only to the extent their proportionate values exceeded their respective profit shares of ninety-five percent and ninety-nine percent.*

An additional significant question relating to paragraph (f)(18) is whether the character of an interest as stock or non-stock must be the same at all times that the interest is held by a 5-percent shareholder (including a member of a public group), or instead can change on any testing date even if the interest is not acquired on that date by a new 5-percent shareholder. Clause (A) of paragraphs (f)(18)(ii) and (iii) (the requirement relating to the degree of participation in corporate growth) is clearly applied only at the time when an interest is issued or transferred to or by a 5-percent shareholder. On the other hand, clause (B) (the requirement that re-characterizing an interest result in an ownership change) is not so limited, and could be met on some testing dates but not others.

To illustrate the ambiguity created by the language of the Regulations, suppose that L has outstanding only a single

* If, contrary to our recommendation, the "disproportionately small" participation standard is retained, it should at least be made clear that the non-stock rule applies only where there is a significant discrepancy between an interest's percentage participation and its proportionate value.

class of common stock which is (and has been for years) owned entirely by A. In 1988, L issues to B a participating debt instrument that offers a potential significant participation in the growth of L. Assume that at all times the debt has an aggregate value equal to the aggregate value of the L common stock. The requirement of paragraph (f)(18)(iii)(B) is not met as a result of the issuance of the debt (because the debt has a value not exceeding fifty percent of the aggregate value of the debt and L common stock), so that the issuance of the debt to B does not cause the debt to be treated as stock. There are no further changes in owner-ship of L stock or debt until 1992, more than three years after issuance of the debt. In that year, C purchases forty percent of L's common stock from A. An ownership change would occur in 1992 if the debt were treated as becoming stock at the time of C's purchase (i.e., if B were deemed to acquire the “stock” at that time). On the other hand, if the debt may be characterized as stock (if at all) only for the entire period that it is held by B, then an ownership change would not occur in 1992 because the only acquisition of “stock” by B would have occurred in 1988 before the beginning of the relevant testing period. How does paragraph (f)(18)(iii) apply on these facts?

It is difficult to answer this question based on the language of paragraph (f)(18). However, a rule that permitted non-stock interests to become stock on any testing date would incorporate into the stock/non-stock rules the “ticking time bomb” feature of the option rules, which is discussed and criticized below. Given that paragraph (f)(18)(iii) contains an express exception for options, and that the clear language in the option rules creating the ticking time bomb feature has no counterpart in paragraph (f)(18), it seems likely that the paragraph was intended to be applied to treat a non-stock interest as becoming stock oily on the dates on which the interest is issued or is acquired by a 5-percent shareholder. We recommend that the Regulations follow this approach, regardless of whether our suggestions regarding the option rules are adopted.*

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* A distinction might be drawn between options and the types of interests dealt with in paragraph (f)(18) on the ground that the holder of an option can exercise the option whereas the holder of such interests cannot take any similar steps to change the character of the interest that he holds. Under the recommended approach, in the example above in the text, the purchase of L common stock by C in 1992 will not cause an ownership change. On the other hand, an ownership change would occur if the purchase by C took place in 1989, because C's purchase would then be combined with B's purchase of "stock" in 1988. If C purchased in 1992 not only 40 percent of the L common stock from A but also 20 percent of the L debt from B, then under the suggested approach, the debt purchased by C would be retested under paragraph (f)(18). On the facts of the example, the debt purchased by C would be characterized as stock, even though the debt that is retained by B would retain its status as debt.

3. Treatment of Options.

The general rule of paragraph (h)(4)(i) treats all options as having been exercised on any testing date if, but only if, such treatment would result in an ownership change. Moreover, such determination is applied separately not only among different classes of options, but also within a single class of options, as between persons or groups of persons who are 5-percent shareholders or would be 5-percent shareholders if such options were treated as exercised. Options are treated as exercised even though they are not currently exercisable or their exercise is subject to material conditions.

There are four aspects of the option rule that we find troublesome: first, the rule that permits (and, indeed, requires) inconsistent assumptions as to the exercise of identical options by different 5-percent shareholders; second, the fact that options may be considered to be exercised on any testing date, even if they have been held by the same holder for more than three years; third, the definition of “option”, which the Committee believes to be overly broad, at least in the absence of certain clarifications; and fourth, the fact that contingencies are never taken into consideration in determining whether an option will be deemed exercised. These topics are considered below. Other technical comments on the option rules are included in section II. C.3., below.

(a) Inconsistent Assumptions. To illustrate the problem with the rule that allows inconsistent assumptions as to the exercise of identical options by different 5-percent shareholders, suppose that L has outstanding a single class of common stock which is owned by two public groups, L1 and L2. L1 owns 30 percent of the stock and L2 owns 70 percent. (These groups may have arisen because of a prior merger, a stock offering or some other transaction described in paragraph (j)(2)). Assume L distributes, pro rata to its shareholders, options to acquire two shares of stock for each share outstanding. Apparently, the Regulations would require that, at the time of such distribution (which is a testing date under paragraph (a)(2)(i)), such option would be deemed to have been exercised by either the L1 group or the L2 group, but not by both, if an ownership change would thereby result. This is the case regardless of the economic terms of the option,* and perhaps even if the option by its very terms may only be exercised as to all holders or as to none. The same result would follow if L1 or L2 was an individual 5-percent shareholder rather than a public group.**

The Committee believes that there is no reason to expect that different 5-percent shareholders would act differently in deciding whether or not to exercise options having identical

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* This rule could affect, for example, a corporation which adopts a "poison pill" rights plan, at least once the rights are separately tradeable and constitute separate property for tax purposes, even though the rights are distributed pro rata, and are initially "out of the money." We assume that if L had only one 5-percent shareholder prior to the distribution of the options, such distribution would not cause an ownership change (unless and until the options were acquired by a different 5-percent shareholder) because L would be permitted to take account of the common ownership of L shares and the options. An example confirming this result would be useful.

** Paragraph (j)(2)(iii)(F) includes a useful rule (discussed in our technical comments) that treats options distributed to two or more groups of public shareholders as being exercised pro rata to the extent they are actually exercised. This approach is consistent with the rule for deemed exercises proposed in the text.

terms, since the basic economic considerations that each holder would take into account in deciding whether or not to exercise the option ordinarily would be the same for all holders. Accordingly, we recommend the general elimination of the rule which assumes inconsistent behavior by different 5- percent shareholders owning identical options.*

A second concern with the rule that assumes different outcomes with respect to identical options relates to the consequences of an actual pattern of exercise of the options that is inconsistent with the assumed pattern. If an option that was deemed exercised in fact lapses unexercised, the issuing corporation is permitted (subject to the applicable statute of limitations) to amend its tax returns so as to reverse the effect of such deemed exercise. See paragraph (h)(4)(viii). However, no

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* The Committee recognizes that special circumstances may cause holders of options to act other than in a strictly economic manner, particularly when options are not readily marketable. For example, an option which is not transferable and which is issued to a bank which could not legally exercise it because of regulatory constraints is clearly less likely to be exercised than the same option held by a person not under such restrictions. However, any potential abuse flowing from these special circumstances can, we believe, be adequately dealt with as special cases, without generally following an inconsistent exercise approach.

similar rule is provided where an option that was assumed not to have been exercised is in fact exercised. For example, on the facts of the example discussed above, if the options have an exercise price significantly lower than the value of the stock (i.e., the options are "in the money"), presumably all shareholders will actually exercise their options, with the result that no actual change in ownership of the corporation will take place. Nevertheless, the Regulations do not provide any mechanism for reversing an ownership change that is caused by the deemed exercise of some options but not others. The Committee believes that, if the inconsistent exercise rule is retained, a "look-back" rule should be adopted for exercised options that were deemed unexercised.

(b) "Ticking Time Bomb" Problem. An additional harsh aspect of the deemed exercise rule in the Regulations is that it is applied to options on each testing date during the life of the options regardless of whether they were acquired during the related testing period. The ticking time bomb quality of this rule is best illustrated by comparing it to the rules which apply in the case of actual issuances of stock. Assume, for example, that L is owned one hundred percent by A, that L issues actual stock amounting to forty percent of its total outstanding stock to B, and that four years later, C purchases forty-one percent of the then outstanding L stock from A. Because the two transactions occur more than three years apart, they are not aggregated, and no ownership change results. Alternatively, assume the same facts, except that B acquires from L a five-year option to purchase forty percent of the stock, rather than the stock itself. In this case, such option is not deemed exercised at the time of issuance, since such an exercise would not result in an ownership change. At the time of C’s purchase from A (four years later), B's option would be retested; at that time the option would be deemed exercised, because the exercise of the option, when aggregated with C's purchase, would result in an ownership change.

We do not believe that the issuance of options should result in worse consequences than the issuance of the underlying stock. In our view, the fact that an option can be converted into another security is not a sufficient basis for distinguishing outstanding options from other equity interests. We therefore recommend that the Regulations be modified to provide that an option may be deemed exercised only as of the date it is issued (or otherwise acquired by a 5-percent shareholder) and then only if the deemed exercise would result in an ownership change on some testing date within three years of the option's issuance or transfer. However, an actual exercise of an option which was not deemed to be exercised, whether before or after three years, would continue to be taken into account, provide there as been no intervening ownership change.

The “ticking time bomb” problem discussed above raises the question of the extent to which options should be treated differently from stock. Questions also exist as to the proper application of section 382 to instruments that are neither pure options nor pure stock. The questions are briefly considered below.[*]

The definition of interests that are similar to options in paragraph (h)(4)(v) includes “an instrument other than debt that is convertible into stock.” This definition includes, among other things, preferred stock that is convertible into common. Since such stock would not be described in section 1504(a)(4) because of the conversion feature, it would be counted as stock for

[*] Part II.B.2., above, comments on the application of the "ticking time bomb" rule to non-stock interests that are treated as stock.

purposes of section 382. Thus, apart from the conversion rules, the value of the preferred stock is taken into account for purposes of section 382 without regard to the option rule. I: addition, it appears (although this is not entirely clear) that, if the ownership percentage represented by the common stock into which the preferred stock is convertible is greater than the ownership percentage represented by the preferred stock (taking into account the conversion privilege), that additional interest (but only that additional interest) would be taken into account under the option rule of paragraph (h)(4).[*] An actual conversion of such stock, whether or not it occurs within three years of issuance or transfer, should not be taken into account for section 382 purposes. This is because, unlike the case of a true option, the percentage of value of stock owned by a holder of such stock does not change as a result of such actual exercise.[**]

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[*] There is perhaps a question whether this result should obtain where the preferred stock is considered "stock" only because of the conversion privilege. We note that convertible preferred stock, absent the conversion privilege would probably have sold at a discount and would therefore have been described in Section 1504(a)(4)(C).

[**] By way of analogy, it should be noted that the exercise price paid upon the exercise of an option written by a loss corporation is not taken into account in determining the value of the loss corporation under section 382 until the option is actually exercised. On the other hand, the value of convertible preferred stock which is surrendered in exchange for common upon the exercise of a conversion right is taken into account even prior to exercise of the conversion right.

Convertible preferred stock should have the same value on the date it is converted as the underlying common stock. Examples illustrating the treatment of convertible stock under the option rules would be helpful.

As the discussion above suggests, different rules apply under section 382 to pure options, convertible stock and stock. The Committee recognizes that the distinction between options and rights which represent the terms of a class of stock may not always be entirely clear. For example, consider a class of stock which is entitled to only a minimal dividend preference and no participation rights unless and until certain earnings thresholds are satisfied. If such conditions are satisfied, it will participate equally with common stock on a share-for-share basis. The potential right to receive participating dividends will be reflected in the value of such a class of stock. An argument might be made that such stock should be analyzed as a convertible stock for purposes of section 382. However, we believe it would be very difficult to fashion sensible rules for distinguishing cases where such treatment is appropriate from cases where changes in participation rights should be viewed as one of the terms of a stock.

(c) Overbreadth. In our view, the rule in paragraph (h)(4)(v) which treats interests similar to options as options is overly broad, particularly when read together with the rule of paragraph (h)(4)(iii) (discussed below) that all contingencies to the exercise of an option are to be disregarded. As one example of such overbreadth, under the Regulations, an ownership change with respect to a loss corporation might result from actions that are not agreed to by either the corporation or any of its stockholders.

Consider for example a case where A wishes to acquire the stock of L, which is owned entirely by B. A writes a letter to B making a “standing offer” (with no expiration date) to purchase the stock of L at a price equal to a specified percentage of L's book value at the time of the purchase. The offer by A may be viewed as providing a “put” option to B to sell his L stock to A even if the offer was unsolicited and is not taken seriously by B. (Paragraph (h)(4)(v) expressly includes puts in the definition of “option”.)[*]

Similarly, a person who neither currently owns stock in a loss corporation nor has a right to acquire any such stock may write a “naked” call option with respect to such stock. Under the Regulations as currently drafted, such an option would apparently be taken into account.

The Committee believes that neither of these cases should be subject to the option rules, and recommends that an “option” be considered to exist under the Regulations only if the option results from an agreement to which either the loss corporation or a shareholder (to the extent of the stock which he directly or indirectly owns) is a party,[**] treating a person as a shareholder to the extent of his direct or indirect interest in shares of the corporation.

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[*] A similar case would be a hostile tender offer for the stock of L by an otherwise unrelated person. So long as the tender offer remains open, it may be viewed as providing a "put" option to all shareholders of L to sell their L stock to the offeror. Even if the tender or purchase offer is subject to meaningful conditions, these conditions would be disregarded pursuant to paragraph (h)(4)(iii).

[**] While such a rule would prevent an ownership change from occurring based, for example, solely on a hostile tender offer or an unsolicited "standing offer" by a third party, an agreement by a loss corporation to be acquired (pursuant to a reverse triangular merger, for example) would be treated as giving the acquiror a right similar to an option to acquire the loss corporation's stock, even if the consummation of the acquisition is subject to conditions such as financing or shareholder approval. A merger agreement of this type should be treated as creating an interest which is similar to an option even though there is no contract with an existing owner of the loss corporation's stock, since the loss company's negotiation of and agreement to the terms of the transaction distinguish this case from that of a unilateral outside offer or naked call option.

Another indication of the potential over-breadth of the definition of an option or similar interest relates to the treatment of pledged stock. Paragraph (h)(4)(x)(G) provides a limited exception for pledges pursuant to loan agreements involving certain financial institutions. This provision is of great concern inasmuch as it suggests that, but for the exception, a pledge would be treated as an option. The Committee believes this treatment to be inappropriate, and suggests that the Regulations state specifically that the exception is intended as a safe harbor and that a pledge or other security arrangement involving shares of a loss corporation (or of an entity directly or indirectly owning stock in a loss corporation) will not be treated as an option if the purpose of the arrangement is in fact to secure the creditor's rights as a creditor and not to transfer ownership interest in the stock.

(d) Contingencies Disregarded. In general, the rule which provides that options may be deemed to be exercised without regard to any contingencies is, the Committee believes, overly broad.* While we recognize the difficulties in crafting a narrower rule, the Committee believes that, at the very least, options than can be exercised only upon the occurrence of remote contingencies should be excluded.

Some members of the Committee have also raised a question as to whether the definition of option is too broad in that it includes rights which, by their terms, cannot be exercised for a lengthy period of time. Specifically, these members suggest that a rule be adopted to permit the closing of an acquisition rather than the signing of an agreement to govern the date of an ownership change where the closing by its terms is not to occur for a substantial period of time (e.g., fifteen years).

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* The fact that the drafters of the Regulations found it necessary to include a limited exception for foreclosures (a situation in which the option rule should never apply in the first place, as discussed above) indicates the overbreadth of this rule.

C. Technical Comments on Regulations

In addition to the major conceptual comments discussed above, the Committee has a number of more technical comments on the Regulations.

1. Ownership Changes Generally.

-2T(a)2(i).

Paragraph (a)(2)(i) states that a loss corporation is required to determine whether an ownership change has occurred immediately after, among other events, an “equity structure shift.” However, the second sentence of the paragraph states that a loss corporation is not required to make such a determination if an equity structure shift occurs unless it is also an owner shift. We recommend that all references to equity structure shifts be omitted from the definition of testing date.

According to paragraph (a)(2)(i), all computations of increases in percentage ownership are to be made as of the close of the testing date. As the preamble to the Regulations confirms, the effect of this rule is to permit purchases and sales by a 5-percent shareholder that occur on the same day to be netted and, therefore, ignored. One benefit of the rule is that it will avoid the need to orchestrate a closing of multiple transactions in a way that avoids adverse results under section

382. For example, suppose that a 5-percent shareholder purchased stock from an existing shareholder on the same day that the loss corporation issued additional shares to other shareholders. It is clear under the one-day rule that the dilution of the 5-percent shareholder’s interest that results from the stock issuance by the loss corporation will be taken into consideration in determining the percentage of shares it has purchased.

Another situation where this rule may have practical significance relates to a firm commitment underwriting of stock before September 4, 1987. If an underwriter acquires more than five percent of the stock of a loss corporation but resells enough of it or the same day so that its ownership is reduced to below five percent, then, apparently,* the underwriter would not

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* Although not entirely clear, the better reading of the Regulation would apply the "end-of-day” rule for purposes of determining who is a 5-percent shareholder, as well as for purposes of determining percentage increases in ownership. Although again not clear, stock that is purchased and resold on the same day by an underwriter that is otherwise a 5- percent shareholder should not be segregated under paragraph (j)(3) because of the transitory ownership of the stock by the underwriter during the day.

be a 5-percent shareholder.[*] This rule will have limited significance in the case of public offerings after September 4, 1987, because the stock issued in such an offering would in any event be segregated under paragraph (j)(2), regardless of whether an underwriter was a 5- percent shareholder. Nonetheless, the rule may help to prevent the segregation under paragraph (j)(3)(i) of stock purchased and resold by an underwriter in a

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[*] Clearly the one-day rule places a premium on proper identification of the time of a purchase and sale. In a conventional underwriting, an underwriter prices securities to be offered to the public on one day (the “pricing day”) and also enters into an underwriting agreement on that day. Approximately five business days thereafter, the underwriter settles the purchase of the stock from the issuer. Given that the underwriting agreement is subject to significant conditions and that the stock is not issued prior to the settlement date, it is likely that the underwriter would be considered under federal income tax principles to purchase the stock on the settlement date. (Although the trade date generally is treated as the date of sale in the case of secondary market sales of stock on an exchange, this rule relates to already issued stock and also reflects the absence of any meaningful closing conditions that would prevent settlement of a trade that has occurred on an exchange; the same considerations would not apply to a sale by the issuer to the underwriter in a public offering.) Thus, assuming that the underwriter resells to his customers on the settlement date with the issuer, its transitory ownership would be disregarded. This analysis assumes that the amount of stock issued in the underwriting, together with other changes in the owner-ship of stock within three years, is less than 50 percent, so that the underwriting agreement itself is not a "deemed exercised" option under paragraph (h)(4).

public offering that occurred prior to that date.

-2T(a)(2)(ii).

This paragraph requires the filing of an information statement by loss corporations with their tax returns. The statement must, among other things, identify the testing date that occurred during and closest to the end of each calendar quarter during the taxable year, regardless of whether an ownership change occurs or that date, identify each 5-percent shareholder on each such testing date and state the percentage of stock owned by such 5-percent shareholder as of each such testing date. Given the extremely complex nature of the attribution rules which must be applied in identifying 5-percent shareholders, we question whether it is useful and necessary to require that 5-percent shareholders be identified at four different times during the year, particularly in the case of a loss corporation that has experienced changes in ownership well below the 50 percent threshold. Also, it would be helpful if it was stated expressly that the loss corporation's reporting requirements under paragraph (a)(2)(ii) (and the requirement to maintain records under paragraph (a)(2)(iii)), are tempered by the limitations on the duty of the loss corporation to inquire as to actual stock ownership set forth in paragraph (k)(3). See also the comment below on the definition of loss corporation.

-2T(b).

Paragraph (b)(5)(ii) assumes that in the examples all corporations have one class of stock outstanding and each share of stock has the same fair market value as each other share. A similar assumption should apply to unincorporated entities. See, e.g., paragraph (h)(2)(iv), Example (2).

-2T(c).

We would suggest that the example in paragraph (c)(4), which illustrated the separate shareholder-by-shareholder calculation discussed in paragraph (c)(1), be moved to paragraph (c)(2). The example now in paragraph (c)(2) seems to add very little and could be omitted.

-2T(d).

Paragraph (d)(3)(i) states that, in general, the testing period shall not begin before the first taxable year from which there is a loss or excess credit carryforward to the first taxable year ending after the testing date. The Regulations make no comprehensive attempt to anticipate the regulations under section 383 (which will deal with credit carryovers). For example, the definition of "loss corporation" in paragraph (f)(1)(i) does not refer to credit carryovers. We recommend that, rather than discussing credit carryovers only in the context of the testing period definition, the Regulations deal with this question in a consistent manner. The Regulations should state, as a general rule, that the definition of "ownership change" set fort therein should also apply for purposes of section 383. See section 383(e).

Paragraph (d)(3)(ii) modifies the definition of testing period for a loss corporation that has a net unrealized built-in loss, unless the loss corporation establishes the taxable year in which the net unrealized built-in loss first "accrued". When does an unrealized built-in loss "accrue" for this purpose? What if the net unrealized built-in loss remains constant but the assets that contribute to it change? What if the net unrealized built-in loss would have been zero as of the beginning of an earlier taxable year but has increased solely because the de minimis threshold has been exceeded in the interim because of a reduction in the value of the loss corporation? It would seem to make sense to treat the net unrealized built-in loss as "accruing" (a better word would be "arising") at the time when it first becomes positive, based on then current values, taking account of the de minimis rule.

- 2T(e)(1)(ii).

Paragraph (e)(1)(ii) states that “[t]ransfers of loss corporation stock between persons who are not 5- percent shareholders of such corporation (and between members of separate public groups resulting from the application of the segregation rules of paragraphs (j)(2) and (3)(iii) of this section) are not owner shifts and thus are not taken into account.” Given that all shareholders are counted as 5-percent shareholders in the sense that they are either 5-percent shareholders individually or are included in a public group that is a 5-percent shareholder, this paragraph would be easier to understand if it referred simply to transfers of stock between holders who are members of the same or different public groups.

2. Definitions.

-2T(f)(1).

The definition of loss corporation includes a corporation that has a net unrealized built-in loss. A foreign corporation could fall within this definition even if it has no income effectively connected with a U.S. trade or business. To avoid a need for such corporations to provide the information statement required under paragraph (a)(2)(H), the definition of loss corporation should be limited, in the case of foreign corporations, to those that have effectively connected income.[*] (A foreign corporation could file a U.S. tax return even if it has no effectively connected income.)

Paragraph (f)(1)(ii) states that a loss corporation whose assets are transferred to another corporation in a transaction subject to section 381 shall be treated as continuing in existence until, among other things, any net unrealized built-in losses (determined as if the date of such transaction were the change date) may no longer be treated as pre-change losses. This definition implies that a determination of the amount of net

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[*] Section 382 could potentially be relevant in determining the earnings and profits of a foreign corporation, which might at times affect the tax treatment of United States taxpayers. See, e.g., Treasury Regulations section 7.367(b)-11(c) (standards of old section 382 applied). Nevertheless, the Committee believes that this indirect link to the United States is not sufficient to warrant imposing the burden of filing information statements on a foreign corporation not otherwise subject to United States taxing jurisdiction. Cf. Proposed technical correction (H.R. 3545, House-passed version, section 10206(d)(17)), which would provide that only items treated as connected with the conduct of a United States trade or business are taken into account in determining the value of a foreign loss corporation.

unrealized built-in losses (including application of the de minimis rule) would be made at the time of the transaction even if that is not a change date. Is that result intended?

-2T(f)(6).

We question whether a definition of “shift” is needed in addition to “owner shift” given that the concept of equity structure shift has been denuded of meaning.

-2T(f)(7).

The definition of “entity” in paragraph (f)(7) refers to a “corporation, estate, trust, association, company, partnership or similar organization”. If the normal tax definition of corporation and partnership are intended, why is there any need to refer to association or company? Also, what does “similar organization” refer to?

-2T(f)(8).

A direct ownership interest is defined as an interest a person owns in an entity without regard to the constructive ownership rules of paragraph (h). We question whether stock should not be treated as directly owned if the only attribution rule that applies is the option attribution rule. Also, under the definition, stock held through a nominee would be considered to be directly held, so that L would have an obligation under paragraph (k)(3) to ascertain the identity of any individual or first tier entity that holds more than five percent of its stock through a nominee. However, if the stock of the loss corporation is “registered stock”, as we understand the Regulations, L can rely on Schedule 13d filings to determine the beneficial ownership of stock held through nominees.

-2T(f)(18).

The last sentence in paragraph (f)(18)(i) would read better if the words “on the basis of the relative” were replaced with “by comparing the.”

In addition to the conceptual points discussed above, we have a number of more technical comments on paragraph (f)(18)(ii). First, it is not entirely clear what the phrase “disproportionately small” means. In particular, is the intent that the non-stock rule would apply whenever the proportionate interest in corporate growth is smaller than the proportionate interest in value (i.e., whenever the proportions of participation in corporate growth and value are not the same, with the former being smaller), or does “disproportionate” modify “small” so that the rule applies only if the two proportions differ by more than some minimum amount?

Second, in determining whether likely participation in future corporate growth is disproportionately small compared with value, how is “likely participation in future corporate growth” to be measured? Suppose, for example, that a voting preferred stock has a fixed dividend and that the holder of the preferred stock believes that corporate earnings in the next few years will be such that the preferred stock dividend will represent a greater proportion of the earnings of the corporation than the value of the preferred stock represents of the value of all stock of the corporation. On the other hand, under the terms of the preferred stock, if the earnings of the corporation increased beyond expectations, the participation in earnings by the preferred stock would not increase to any extent. Under these circumstances, is the likely participation of the preferred stock in future corporate growth disproportionately low? The use of the term “corporate growth” rather than, for example, “earnings” may suggest that the test will be based on a hypothetical improvement in the corporation’s condition, with the result that a true open-ended participation right is required before a stock can avoid the non-stock rule. On the other hand, the word “likely” indicates that actual expectations are relevant. This view is bolstered by the fact that the status of stock is tested not only as of the time of its issuance but also as of the time of its transfer to or by a 5-percent shareholder, which implies that stock can be non-stock at some times and not at others, perhaps based on changes in the prospects of the corporation. However, another possible explanation of the retesting rule is that the drafters had in mind a case where a stock has an open-ended right to participate in corporate growth above some threshhold, and intended that the participation right would be taken into consideration only if, as of the time when the status of the stock was tested, the threshhold was likely to be met. The Regulations should explain the circumstances under which outstanding stock can fall within and without the rule at different times.

Another point that should be clarified is whether “corporate” growth refers to the growth of the loss corporation or of the shares' issuer? Suppose, for example, that P has a wholly-owned subsidiary, L, and that P issues “Series L” stock that will be entitled to receive dividends corresponding to all net earnings of L. Would stock of P other than the Series L stock be disregarded in measuring changes in the ownership of L on the ground that the right of such stock to participate in future growth of L (as distinguished from P) is disproportionately small?

Paragraph (f)(18)(iii) treats as stock of a corporation any "ownership interest" that would not be treated as stock under paragraph (f)(18)(i) of this section (other than an option that is subject to paragraph (h)(4)) if, among other things, such interest offers a potential significant participation in the growth of a corporation. The preamble to the Regulations suggests that this rule was intended to apply to instruments otherwise treated as debt for tax purposes. It is not clear that the regulation reaches this result since it requires an "ownership interest." Moreover, the Regulations should state expressly that if a financial instrument that otherwise would be treated as debt is treated as stock under this rule, the recharacterization applies only for purposes of section 382.

-2T(f)(21).

The second reference to section 382 in the definition of old section 382 should be replaced with "amendments to section 382 included."

-2T(f)(22).

The definition of “pre-change loss” includes any recognized built-in loss for any recognition period taxable year (within the meaning of section 382(h)). The extent of any such losses will not be known for five years. Should the reference be to “net unrealized built-in loss”? Compare the use of the term pre-change loss in paragraph (h)(4)(ix).

3. Attribution Rules.

-2T(h)(2).

Paragraph (h)(2)(ii) limits attribution through an interest that is not treated as stock within the meaning of paragraph (f)(18). It would seem reasonable to allow attribution to occur through non-stock interests that are treated as stock under paragraph (f)(18)(iii).*

Paragraph (h)(2)(iii) states that for purposes of all of section 1.382-2T, any entity that is not the loss corporation and does not own directly or indirectly at least five percent of the stock of the loss corporation shall be treated as an individual who is unrelated to any other owner (direct or indirect) of the

* The definitions in paragraph (f) apply for purposes of all of section 382. Nonetheless, it is not clear that all aspects of the definition of stock were intended to be incorporated into the attribution rules.

loss corporation. This rule seems to be largely ignored in the balance of the Regulations, in that ownership interests that are in higher tier entities that own less than five percent of the stock of the loss corporation appear to be accounted for as if the entity was being recognized as an entity. Compare paragraph (g)(4), Example (2)(iii) (discussion of P4) with paragraph (j)(1)(vi), Example (4)(ii). As written, the rule seems broad enough to allow the ownership interests in any entity to be ignored if that entity owns less than a five percent direct or indirect interest in L (in the absence of actual knowledge of cross-ownership through that entity). As explained above, this rule could provide a foundation for a simpler approach to the aggregation rules.

Paragraph (h)(2)(iii)(C) generally treats as an individual who is unrelated to any other owner of the loss corporation “any State, any possession of the United States, the District of Columbia, the United States (or any agency or instrumentality thereof), any foreign government, or any political subdivision of any of the foregoing.” It would be preferable if the quoted language after the second reference to United States were revised to read as follows: “any foreign government, any political subdivision of any of the foregoing, or any agency or instrumentality of any of the foregoing” to make it clear that agencies or instrumentalities of any of the governmental units referred to would be included within the rule.

-2T(h)(4).

Regulations paragraph (h)(4)(iii) provides that the option attribution rules apply without regard to whether there are conditions on the exercisability of an option. The Regulations should clarify that the rules should not apply where an optionee's right to exercise is contingent upon actions within the control of the optionor. For example, a right of first refusal may be viewed as an option to purchase which is contingent upon the optionor's decision to sell. Since stock can only change hands pursuant to such a right if both parties agree to the transaction, it should not be considered an option giving rise to attribution.

Paragraph (h)(4)(vi)(A) is intended (along with paragraph (h)(4)(x)(F)) to give effect to the rule that starts a new testing period if an ownership change occurs. Under that rule, any pre-existing holdings of stock by 5-percent shareholders are in effect considered to represent historical holdings for purposes of determining if a second ownership change has occurred. Absent special relief, this rule would be defeated in the case of an option that was outstanding on the date of an ownership change because such option would be treated as being newly exercised on each subsequent testing date or on the date on which it is actually exercised. Subparagraph (A) prevents that result in the case of an actual exercise as long as the option is exercised by the 5-percent shareholder (or person who would have been a 5-percent shareholder if the option owned by such person had been exercised) who owned the option immediately before and after such ownership change. Presumably this rule would apply if the option had been owned by a public shareholder that continued to own the option following the ownership change even if the public ownership group was segregated. This point should be made clear.

Under subparagraph (B), if the actual exercise of an option occurs within 120 days after the date on which the option is treated as exercised under paragraph (h)(4)(i), the loss corporation may elect to take account only of the acquisition of the stock resulting from actual exercise of the option for purposes of determining the change date. This rule has no effect on whether an ownership change occurs; it only affects the timing of such ownership change. Thus, if an option to acquire eleven percent of the stock of L is acquired within three years after a forty percent change in ownership, so that an ownership change would occur if the option is assumed to be exercised, but the actual exercise is delayed for not more than 120 days to a date that is more than three years after the forty percent change, then the rule has the effect of delaying the change date but would not prevent the occurrence of an ownership change.

The Committee believes that the 120-day period for applying this special rule is unrealistically short in view of the actual time required to consummate many acquisition transactions. In particular, in the case of any loss corporation operating in a regulated industry, it is quite unlikely that the approvals necessary for an acquisition can be obtained within the requisite 120-day period. Moreover, even in the case of a loss corporation operating in a non-regulated industry, the time required, for example, to obtain a private letter ruling as to the tax consequences of the transaction or to complete other necessary steps may well exceed 120 days.

We believe the “grace period” rule is useful, and urge that a more commercially realistic standard be adopted, such as 180 days, subject to further extension where the delay is the result of a requirement of govern-mental or regulatory approval, consent or registration.

Paragraph (h)(4)(vii)(C) states that the deemed exercise of an option with respect to unissued stock or Treasury stock shall have no effect on the determination of the value of a loss corporation and the computation of the section 382 limitation. The justification given is the rule in section 382(1)(1)(B) disregarding capital contributions made during the two-year period preceding the change date for purposes of computing the section 382 limitation. The legislative history of TRA 1986 indicates that the two-year presumption will be subject to certain exceptions under regulations. If in a particular case one of those exceptions would apply if an option were actually exercised, should it apply here? Would it make any difference if the capital that was to be contributed upon exercise of the option had already been contributed to the corporation (e.g., if the optionee has the right to convert a debt instrument)?

In a case where an option is deemed to be exercised, the Regulations should make clear that the effect, if any, on relative share values resulting from payment of the exercise price should be taken into account in determining whether there has been an ownership change.

For example, assume that L corporation, with net assets of zero, has outstanding a class of preferred stock with a liquidation preference of one hundred, and one hundred shares of common stock. It grants to A (who is not currently a shareholder) an option to purchase 200 shares of common stock at $0.50 per share. If such option were in fact exercised, the full exercise price would, in effect, represent capital on which the holder of the preferred stock has a claim, with the result that, presumably, the value of the preferred stock relative to that of the common would increase. Accordingly, a determination of the percentage' ownership change based on the pre-change values of the common and preferred stock would be overstated.

Paragraph (h)(4)(viii) states that if an option that is treated as exercised under the option attribution rule “lapses unexercised or the owner of such option irrevocably forfeits his right to acquire stock pursuant to the option,” then the option shall be treated for purposes of the attribution rule as if it had never been issued. It is not clear from this language what the consequences would be if the issuer of the option repurchased it for cash in a negotiated transaction. To illustrate, suppose that L, which is entirely owned by the public, issues an option to A to purchase stock which, on a fully diluted basis, would represent fifty-one percent of all outstanding stock of L. The issuance of the option would be treated initially as an ownership change. Suppose that the option is exercisable at a price of $10 per share at any time within the three years following its issuance, and that two years after the option is issued, L repurchases the option from A at a negotiated price reflecting its then fair market value. Suppose further, that the fair market value of the L stock at the time is, alternatively, $5 or $15, and that the repurchase price of the option is $.10 or $6 per share, respectively. How should the transaction be handled under section 382?

One approach to the problem would be to attempt to distinguish between repurchases of options that should be treated as equivalent to the exercise of the option and those that should be treated as equivalent to lapses. We are concerned, however, that such a rule would be overly complex and would also provide for very different consequences of the repurchase depending on relatively slight differences in the repurchase price. As an alternative, we suggest that a repurchased option be treated as if it had been at all times a number of shares of L stock equal to the number of shares that could be purchased at the time of repurchase of the option, for an amount equal to the repurchase price of the option. Thus, in the example above, each warrant that is repurchased for $.10 would be treated as if it had represented at all times since issuance of the option two percent of one share of L's stock (.1/5), and each warrant that is repurchased for $6 would be treated as if it had represented .4 shares of L’s stock (6/15). If an ownership change would not have occurred if the option had been so treated since its issuance, then L would be entitled to the same treatment under paragraph (h)(4)(viii) as if the option had lapsed.

Paragraph (h)(4)(viii) should also be clarified. The first sentence states that “the option <u>shall</u> be treated as if it never had been issued”; on the other hand, the second sentence states that “the loss corporation <u>may</u> [(but, by implication, need not)] file an amended return.” (Emphasis added.) Assume, for example, that loss corporation L (a calendar-year taxpayer) is owned fifty percent each by A and B, and that the following transactions occur: On January 1, 1988, C purchases newly-issued stock from L amounting to forty percent of the stock of L outstanding immediately after the transaction. On February

1, 1988, A grants D an option to acquire A's entire interest in L (which is now thirty percent). Pursuant to paragraph (h)(4)(i), this option is deemed exercised, and an ownership change occurs (tentatively) on February 1, 1988.

Assume further that on January 1, 1989, B sells its thirty percent interest to E. Since a new testing period began on February 2, 1988, this sale does not result in an ownership change. Assume, however, that on July 1, 1989, D's option (which had previously been assumed to be exercised) expires unexercised. Under the rule of paragraph (h)(4)(viii), the February 1, 1988 ownership change is nullified, with the result that E's thirty percent purchase on January 1, 1989 would be aggregated with C's January 1, 1988 purchase to cause an ownership change on January 1, 1989. Depending on the relative values of L on February 1, 1988 and January 1, 1989, this may be better or worse than the February 1, 1988 ownership change which was originally assumed. If L prefers to treat the ownership change as occurring in 1988, can it achieve this result simply by not filing an amended return? We believe that a better reading of the Regulations (and a better result) is that the ownership change is automatically nullified and the ownership change only occurs on January 1, 1989, regardless of whether L files an amended return for 1988. This point should be made clear in the Regulations.

The current look-back rule with respect to the lapse of options which were deemed to have been exercised may be inadequate in that the ability to look-back is subject to the applicable statute of limitations (generally, three years from the time the return was filed or two years from the time the tax was paid, see section 6511). Thus, in the case of options that were deemed exercised at the time of issuance and that have a term which extends beyond such period, the look-back rule is of no use if the statute of limitations has expired. Normally, the statute could be kept open by filing a refund claim. However, it is not clear that such a claim could be filed if it is contingent on events that have not yet occurred. The Committee believes that in any case where an ownership change occurs at least in part as a result of a deemed exercise of an option, it should be made clear that the statute of limitations can be kept open until some time after the date the options will lapse by filing a conditional refund claim or through some other procedure set forth in the Regulations. One possibility would be to provide by regulation that the filing of a return that reflects the occurrence of an ownership change that is attributable in whole or in part to the deemed exercise of an option would automatically extend the loss corporation's statute of limitations for filing refund claims based upon a determination that there is no ownership change for the years affected by such tentative ownership change until some time after the exercise or expiration of the options. This would have the advantage of avoiding additional paperwork, and would prevent the accidental loss of the tax benefits by unsophisticated taxpayers who may be unaware of the need to file a protective refund claim.

A further clarification should be made to paragraph (h)(4)(viii) relating to the determination of when an option lapses. Specifically, if an option is materially modified and is subsequently exercised, the Committee believes that the original (pre-modification) option should be deemed to have lapsed, and that the option that was exercised should be considered a new option granted at the time of modification. For example, suppose that as part of the negotiations for the purchase of a corporation, a potential buyer makes an irrevocable purchase offer that is treated as a “put” option. If, after negotiations, an offer is accepted from such bidder, but at a higher price, the first option should be deemed to have lapsed, and any ownership change arising from its deemed exercise should be “nullified.” Since an ownership change will have occurred only at the time such bidder made the offer which was finally accepted (assuming such offer was irrevocable), the higher price reflected in such later offer would control for purposes of determining the value of the corporation.

-2T(h)(4)(x)(A).

Paragraph (h)(4)(x)(A) provides a rule for long held options with respect to actively traded stock. The rule applies to an option with respect to stock of the loss corporation if the stock is actively traded or an established exchange, and the option has been continuously owned by the same 5-percent shareholder for three years, but only until the earlier of such time as the option is transferred by or to a 5-percent shareholder or the fair market value of the option stock exceeds the exercise price for such stock on the testing date. The rule is denied much vitality by virtue of the fact that it ceases to apply when the fair market value of the stock exceeds the option price.

Suppose that the option relates to stock issued by a corporation that owns stock in the loss corporation.

In that event, it would seem to be irrelevant whether the loss corporation stock is actively traded; instead the actively traded test should apply to the stock that is the subject of the option. It is possible to reach this result by applying paragraph (f)(18)(iv), which provides that the term “stock of the loss corporation” includes indirect interests. However, this should be clarified.

The rule applies if the option has been continuously owned by the same 5-percent shareholder for at least three years, but only until the fair market value of the stock that is subject to the option exceeds the- exercise price for such stock on the testing date. It is not clear from the Regulation language whether the rule would be unavailable in a case where the fair market value of the stock equals or is less than the exercise price at all times after expiration of the three-year holding period, but exceeds the exercise price at some point during that three-year holding period. In addition, it appears that an increase in the fair market value of stock above the exercise price would not have any consequences under the rule except on a testing date, and that a testing date would not result merely from such a change in stock value. Cf. section 382(1)(3)(D), discussed in Part V, below. This point should be clarified.

-2T(h)(4)(x)(B).

Paragraph (h)(4)(x)(B) provides an exception for the right to receive stock on maturity of mandatory convertible debt also known as primary capital notes.* These securities are described in Revenue Ruling 85-119, 1985-2 C.B. 60. We believe that this paragraph would be clearer if it were revised to read as follows:

> "Any right to receive or obligation to issue stock pursuant to the terms of a debt instrument that, in economic terms, is equivalent to non-convertible debt. A right or obligation will meet this test if it is a right or obligation to receive or issue a fixed dollar amount in value of stock based upon the fair market value of such stock determined at or about the time the stock is transferred pursuant to such right or obligation (i.e., the amount of the stock transferred pursuant to the option is equal to a fixed dollar amount, divided by the value of each share of such stock at or about the date of the stock transfer) and the method for determining the fair market value of the stock is not intended to provide, and does not in fact provide, the owner of the debt instrument with a participation in any appreciation of the stock of an issuer."

* The heading for the rule reads: "Right to receive or obligation to issue a fixed dollar amount of value of stock upon maturity of certain debt." However, the actual text of the rule does not limit it to rights or obligations to receive stock on maturity. We do not believe that the rule should be so limited. However, if such a limitation was intended, the text should be changed.

-2T(h)(4)(x)(c).

Paragraph (h)(4)(x)(c) excepts from the deemed exercise rule any right or obligation of the loss corporation to redeem any of its stock at the time such stock is issued, but only to the extent such stock is issued to persons who are not 5-percent shareholders immediately before the issuance. Although not clear from the language, the provision apparently applies only where the right or obligation exists at the time the stock to be redeemed is issued, and this should be made clear. It should also be made clear that this exception also applies to a right or obligation of a corporation that is not the loss corporation to redeem its own stock. Furthermore, what is the purpose of the restriction on issuing stock to 5-percent shareholders? If it is to ensure that the securities are issued on arm's length terms, then the restriction should be relaxed. For example, why should it not be possible to issue such stock to a 5- percent shareholder who does not have a controlling interest in the loss corporation? Or, what if the stock is issued to both 5-percent shareholders and to others on identical terms?

-2T(h)(4)(x)(F).

This paragraph prevents the deemed exercise rule from applying to an option following an ownership change if there is no change in the ownership of the option. The rule is illustrated in the example in paragraph (h)(4)(x)(F)(2). The reference to paragraph (h)(4)(i) in subdivision (iii) of the example should be a reference to paragraph (h)(4)(x)(F)(1).

-2T (h)(4)(x)(H).

The Committee believes that limiting this exception to cases where (i) the holder of the option "actively participate[s] in management," and (ii) the corporation is not a loss corporation at the time the options were issued, is, as to both conditions, unnecessarily restrictive. Presumably this exception is intended to provide some relief for closely-held "mom-and-pop" businesses that wish to provide buy-out arrangements for the retirement of the owners. Such corporations may very well have losses, particularly in their early years. The valid business purposes which apparently inspired this exception are no less present when the company is a loss corporation. Similarly, the requirement of "active" participation in management is quite restrictive, and would make the exception inapplicable if there are shareholders whose contribution to the business venture is capital, rather than services, but whose economic participation in the venture is nonetheless substantial.

-2T(h)(6)(iv).

This paragraph provides that if an individual may be treated as a member of more than one family under the attribution rules, and each family that is treated as one individual is a 5-percent shareholder, then such individual shall be treated only as a member of the family that results in the smallest increase in the total percentage stock ownership of the 5-percent shareholders on the testing date. What if under one application of the family attribution rules the individual would be treated as a member of a family that is not a 5-percent shareholder?*

4. Definition of 5-percent Shareholder and Aggregation and Segregation Rules.

In addition to the conceptual points discussed above, we also have the following additional technical comments in connection with the portions of the Regulations dealing with the definition of a 5-percent shareholder and the aggregation and segregation rules:

* Note that under paragraph (h)(6)(iv), an individual would be treated as a member of such a family only if L had actual knowledge of the family relationships.

-2T(g).

Paragraph (g)(1) Includes the definition of a “5-percent shareholder”. The next to last sentence in paragraph (g)(1) refers to an individual owning five percent or more of the stock of a loss corporation at any time during the testing period as being a 5-percent shareholder. It would be better if the definition tracked paragraph (g)(1)(i).

Paragraph (g)(2) limits attribution from an entity to an owner to cases where the loss corporation's stock is attributed to a person in his capacity as a higher tier entity or a five percent owner of the first tier entity or higher tier entity from which such stock is attributed. Given that this rule is only a presumption, it would be better to state it as a presumption (as is in any case done in paragraph (j)(1)) and not suggest that it is a substantive limitation on ownership attribution.

The definition of a 5-percent shareholder requires an indirect ownership interest of an individual in stock of a loss corporation to be counted only if it represents five percent or more of the loss corporation and is by virtue of an ownership interest in any one first tier or higher tier entity. Is it really intended that interests in first tier entities and higher tier entities relating to the same first tier entities would not be aggregated, at least if the individual is a five percent owner of the first tier entity or higher tier entity, as the case may be?

The stock ownership presumptions in paragraph (g)(5) deal with the problem presented by the fact that an individual will be treated as a 5-percent shareholder if he owns at least five percent of the stock of a loss corporation at any time during the testing period (whether or not on any particular testing date). The rule in paragraph (g)(5)(i)(A) allows a loss corporation to treat an individual who becomes a 5-percent shareholder as if all of his stock had been owned by a public group before such person exceeded the five percent threshold. This rule may apply even if the loss corporation has knowledge to the contrary. We note that since this rule, if it has any effect at all, would overstate the increase in the ownership by a 5-percent shareholder, it would be helpful to a loss corporation only if it wished to establish that an ownership change had occurred on a date earlier than the date on which it would otherwise occur.

Paragraph (g)(5)(i)(B) allows a loss corporation to presume that if a 5-percent shareholder’s percentage ownership interest is reduced to less than five percent, then the remaining stock owned by such 5-percent shareholder immediately after such reduction is the stock owned by such shareholder for each subsequent testing date during the testing period that includes the date on which the reduction occurred as long as the shareholder continues to own less than five percent of the stock of a loss corporation. For example, if A owned six percent of L and sold two percent, L could presume that A would continue to own four percent for the balance of the testing period, even if A thereafter actually sold his remaining four percent. On the other hand, if A sold all of his stock in one transaction, the entire six percent change in ownership would be counted. What if A sells two percent and, in the Schedule 13d filed at the time of such sale, states an intention to dispose of his remaining four percent?

-2T(1)(1).

Paragraph (j)(1)(ii) states that each public group that is treated as a 5-percent shareholder shall be treated as one individual. The implications of this are unclear. If it were further stated that such individual shall be presumed not to be related to any other 5-percent shareholder, would this obviate the need for paragraph (j)(1)(iii)? The rule illustrated in paragraph (j)(1)(vi), Example (5), that allows L to ignore a direct ownership interest of less than five percent by an individual that L is required to identify because of other indirect holdings may create a false sense of security. Unless that individual holds through nominees, L would be on notice because of its stock records.

-2T(j)(2).

In presenting rules for options, the Regulations sometimes refer to options that are transferred to or by a “person who would be a 5-percent shareholder if the option were treated as exercised,” or words to similar effect. See, e.g., paragraphs (a)(2)(i)(A), (h)(4)(i)(A), (h)(4)(vi)(A), (h)(4)(x)(A)(1) and (m)(8)(i). This rule may produce unintended results when combined with the rule in paragraph (j)(2) for segregating public groups following an issuance of stock. In particular, it appears that if an option to purchase stock of a loss corporation is issued by the loss corporation, then any holder of the option would be treated as a “person who would be a 5-percent shareholder if the option were exercised” regardless of the amount of stock subject to the option or otherwise actually held by that person. The reason is that if stock issued upon exercise of an option were held by a person who did not already own five percent of the stock of the issuing corporation, then that stock would be considered to be held by a public group which would be segregated (and treated as a separate 5-percent shareholder) under paragraph (j)(2). Almost certainly this result was not intended, and transfers of an option relating to stock of a corporation to (or by) a person should be counted only if that person already owns or would own at least five percent of the stock of the loss corporation, taking into account the stock that would be acquired upon exercise of the option.

Paragraph (j)(2)(iii) applies to segregate public groups in a case where a loss corporation issues stock to the public. It is not clear how the rule would be applied in a case where a corporation issues a unit consisting of more than one class of separately traded stock. Would there be one public group or two? The facts of paragraph (j)(3)(iv) (Example 2) suggest this question, but it is not an issue (and is not addressed) in the example.

Paragraph (j)(2)(iii)(F) states that in the case of any transaction described in paragraph (j)(2)(iii)(B), (D), or (E) in which the loss corporation issues rights to acquire its stock to the members of more than one public group, those rights shall be presumed to be exercised pro rata by each such public group as those rights are actually exercised. An example illustrating this rule indicates that if L issues warrants pro rata to more than one public group, then under paragraph (h)(4)(i) each public group would be considered to exercise separately the warrants it receives, if that results in an ownership change. However, applying the (h)(4)(i) rule to treat one group of public shareholders as exercising their warrants makes no sense in this context. To the extent the warrants are not exercised, they will be treated as if they never existed. To the extent they are exercised, they will be treated as exercised pro rata (not giving favor to one public group over another). Paragraph (h)(4)(i) should not be applied to anticipate an event (the exercise of the warrants by only one group) that cannot actually happen under the Regulations.

If the approach of applying paragraph (h)(4)(i) separately to each public group is preserved, then at least it should be made clear that if the actual exercise of an option is treated differently from the presumption, and an ownership change would not have occurred based on the treatment of the exercised options, then L has a right to treat the ownership change as if it had not occurred. See our comments on options in Part B.3., above.

Paragraph (j)(2)(iv) contains a rule under which certain public groups being first identified during a taxable year and each owning less than five percent of the loss corporation's stock may be combined. It is not clear from this rule what the effect is of combining different public groups into a single group. For example, was it intended that the changes in stock ownership that resulted in the creation of the individual groups would be treated as occurring at some one time during the year? If it is necessary to continue to track the changes in stock ownership represented by the creation of each group, it is not clear what the rule accomplishes.

Paragraph (j)(2)(vi) states that an acquisition of loss corporation stock by either a 5-percent shareholder or the loss corporation on any date on which more than one public group of the loss corporation exists by reason of the application of paragraph (j)(2) shall be treated as being made proportionately from each public group existing immediately before such acquisition. Presumably, it was intended that this rule would apply only to purchases from members of a public group. If so, the point should be clarified.

-2t(j)(3).

Paragraph (j)(3)(i) applies to segregate public groups following a sale of stock in a loss corporation by a first tier entity or an individual that owns a direct ownership interest in the loss corporation of five percent or more. This language suggests that a disposition of stock by an individual who owns less than five percent of the stock of L would not result in segregation even though that individual is a 5-percent shareholder because of other indirect stock holdings known to L. Was this intended?

The rule in the last sentence of paragraph 2T(j)(3)(iii) may escape notice, and should be illustrated with an example.

5. Effective Dates.

The General Explanation of the Tax Reform Act of 1986, Staff of the Joint Committee on Taxation (the “Bluebook”) states (at page 327) that

> The 1954 Code version of section 382 is generally intended to have continuing application to any increase in percentage points to which the amendments made by the Act do not apply by application of any transitional rule, including the rules prescribing measurement of the testing period by reference only to transactions after May 5, 1986, and the rules grandfathering or disregarding ownership changes following or resulting from certain transactions.

The Joint Committee explanation to the proposed Technical Corrections Bill is to the same effect, but excludes the phrase “generally intended” (see page 39). In addition, the Bluebook includes an example of a would be ownership change straddling the May 6 date. Accordingly, the' purpose of providing for the continued application of old section 382 is to act as a policing device with respect to transactions straddling the effective dates of new section 382.

The literal language of the proposed technical correction, however, is much broader -- applying old section 382(a) to any increase in percentage points occurring prior to <u>1989</u>, with the caveat that:

> In no event shall sections 382(a) and (b) of [the 1954] Code (as so in effect) apply to any ownership change described in subparagraph A.

<u>See</u> H.R. 3545 (House-passed version), section 10206(d)(11). The proposed language would also subject changes in ownership exempted by the <u>substantive</u> provisions of new section 382 to the provisions of old section 382. One example is a change in ownership that falls within the ESOP exception in section 382(1)(3)(C). Because certain acquisitions by a qualified ESOP are not taken into account in determining an ownership change, if prior to 1989 an ESOP acquires over fifty percent of a loss

corporation, old section 382 could apply to eliminate the loss corporation's NOL. This seems directly contrary to the legislative intent of the technical correction and to the purpose of the ESOP exception.

We recommend clarification of the language of the Technical Corrections Bill to provide that old section 382(a) will only apply where an ownership change under new section 382 would have occurred but for the application of the effective date rules of TRA 1986 section 621(f).

The rules segregating public groups found in section 1.382-2T(j)(2) apply separately to actual issuances of stock by a loss corporation (paragraph (iii)(B)) and to deemed issuances of stock by the loss corporation as a result of the ownership of a right to acquire such stock (paragraph (iii)(D)). Neither of these rules is effective with respect to stock or rights issued before September 4, 1987 (see section 1.382-2T(m)(4)(i)(B), and (m)(4)(iii)). However, suppose that an option was issued prior to September 4, 1987 and was actually exercised on or after that date. (This might occur, for example, if a convertible debt instrument issued in a public offering before September 4, 1987 was converted in December of 1987.) Although the segregation rules would not apply to stock considered issued upon the deemed exercise of that option, apparently the rule would apply to the issuance of stock upon actual exercise of the option. We do not see any reason to distinguish between the deemed and actual exercise of an option for purposes of the effective date rule, and recommend that the segregation rule not apply to stock acquired upon the exercise (whether deemed or actual) of an option issued before September 4, 1987. Moreover, the rule which we have suggested*is consistent with the principle that the segregation rule for new offerings of stock would not be retroactive. See Bluebook at 306.

If our recommendation is not accepted, we suggest that an example be added to the Regulations explaining that the segregation rule would in fact apply in these circumstances, in order to alert loss companies to this retroactive feature of the Regulations.

III. Built-in Gains and Losses

Section 382(h) includes special rules for built-in gains and losses and section 338 gains. In general, the effect of these rules is to treat certain gains and losses that arose economically prior to the change date as if they had been recognized prior to the change date for purposes of applying the limitations of section 382.

More technically, under subsection (h), any “recognized built-in gains” of the loss corporation in any year increase the section 382 limitation for that year, but only in an amount that does not exceed, in the aggregate for all years, the corporation's “net unrealized built-in gain.” Similarly, “recognized built-in losses” are subject to limitation in the same manner as if they were pre-change losses, except that the aggregate amount of recognized built-in losses subject to such limitation cannot exceed the corporation's “net unrealized built-in loss.” These four terms are the principal building blocks of subsection (h).

Recognized built-in gain is defined as any gain recognized during a recognition period taxable year (a taxable year that falls in whole or in part within the five-year period beginning on the change date) on the disposition of any asset to the extent the loss corporation establishes that such asset was held by it immediately before the change date, and the gain does not exceed the excess of the fair market value of the asset on the change date over its adjusted basis on that date. Recognized built-in losses are defined in a parallel fashion except that a loss corporation has the burden of establishing that a loss is not a recognized built-in loss.

In general, a net unrealized built-in gain or net unrealized built-in loss is the amount by which the fair market value of the assets of a loss corporation immediately before an ownership change exceeds, or is less than, respectively, the aggregate adjusted basis of those assets at that time,. However, if the amount of net unrealized built-in gain or loss as so determined is not greater than twenty-five percent of the fair market value of the assets of the loss corporation, excluding cash and certain other items, then the net unrealized built-in gain or loss is zero.

A special rule applies to gain recognized by reason of an election under section 338. Such gain increases the section 382 limitation for the taxable year in which such gain is recognized except to the extent that such gain has already been taken into account in computing recognized built-in gains for that year.

Under section 382(h)(6), the Treasury has authority to issue regulations treating amounts which accrue on or before the change date but which are allowable as a deduction after such date as recognized built-in losses.

We have a number of comments on the built-in gain and loss rules. Addressing some of these comments will require amendments to subsection (h).

1. Subsection (h)(4) deals with the carryover of disallowed losses. It reads as follows:

> DISALLOWED LOSS TREATED AS A NET OPERATING LOSS. -- If a deduction for any portion of a recognized built-in loss is disallowed for any post-change year, such portion --

(A) shall be carried forward to subsequent taxable years under rules similar to the rules for the carrying forward of net operating losses, but

(B) shall be subject to limitation under this section in the same manner as a pre-change loss.

H. R. Conf. Rep. No. 841, 99th Cong., 2d Sess. 11-191 (the "Conference Report") describes subsection (h) as follows:

> Under the conference agreement, the amount of any recognized built-in loss that exceeds the section 382 limitation for any post-change year must be carried forward (not carried back) under rules similar to the rules applicable to net operating loss carryforwards and will be subject to the special limitations in the same manner as a pre-change loss.

The Technical Corrections Bill would amend subsection (h)(4) by inserting before the comma* at the

* The text of the amendment in the House version erroneously referred to "period" rather than "comma."

end of subparagraph (A) the following: “(or to the extent the amount so disallowed is attributable to capital losses, under rules similar to the rules for the carrying forward of net capital losses).”

The operation of this rule is straightforward where the loss corporation has taxable income in a year and section 382(h)(1) operates to prevent a recognized built-in loss from being used to offset such income. or example, suppose that in a given taxable year a loss corporation has ample taxable income, the section 382 limitation is $50 and the corporation has a recognized built-in loss of $100 which is treated entirely as a pre-change loss under subsection (h)(1). In that situation, it is clear that subsection (h)(4) would allow the $50 of recognized built-in loss that cannot be used currently to be carried forward in the same manner as a net operating loss (assuming the loss is an ordinary loss). It is also clear from the Conference Report that the $50 of excess loss could not be carried back.

Suppose, however, that the facts are the same as in the example above except that the loss corporation has taxable income (before taking account of the recognized built-in loss) of zero, and wishes to carry the one hundred dollar loss back to offset income from prior years (either post-change or pre-change). Can it do so? Subsection (h)(4) applies only with respect to the portion of a recognized built-in loss that is "disallowed" for any post-change year. If the reference to disallowed was intended to mean "disallowed under subsection (h)(1)(B) and subsection (a)," then no portion of the loss would in fact be disallowed in the current year because the deduction that would be allowed would be the same whether or not section 382 applied. Under this interpretation the entire recognized built-in loss could be carried back to offset income in prior years. On the other hand, the Conference Report suggests that the loss could be carried back only to the extent it does not exceed the section 382 limitation for the year (i.e., only to the extent of $50).[*]

We recommend that subsection (h)(4) be clarified to provide that (i) it applies to recognized built-in losses only to the extent they are treated as pre-change losses under subsection (h)(1)(B), (ii) the amount of those losses that is not used to offset income in the loss year may be carried back to pre-change

[*] To the extent that the loss corporation did not have pre-change losses sufficient to offset the full section 382 limitation in prior years, the unused portion of the limitation would have been carried over to the current year under section 382(b)(2).

years to the same extent as if section 382 did not exist, (iii) the amount of those losses that is not used to offset income in the loss year and that may be carried back to post-change years is limited to the section 382 limitation for the loss year (reduced by the amount of those losses that is used to offset income in the current year) and (iv) any amount of those losses that is not carried back can be carried over under the normal carryover rules for ordinary or capital losses, as appropriate.

The reason for allowing carrybacks to pre-change years without limitation under section 382 is straightforward. The basic objective of section 382 is to limit the use of pre-change losses to offset post-change income. Thus, to the extent that a loss accrued economically before the change date and is otherwise treated as a pre-change loss under subsection (h), there is no reason to apply section 382 to prevent such loss from being carried back to offset pre-change income. On the other hand, it would be appropriate to limit any carrybacks to years following the change date to the section 382 limitation amount.

2. Net unrealized built-in gains and losses are defined in subsection (h)(3)(A)(i) as the difference between the fair market value of the assets of the loss corporation immediately before an ownership change and the aggregate adjusted basis of those assets. Subsection (h)(3)(A)(ii) states that if a redemption occurs in connection with an ownership change, "determinations under clause (i) shall be made after taking such redemption into account."* The purpose of this special rule for redemptions is not readily apparent. Moreover, it can produce results that seem patently unfair. Consider, for example, a loss corporation L that undergoes an ownership change. L has an asset, GA, that has a substantial built-in gain, but no other built-in gain assets. Assume that if L were to sell GA following the ownership change, the amount of the built-in gain would increase the section 382 limitation. If, however, it chooses instead to distribute the asset in redemption of stock, and such redemption is considered to occur in connection with an ownership change,

* As discussed in Part VI, the Technical Corrections Bill would insert "or other corporate contraction" after "redemption" each place it appears in subsection (h)(3)(A). It is not clear what the effect of the corporate contraction rule is intended to be in this context.

then, under subsection (h)(3)(A)(ii), the amount of net unrealized built-in gain would be determined after taking such redemption into account. Apparently, this means that the gain with respect to GA would be ignored, and, because net unrealized built-in gain would then be zero, the section 382 limitation would not be increased. We do not understand why gains recognized in redemptions should be disadvantaged. The general approach under section 382 to redemptions that occur in connection with an ownership change is to treat them as if they occurred prior to the ownership change (see section 382(e)(2)). Following this analysis, gain recognized upon the distribution of an asset in a redemption should clearly increase the section 382 limitation because such gain would be attributable to a pre-change date transaction. (The gain would be analogous to gain recognized in a section 338 sale.) If a built-in loss asset is distributed in a redemption, the loss would also be ignored under subsection (h)(3)(A)(ii) in determining the amount of net unrealized built-in gain or loss; however, this result may be appropriate since no loss deduction would be allowed because of section 311(a). We recommend that subsection (h)(3)(A)(ii) be eliminated, at least as it applies to distributions of built-in gain assets.*

3. Subsection (h)(6) authorizes the issuance of regulations treating amounts which accrue on or before the change date which are allowable as a deduction after such date as recognized built-in losses. Even if such regulations were issued, they might well be ineffective under the present statute because of the definition of net unrealized built-in loss. The characterization of an accrued deduction as a recognized built-in loss would not result in the treatment of that deduction as a pre-change loss except to the extent that the loss corporation has net unrealized built-in losses. The definition of net unrealized built-in losses in paragraph (3)(A)(i) looks to the difference between the fair market value and basis of the loss corporation's assets, but makes no reference to accrued deductions. The Technical Corrections Bill would address this problem by adding the following language at the end of paragraph (6): “(and the amount of the net unrealized built-in loss shall

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* It is possible that the special rule for redemptions was intended to require that the fair market value of the assets of a loss corporation be determined after the redemption for purposes of applying the de minimis rule in subsection (h)(3)(B)(i), although such a reading is not possible given the existing language of the subsection.

be increased by the amount so treated as a recognized built-in loss)". However, this language could be read to circumvent the de minimis rule in subsection (h)(3)(B), which presumably was not intended. Also, the language does not deal adequately with the case where a loss corporation does not have a net unrealized built-in loss before application of paragraph (6). It would be better to substitute for the new language the following: "(and the amount so treated as a recognized built-in loss shall be taken into account in calculating the amount determined under subsection (h)(3)(A)(i))."

4. Subsection (h)(6) refers to amounts which "accrue" on or before the change date and which are "allowable as a deduction" after such date. The meaning of the word "accrue" in this context is not clear. Particularly in light of section 448, virtually all loss corporations will use an accrual method of accounting. Accordingly, they would generally be allowed deductions for expenses as they "accrue," subject to the economic performance requirement of section 461(h) and other Code sections dealing with specific expense items. On the other hand, section 382(h)(6) obviously contemplates the existence of a category of expenses that have not been deducted as of the change date even

though they have arisen as of that date. It is possible to read the subsection to apply (i) only to cash basis taxpayers or (ii) only with respect to items that have accrued under normal tax accounting concepts, but are not currently deductible because of section 461(h) or some other explicit Code provision. The Conference Report at 11-191 is consistent with this latter interpretation; the only examples it offers of accrued deductions are deductions that are suspended under section 267 or 465.

On the other hand, the term “accrued” could be read to mean “built-in economically” rather than accrued in a tax accounting sense. We believe that (h)(6) should be extended to deductions 'that are accrued in this sense only in limited circumstances, if at all, in view of the attendant problems of valuation.

In order to explore these problems, consider an acquisition of L by P that results in an ownership change. On the change date, L is subject to a number of liabilities that have not accrued in a tax accounting sense. One approach to applying section 382 to L’s liabilities would be to identify those liabilities that are attributable to the pre-change period (perhaps by asking which liabilities P would be required to capitalize in connection with an asset purchase), and then to treat all deductions allowed in respect of those liabilities during the recognition period as recognized built-in losses. In our view, such an approach would be inconsistent with the overall operation of subsection (h) in that it fails to distinguish between the portion of the liabilities that is truly built-in as of the change date and the portion that is attributable to subsequent events. Instead, it would be necessary to limit the portion of a liability that is a recognized built-in loss to the fair market value of the liability on the change date. Such fair market value would equal the amount which a third party would demand in order to assume the liability or, in the context of section 382, the amount by which the fair market value of the equity of the loss corporation is reduced because of the existence of the liability. However, determining the fair market value of liabilities that have not accrued in the tax accounting sense would be a daunting task. Liabilities generally do not "accrue" either because they are contingent or because their amount cannot be determined with reasonable accuracy (see Treasury Regulation section 1.461-1(a)(2)). If the second ground for nonaccrual applies, the difficulty of valuation is obvious. Even where value can be determined with "reasonable" accuracy, the existence of any kind of contingency is likely to make precise valuation difficult.

In assessing the practical problem of valuing liabilities that have not accrued in a tax accounting sense for purposes of determining the portion of those liabilities that is considered “built-in,” it is important to keep in mind the consequences of that determination. Under section 382, valuation may affect not only the timing of a deduction (which is normally the issue in determining when a liability has “accrued”) but also the extent to which a deduction for the liability will ever be allowed. To illustrate, suppose that L has a low net worth and that its principal contingent obligation is a products liability claim. P acquires the stock of L for a nominal sum believing that the underlying business will prove to have a substantial value in excess of the claim. In these circumstances, the section 382 limitation would be virtually zero, with the result that the ability of L to deduct amounts in respect of the products liability claim will be reduced, dollar for dollar, by the portion of such liability that is treated as a built-in deduction subject to the section 382 limitation. Thus, assigning a precise dollar value to the liability would be of great significance to P and to the Service.

Given the practical problems of valuation, we recommend that section (h)(6) generally be limited to deductions that have accrued in a tax accounting sense. The only exception to this rule that we would support would be an exception for liabilities that have been valued for financial statement purposes at or about the change date.

As noted above, the examples given in the legislative history of the types of deductions to which section 382(h)(5) may apply suggests that a narrow reading of the word “accrue” was intended, and in particular that it may be limited to deductions that have accrued in a tax accounting sense, but are deferred under some special rule. If regulations are adopted under that subsection that extend its reach beyond deferred deductions of this type, then we recommend that the regulations apply only to testing dates after the date of issuance of the regulations (with a transitional rule for ongoing transactions).

5. By its terms, section 382(h)(6) applies only to amounts which are allowable as a deduction after the change date. This language raises two questions: first, whether built-in income items should not receive parallel treatment to built-in deductions, and, second, whether the rule would apply to liabilities that are not pure expense or income items.

We have previously recommended that the built- in deduction rule be extended to accrued income items.* Presumably this result would follow in any event (subject to the 25 percent de minimis rule) to the extent income from a built-in income item is created by disposing of the right to such income. (The right would be an asset having a fair market value greater than its adjusted basis and accordingly gain from a disposition of the item would potentially be recognized built-in gain.) It makes little sense to us to distinguish (i) the case where income from a built-in income item is recognized after the change date by disposing of the right to such income before such income accrues from (ii) the case where the right to such income is retained and the income is recognized after the change date under the holder's method of accounting.

* H.R. Rep. No. 100-391 at 1179.

Two examples of liabilities that are not pure expense or income items would be debt obligations and liabilities that have accrued in part prior to the change date. Debt obligations may, of course, have a fair market value that differs significantly from the amount at which they are carried for tax purposes as a liability.

We question whether gains or losses that would result from the retirement of debt at its fair market value should not be taken into consideration in computing built-in gains or losses.[*] The principal drawback is complexity, but valuing fixed liabilities would appear -to be no more difficult than valuing assets, which is already required. It is standard financial accounting practice to revalue liabilities when they are assumed in connection with a purchase of assets.

To illustrate how the rule might operate in calculating net unrealized built-in gain or loss, suppose that L owns assets having a basis of $130 and a fair market value of $100. Looking

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[*] The rule could be limited to gains or losses resulting from the retirement of debt, but it would seem to make more sense to treat as recognized built-in gains or losses the difference between the actual interest deductions that are allowed in the recognition period and the interest deductions that would be allowed if debt obligations outstanding on the change date were treated as being newly issued on that date at their fair market values on that date.

only at the assets, L would have a net unrealized built-in loss of $30. Suppose, however, that the assets were acquired in part by incurring $50 of debt, and that the debt bears interest at a fixed rate significantly below a current market rate. If the current value of the debt was $40, and the debt was taken into account in determining the net unrealized built-in gain or loss of L, then L would have a net unrealized built-in gain of zero because the built-in loss of $30 with respect to the asset would be offset by the built-in gain of $10 with respect to the liability, for a net amount less than the twenty-five percent de minimis amount. Obviously, under a parallel rule, the existence of a “premium” debt obligation would potentially contribute to a net unrealized built-in loss.

6. Subsection (h)(8) states that if eighty percent or more in value of the stock of a corporation is acquired in one transaction (or in a series of related transactions during any 12-month period), for purposes of determining net unrealized built-in loss, the fair market value of the assets of such corporation shall not exceed the grossed-up amount paid for such stock properly adjusted for the indebtedness of the corporation and other relevant items. We note that this section applies where

the stock of a corporation is “acquired” whether or not it is “acquired by purchase,” so that the section would apply even though the acquisition takes the form of a purchase from a related person, a gift or any other transaction that is not a ’’purchase.” Cf. section 338(h)(3). We assume that in those cases the “amount paid” for stock would be considered to be the fair market value of the stock of the loss corporation at the time it is acquired.

7. The Technical Corrections Bill would amend subsection (h)(1)(C) (relating to gain recognized by reason of a section 338 election) to limit the amount of such gain that increases the section 382 limitation to the amount of net unrealized built-in gain, determined without regard to the twenty-five percent de minimis rule, reduced by any prior recognized built-in gain. The effect of this change would be to prevent appreciation between the change date and the acquisition date under section 338 from being included in the section 382 limitation, and we do not object to this result.[*] However,

[*] The change would also ensure that the amount of gain that is included in the section 382 limitation is calculated net of built-in losses. Presumably, the reference to "gain" recognized by reason of a section 338 election was intended to mean "net gain," although this is not clear.

the amendment would also provide that if a section 338 election is made, then the normal rules increasing the section 382 limitation under subsection (h)(1)(A) would not apply. We believe this result is unwarranted. If a loss corporation sells an asset at a gain between the change date and the section 338 acquisition date, and that gain would otherwise increase the section 382 limitation, why should that result be denied because of the making of a subsequent section 338 election? If any special rule is needed for gains arising from sales during that period, it would be a rule that treats such gains in the same manner as if they had been recognized in the subsequent section 338 sale (i.e., subsection (h)(1)(A) should be applied without regard to the de minimis rule). Moreover, it is unfair to reduce the amount of gain from a section 338 deemed sale that may increase the section 382 limitation by the amount of "prior recognized built-in gain," as the Technical Corrections Bill would do, if that prior recognized built-in gain has not increased the section 382 limitation.

IV. Application of Section 382 to Affiliated Groups Filing Consolidated Returns

Neither the statute nor the Regulations address the issues raised by the application of section 382 in the context of an affiliated group of corporations filing a consolidated Federal income tax return.* These issues include (i) the determination of whether an ownership change has occurred, (ii) whether the section 382 limitation is to be applied on a consolidated or company-by- company basis, (iii) the application of the built-in gain and loss rules, (iv) the rules concerning continuity of business enterprise, (v) the application of the “anti-stuffing” rules of section 382(1)(1), (vii) the preservation of the separate return limitation year (“SRLY”) and consolidated return change of ownership (“CRCO”) rules, (viii) the application of the bankruptcy exception of section 382(1)(5), (ix) the proration of income for the year of an ownership change to the portions of the year before and after the change date, and (x) the application of section 382 to groups not filing consolidated returns.

A. General Approach

The basic policy of section 382 is, in general, to limit the amount of losses which a loss corporation may use following an ownership change to the amount of such losses which it hypothetically could have used if the ownership change had not

* Unless otherwise indicated, references below in this Part IV to affiliated groups are to affiliated groups that file consolidated returns.

occurred. Accordingly, the rules governing the use of losses in affiliated groups in the absence of an ownership change should be the starting point for an analysis of section 382 in the affiliated group context.

In general, in the absence of an ownership change, one hundred percent of the income and losses of each group member is taken into account in computing the group's consolidated income or loss, even if a minority interest in a member (up to twenty percent of its “stock” or any amount of its preferred stock which meets all the requirements of section 1504(a)(4)) is held outside the group.* An exception to this general rule exists where the SRLY rules of Treasury Regulation section 1.1502- 21(c) apply. Loss carryovers and “built-in deductions” (as defined in Treasury Regulation section 1.1502- 15(a)(2)) of a member that are subject to those rules may only be used against such member's own income. Generally, when an entire group is acquired by another corporation, each member of the acquired group is considered to

* A proposal which would have limited this offset to the parent's percentage ownership interest in its subsidiary (measured by value) was included in the House-passed version of the Revenue Bill of 1987, but was dropped from the Bill as finally enacted. See H.R. 3545, section 10134 (House-passed version).

join a new affiliated group and becomes subject to the SRLY rules. Also, if an affiliated group experiences a CRCO, as defined (by reference to old section 382(a)) in Treasury Regulation section 1.1502-l(g), losses of the “old” group members cannot be used to offset income of “new” members.

As discussed in greater detail below, the Committee believes that the purposes of section 382 are best served by applying its limitations to the members of an affiliated group that experience an ownership change on a consolidated (i.e., aggregate) basis, effectively treating those members as a single corporation.

B. Ownership Changes

The first issue that must be addressed in applying section 382 to an affiliated group is whether an ownership change with respect to the group's common parent should cause an automatic ownership change with respect to each group member, or whether the determination should instead be made separately for each group member. Although the Regulations do not specifically address the ownership change issue in the context of an affiliated group, they imply that the determination of whether an ownership change has occurred is to be made on a member- by-member basis.

In the case of an affiliated group consisting of a common parent corporation and its direct or indirect wholly-owned subsidiaries, any changes in the ownership of parent stock will, through the application of the attribution rules of paragraph (h), also be considered changes in the ownership of stock of each subsidiary. Similarly, in general, changes in the ownership of those subsidiaries can only occur through transfers of the parent's stock. Hence, in the case of a group where all the subsidiaries are (and have been throughout the testing period) wholly-owned, an ownership change with respect to the parent generally will occur only in conjunction with an ownership change with respect to all the subsidiaries, and vice versa.

An exception may occur where there is a transfer of interests in stock of a subsidiary if such interests are not considered stock for purposes of section 1504 but are counted for purposes of section 382. For example, a holder of an option to acquire stock of the subsidiary may be deemed to own the underlying stock under paragraph (h)(4), even though the option might be disregarded in applying section 1504.[*] Similarly, the subsidiary might have interests outstanding that are not treated as stock for purposes of section 1504 but “offer a potential significant participation in the growth of the corporation” and are therefore treated as stock under paragraph (f)(18)(iii).

In the case of a less than wholly-owned subsidiary, ownership changes in the parent without a corresponding ownership change in the subsidiary, or in the subsidiary and not the parent, are clearly possible. For example, assume that P, the common parent of an affiliated group, owns (and has owned for years) eighty percent of the stock of a subsidiary, S, and that A acquires fifty-one percent of P. There is an ownership change with respect to P; however, because A's stock represents only a 40.8 percent interest in S, there is no ownership change with respect to S.

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[*] Cf. section 1504(a)(5). The legislative history of this section suggests that the likelihood that an option will be exercised is a relevant factor. For a discussion, see New York State Bar Association, Committee on Corporations, Report on Tax Reform Act of 1984 Amendments to Section 1504(a), The Definition of Affiliated Group, reprinted in Tax Notes, August 19, 1985, at 895.

Alternatively, assume that A acquires forty percent of P and twenty percent of S. There is no ownership change with respect to P, but there is an ownership change with respect to S, since A has acquired fifty-two percent of S (twenty percent directly and thirty-two percent by attribution).

Finally, even if a subsidiary is currently wholly-owned, an ownership change may occur for the subsidiary but not its parent if all or a portion of the subsidiary's stock was acquired by the parent during the testing period. For example, suppose that P has owned- for many years eighty percent of the stock of S and acquired the balance in 1988. If, in 1989, A acquires forty percent of P, there would be an ownership change with respect to S but not P (since A and the other P shareholders would have acquired fifty-two percent of S but A would have acquired only forty percent of P).

As the discussion above indicates, an ownership change may occur with respect to one member of an affiliated group but not another because there is currently, or has been during the testing period, a difference in the ultimate beneficial ownership of each of the two members that is considered significant in light of the purposes of section 382. However, such differences in ownership are not necessarily significant in determining whether the two corporations should be permitted to file consolidated returns. Sections 382 and 1504 have not developed along parallel paths and reflect different tax policies. The Committee believes that the policies of both the affiliated group definition and section 382 are best accommodated by requiring a company-by-company determination of whether an ownership change has occurred and then, as discussed below, applying the section 382 limitation on a consolidated basis to those group members that have jointly experienced an ownership change.

C. Application of Limitations

1. General Theory.

In determining the appropriateness of different methods of calculating and applying the section 382 limitation in an affiliated group context, it is helpful to compare two situations. In each case, P is a corporation that has a net worth of $400 and conducts, directly or indirectly, two businesses: business A, having assets with a net value of $100, and business B, having assets with a net value of $300. In case one, P has no subsidiaries and conducts both businesses directly. In case two, P owns (and has for many years owned) all of the stock of subsidiary S through which it conducts business B while P conducts business A directly. P and S file consolidated returns.[*] How should section 382 apply in these two cases? More particularly, does the difference in corporate structure justify a difference in results?

The application of section 382 in case one is straightforward. P is a single taxpayer, and can freely offset income from any of its assets against losses from any other of its assets. Thus, a single section 382 limitation should and clearly would be calculated based on the aggregate net value of P's assets, and losses from both business A and business B would, in the aggregate; be subject to that limitation.

In case two, P and S operate businesses A and B, respectively, and file a consolidated return. The overall purpose of the consolidated return rules is to allow the offsetting by P and S of the losses of one against the income of the other, and thus to place P and S in substantially the same tax position as if P owned the S assets directly (*i.e.*, in the same position as

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[*] Affiliated groups that do not file consolidated returns are discussed in part IV.J., below.

in case one above).[*] As discussed above, the overall purpose of section 382 is to leave a loss corporation in substantially the same position in terms of the offsetting of losses against income as if no ownership change had occurred. We believe that both of these statutory purposes can be accommodated by calculating a combined section 382 limitation for P and S based on their aggregate value of $400 and counting the aggregate losses of each of the two corporations against that combined limitation -- i.e., the same result that would obtain in case one.[**]

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[*] Under the consolidated return regulations, the net operating loss deduction is itself a consolidated calculation. Treasury Regulation section 1.1502- 21(f). Thus, under the regulations a consolidated group does not calculate its net operating loss on a company-by-company basis even as a preliminary step in determining consolidated income. Instead, it commences the computation by aggregating the income and losses of all members.

[**] An exception to the Committee's proposed consolidated approach would be needed for a loss member that leaves the group. Assuming that the group, including the departing member, jointly experienced an ownership change, it will be necessary to determine (i) the departing member's remaining pre-change losses (which necessitates a determination of the extent to which such member's pre-change losses have been used by the group), and (ii) such member's unused limitation carryover, if any, under section 382(b)(2). To this extent, member-by-member computations seem unavoidable. An appropriate method of computing such separate limitations would be to determine the value of each departing member as if it and its subsidiaries were a separate group.

If the events that give rise to an ownership change also result in application of the SRLY limitations then the group would not be allowed to offset losses of one member against income of other members in the absence of section 382; in such a case, it could be argued that to ensure consistency with the use of losses in the absence of section 382, the section 382 limitation should be applied on a separate company basis. We do not accept this view. First, the proper point of reference for determining how section 382 should apply to an affiliated group undergoing an ownership change is the situation that would have existed absent the ownership change. Accordingly, to the extent the SRLY rules would not have applied to the loss corporation but for the ownership change, they should not be relevant in determining the proper application of section 382. Second, as discussed below, we believe that the corporation-by-corporation approach of the SRLY rules should be reconsidered in light of section 382. If anything, section 382 should dictate the future of the SRLY rules, not the other way around.

2. Problems with Member-by-Member Approach.

Although our conclusion that the section 362 limitation should be applied on a consolidated basis follows directly from the ability to offset income and losses *in a consolidated return, it may be helpful to consider the problems that would be encountered under a member-by-member approach.

Assume that P owns one hundred percent of the stock of S with which it files a consolidated return. P and S both have loss carryovers. A acquires fifty-one percent of the stock of P, resulting in an ownership change with respect to both P and S. Assume further that S has a value of $100, P has a value, disregarding the stock of S, of $200, and the long-term tax-exempt rate is ten percent.

Under a strict member-by-member approach, S's limitation would be $10, and P's limitation would be $30 (ten percent of an aggregate value of $300), for a combined limitation of $40. In effect, S's equity value would be counted twice. At first blush, it would seem that the value of S should be subtracted from the value of P in calculating the separate section 382 limitation for P to avoid such double counting.

However, such a reduction in P's limitation is not always appropriate. To illustrate, assume the same facts as above except that S has no NOLs of its own. In this case, subtracting the value of S from the value of P is not necessary to avoid double counting (section 382 would not apply to S), and it seems unfair to disregard a significant source of P’s income and value simply because S’s business is conducted through a subsidiary. Accordingly, in this case, it would seem appropriate to use the gross value of P ($300) in calculating the amount of P's annual limitation. However, it cannot make sense to make the inclusion or exclusion of the value of S from the value of P turn on whether S has any amount (e.g., $1) of losses.

It appears that the correct result can be achieved in all cases only by calculating a section 382 limitation of $30 for the group, and then counting the losses of both P and S against that limitation (i.e., by applying an aggregate approach).

In addition, the aggregate approach simplifies valuation questions generally associated with private companies (which would include wholly-owned subsidiaries of a public company). The transaction which creates an ownership change with respect to a public company would not typically provide any independent evidence of the separate values of the parent and its subsidiaries (at least if such subsidiaries are wholly-owned). Accordingly, if it is necessary to determine separate section 382 limitations for the parent and its subsidiaries for any purpose, taxpayers will be forced to establish such values without the benefit of arms'-length transactions to support such valuations. An aggregate limitation limits the need to establish such independent values, since the value of the group would be determined by reference to the actual price paid for the parent's stock.*

3. Partially-Owned Group Members.

Special problems arise in the case of less than wholly-owned subsidiaries. Consider the following example: L owns eighty percent of SI which owns eighty percent of S2. L has assets with a net worth of $100 disregarding its SI stock, and SI has assets with a net worth of $100 disregarding its S2 stock. S2 also has assets with a net worth of $100. Assume further that each of L,

* Although a separate valuation of a subsidiary may be required if the subsidiary leaves the group, as explained above, the need for separate valuations would be significantly reduced by an aggregate approach.

S1 and S2 has losses.* The issue presented is whether to value the L group at $300 (the aggregate value of all of the group's assets) or at $244 (representing L's pro rata interest in the assets of its subsidiaries assuming no premium for a control position).** The Committee believes that the better view under the current consolidated return rules is that the section 382 limitation should be based on a value of $300. This conclusion follows from the previously stated policy of applying the section 382 limitation so as to produce results similar to those that would obtain absent an ownership change. Under current law, the losses of each group member can be offset against one hundred percent of the income of all group members notwithstanding the existence of minority interests, and thus it is appropriate to count 100 percent of the value of each member's assets.*

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* The same principles would apply where only some members of the group have losses.

** As discussed above, the double-counting approach, (which would result in a value of $600 or $524 de-pending on whether one hundred percent or eighty percent of the value a subsidiary is counted), is clearly not correct.

* The Committee notes that if the L group's corporate structure were collapsed by section 332 liquidations with distributions to the minority shareholders of SI and S2 of their proportionate shares of the liquidating corporation’s assets, P would be entitled to 100 percent of the NOL carryovers of both SI and S2. Section 381.

4. Loss Members Not Experiencing an Ownership Change.

As noted above, we believe that the definition of ownership change should be applied separately to each member of an affiliated group. As a result, on any testing date, an ownership change may occur with respect to some group members (“change members”) but not with respect to others (“non-change members”).[*] (The group of change members will be referred to as the “change group” and the group of non-change members as the “non-change” group.) Mow should section 382 be applied in these circumstances?

We have three principal recommendations. First, we believe that an aggregate section 382 limitation should be computed for, and applied to, the pre-change losses of the change group. Under this approach, pre-change losses of the change group could be offset in any year against income of any change or non-change member, but the aggregate amount of such losses so used in

[*] Technically, a corporation that is not a "loss corporation" cannot experience an ownership change. See paragraph (a)(1). However, for purposes of determining whether a corporation is a change member or a non-change member, the ownership change definition should be applied without regard to whether a corporation is a loss corporation.

any year could not exceed the section 382 limitation for the change group for that year.

Second, we believe that it is inappropriate to subject the losses of non-change members to any limitations under section 382; to do otherwise would be inconsistent with the basic statutory approach which applies a section 382 limitation only to corporations that have experienced an ownership change.*

Finally, because pre-change losses of the change group would be limited but those of the non-change group would not, it is important to determine the order in which each type of losses is used in any taxable year. We propose that losses be considered to be used in the order in which they arose, according to the normal rules governing carryovers, and that, in accordance with section 382(1)(2)(B), if restricted and unrestricted losses arose in the same taxable year, the restricted losses would be considered to be used first.

Two further issues that must be resolved in applying section 382 to the change group are (i) how the value of the

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* NOLs should be allocated to non-change or change members in accordance with the principles of Treasury Regulation section 1.1502-79.

stock of non-change members should be counted in determining the value of the change group and (ii) how losses of non-change members that would be pre-change losses if they were change members should affect the section 382 limitation for the change group.

With regard to the first issue, we believe that the value of the stock of non-change members held by change members should clearly be counted in the same manner as any other assets of the change members. There is little reason to distinguish stock of a non-change member from other potential income sources. Accordingly, we believe that, for example, a parent corporation's interest in the stock of its non-change subsidiary should be counted as part of the parent's value. While the question is a much closer one, we believe that if the change group has no economic interest in a non-change member, the value of the stock of that member should not be included in the value of the change group, notwithstanding that the losses of the change group can be offset in consolidation against the income of all non-change members. Although we recognize that there is some inconsistency between this view and the reasoning above that looks to the ability of a group of corporations to offset income and losses in consolidation as a starting point in applying section 382 to that group, we believe that where an ownership change occurs with respect to a subsidiary group but not a parent of that group, there is a sufficient severing of the ownership link between the two as measured for section 382 purposes to exclude the value of the parent in calculating the value of the subsidiary group (or stated differently, to limit the use of the subsidiary group's losses to an amount equal to the hypothetical income of the subsidiary group including any non-change members thereof).* One advantage of our recommendation is that it permits the same rules to apply to a change group and non-change group (i) where they were affiliated before the ownership change, and (ii) where the change group becomes affiliated with the non-change group as a result of the ownership change, in which case it is clear that the value of the acquiring group should not be taken into account (<u>see</u> discussion of SRLY rules below).

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* Although the section 382 limitation would be calculated excluding the value of non-change members not owned by the change group, as noted above, the losses of the change group should be available (to the extent they do not exceed the section 382 limitation for the change group) to offset income of both change and non-change members.

With regard to the use of losses of non-change members that would be pre-change losses if they were change members, we generally believe that those losses should not be offset against the section 382 limitation applicable to the change group. The effect of such an offset would be to reduce the utilization of the losses of the non-change members because their use would carry with it an extra cost, which seems inconsistent with the fact that the non-change members have not experienced an ownership change. On the other hand, we have some concern that there would be an element of double counting if the value of a non-change member is taken into account in determining the value of the change group (i.e., where a non-change member is owned by a change member), and pre-change losses of the non-change member were not applied to any extent against the section 382 limitation of the change group.

In the general discussion of affiliated groups above, we indicated that where P and S file a consolidated return and both corporations experience an ownership change, then an aggregate section 382 limitation should be calculated and the pre-change losses of each corporation should be offset against that limitation. This approach served to place P and S in substantially the same position as if P conducted the S business directly. In a case where P experiences an ownership change but not S, P should be placed in the same position as if it conducted the S business directly insofar as the use of its losses to offset income from the S business is concerned (because there is no section 382 policy limiting the use of P losses against any of its income sources), but the S losses should not be restricted because it has not experienced an ownership change. This difference in the treatment of S income and losses could justify not offsetting the S losses against the P limitation even though the value of P includes the stock of S, and some members of the Committee support this position. This position is reflected in the examples below. Nonetheless, the fact that P can offset its losses against the income of S suggests that they are to some extent in the same posture as a single taxpayer and that there may accordingly be an element of double counting in allowing P to offset its losses against S's income (and to increase its section 382 limitation by the value of S) without requiring S's pre-change losses to be taken into account as an offset to P's section 382 limitation. A compromise position that is favored by some Committee members would be to allow the pre-change losses of a non-change member to reduce the section 382 limitation of a change group if and only if the value of the stock of the non-change member is included in the value of the change group, and then only to the extent that those losses do not exceed the increase in the section 382 limitation attributable to the inclusion of such stock in the value of the change group. This approach limits the losses of non-change members to the least extent necessary to eliminate the apparent double counting.

If the losses of non-change members are not offset to any extent against the section 382 limitation of the change group, and the non-change members subsequently experience an ownership change, all members of the Committee agree that it would then be appropriate to offset the losses of those non-change members that are pre-change losses with respect to the first ownership change against the section 382 limitation of the first change group, to the extent that such losses do not exceed the increase in the section 382 limitation (for the first ownership change) attributable to the inclusion of stock of the non-change members in the change group.

Our recommendations may be illustrated by the examples set forth below. Assume unless otherwise noted that P is the common parent of an affiliated group and that except as indicated in the examples there are no changes in stock ownership that are relevant in applying section 382.

Example (1). P owns 100 percent of the stock of S1 which in turn owns 100 percent of the stock of S2. P, S1 and S2 have assets (disregarding stock in subsidiaries) with a net value of §500, $100 and $100, respectively. P writes an option in favor of A to buy all of the S1 stock, with the result that an ownership change occurs with respect to S1 and S2 but not P. S1 and S2 are the sole members of the change group, and their losses are subject to limitation. The section 382 limitation for that group is based on a value of $200 (i.e., the value of the change group calculated in the manner described above for an affiliated group consisting of S1 and S2, but not including the value of P).

Example (2). (i) P owns 80 percent of the stock of S. The P-S group has a taxable year that is the calendar year. At the beginning of 1988, A acquires 51 percent of P, resulting in an ownership change with respect to P but not S. Thus, the change group and non-change group consist of P and S, respectively. At the time of the ownership change, P and S each has assets with a net value of $100, excluding, in the case of P, the stock of S. A section 382 limitation is calculated for the change group based on the aggregate value of the group and taking account of the stock of non-change members. The only member of the group is P, which has a value of $200. Thus, assuming that the long-term tax-exempt rate is ten percent, the section 382 limitation with respect to P is $20.

(ii) Assume first that the only loss in the P-S group is a $25 loss carryover from 1987 which is attributable entirely to P, and that in 1988 the P-S group has income of $35. The carryover is subject to the section 382 limitation because it is attributable to a change member, and thus can be used only to the extent of $20.

(iii) Same facts as (ii), except that the loss carryover from 1987 is $50 and is attributable $25 to S and $25 to P. The restricted loss attributable to P can be used only to the extent of the section 382 limitation of $20 and is considered to be used first. The loss attributable to S is unrestricted and can be used to offset the remaining taxable income of $15.*

Example(3). Same facts as Example (2), except that at the beginning of 1989, S (but not P) experiences an ownership change.** Assume that there is a loss carryover from 1987 of $50 which is attributable $25 to S and $25 to P, that the P-S group had no taxable income or loss in 1988 and that it has taxable income of $50 in 1989. The value of S at the beginning of 1989 is $120 and the long-term tax-exempt rate at that time is 10 percent, so that the section 382 limitation that applies to S as a result of the ownership change in 1989 is $12. The 1987 carryover, to the extent attributable to S, can be used in 1989 only to the extent of $12. The 1987 carryover, to the extent attributable to P, can be used in 1989 only to the extent of $10 (the section 382 limitation of $20, less the amount of pre-1987 losses of S that are used in the year, to the extent of the increase in P's

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* This result assumes that the pre-1988 losses of S are not offset to any extent against the section 382 limitation of the change group. Under the compromise position discussed above in the text, those losses would be offset against the section 382 limitation only to the extent they do not exceed the increase in P's section 382 limitation that is attributable to the value of the S stock (i.e., $10). Under that approach, the P loss carryover could be used only to the extent of $10 ($20 less $10).

** This example assumes that before the occurrence of the ownership change with respect to S, the pre-1988 losses of S are not offset to any extent against the section 382 limitation of P.

section 382 limitation attributable to P's ownership of S ($10)).

D. Built-in Gains and Losses

A number of difficulties arise in applying the built-in gain and loss rules of section 382(h) in the context of an affiliated group.

The terms “net unrealized built-in gain” and “net unrealized built-in loss” are defined by reference to a corporation's basis in its assets and their fair market value. In determining the net unrealized built-in gain or loss of a parent corporation having consolidated subsidiaries, however, the calculation of built-in gain or loss may lead to different results depending on whether the relevant “asset” is the stock of the subsidiary (as the Service has ruled in Revenue Ruling 83-14 in interpreting the built-in loss rules in the consolidated return regulations) or whether one “looks through” the subsidiary to its underlying assets. Cf. section 368(a)(2)(F)(iii) (look-through for purposes of investment company definition).

Assume, for example, that P, a loss corporation, owns as its only asset S stock with a fair market value of $100 and a basis of $10. Assume further that S has assets with a fair market value of $200 and liabilities of $100 (for a net equity value of $100), and that its basis in its assets is $50. If the built-in gain limitation were applied on a consolidated basis (i.e., by "looking through" the subsidiary to its underlying assets), the net unrealized built-in gain of the P group would be $150 (the excess of $200 over $50). This is the same result as if P had held the S assets directly following a liquidation of S. On the other hand, if the calculation were made on a stand-alone basis, P's net unrealized built-in gain would be $90 (the excess of $100 over $10).

A "look-through approach" is consistent with our recommendation that a change group be treated effectively as one corporation for purposes of applying section 382. In addition, if stock in subsidiaries were considered the relevant asset, a great deal would turn on whether assets were held directly by a loss corporation or through subsidiaries at the time of an ownership change. Moreover, what would happen under a stock-as-assets regime if following an ownership change a subsidiary were liquidated into its parent under section 332? Would the built-in gain or loss reflected in the stock simply disappear? It seems likely that a look-through rule would be less susceptible to manipulation and easier to administer than a member-by-member approach.

In addition, because a built-in loss can be transferred, at least in a taxable sale, only by selling stock (rather than the underlying loss assets), significant built-in losses are much more likely to be present with respect to operating assets than stock. Similarly, on the gain side, in the era of General Utilities repeal, significant built-in gains are also more likely to be encountered with respect to operating assets (including related intangibles) than stock. Moreover, because stocks would typically reflect interests in operating businesses that cannot conveniently be disposed of for tax avoidance reasons, and in any event reflect a blend of built-in gain and loss assets, applying the built-in loss rules to operating assets rather than stock would be more likely to frustrate selective sales of built-in loss assets for tax-avoidance purposes.

For these reasons, the Committee believes that the built-in gains and losses of all members of a change group should be determined on a consolidated basis. Under this approach, intra-group holdings of stock would be ignored, and the amount of built-in gain or loss would be determined by looking through to the underlying assets of each group member.[*] Revenue Ruling 83-14, which applies a member by member approach in determining whether there is a built- in deduction for purposes of Treasury Regulation section 1.1502-15, should not control the manner of calculating built-in gains and losses for purposes of section 382.

The facts of Revenue Ruling 83-14 necessarily involve a situation in which the SRLY rules apply. Although commentators have differed with the Service's position, it is not unreasonable to conclude that if a parent’s losses from the sale of its assets, including its subsidiary's stock, would be limited under the SRLY rules to the parent's own income, then the built-in-deduction rules should be applied to the loss assets actually held by the parent. If the subsidiary sold its

[*] By contrast, if a change member owns stock in a non-change member, there is a more substantial argument for treating that stock and not the underlying assets as the relevant asset of the change group. It would seem to be inappropriate to treat a built-in loss that existed with respect to assets of a non-change member (but not with respect to stock held by a change member) as a built-in loss of the change group; to do so would subject the built-in losses of non-change members to the limitations of section 382. It would also seem inappropriate to allow a built-in gain with respect to assets of a non-change member to increase the section 382 limitation of the change group even though losses of the non-change members are unrestricted.

assets, under the SRLY rules, the loss would be deductible only against the subsidiary's income and not the parent's. In contrast, the SRLY rules may or may not apply in cases where the section 382 limitation applies; in any event, their application is independent of section 382, and should not dictate the application of section 382.

A further aspect of section 382(h) relates to the 25 percent threshold requirement of section 382(h)(3)(B). This is applied by comparing built-in gain or loss to the gross value of the corporation's assets. Since this test will create different results depending solely on the gross size (as opposed to the net equity value) of the tested corporation, there is a very real potential for distorted results and, possibly, taxpayer abuse if the twenty-five percent test is applied on a separate company-by-company basis. Such approach would disregard gross assets of subsidiaries to the extent of the liabilities of subsidiaries even though such liabilities do not result in a different amount of built-in gain or loss with respect to the stock of the subsidiary. Other questionable differences could result from the fact that although certain assets, including cash and cash items, are ordinarily excluded in determining the amount of built-in gain or loss, such assets apparently would be fully counted as part of the value of a subsidiary's stock if a separate member approach were used.*

In calculating built-in gains and losses on a consolidated basis, the gains and losses with respect to assets of a subsidiary which is not wholly owned but which experiences an ownership change at the same time as its parent should be handled in a manner that corresponds to the determination of the group's value for section 382 limitation purposes. If our recommendation that one hundred percent of the subsidiary's value be taken into account is adopted, then one hundred percent of the subsidiary's assets should be considered in determining the group's consolidated built-in gain or loss. If less than one hundred percent of the subsidiary's value is counted in determining the group's value, the same fraction should be applied in determining the consolidated built- in gain or loss.

Regardless of whether the built-in gain and loss rules are applied on a consolidated or member-by-member basis, an

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* Other significant discontinuities between a parent's basis in the stock of a subsidiary and the subsidiary's basis in its assets may exist if the subsidiary was acquired by purchase or in a tax-free transaction.

additional issue arises in making such calculations regarding the treatment of deferred intercompany gains and losses. Since such deferred items have already been recognized for tax purposes, they technically do not give rise to built-in gains or losses. However, since generally no tax will be payable or benefit obtained until some point in the future, the Committee believes that such deferred items should be treated as though they were built-in gains or losses.*

E. Continuity of Business Enterprise

Under section 382(c), the section 382 limitation following an ownership change is zero unless the new loss corporation continues the "business enterprise" of the old loss corporation. According to the legislative history, this rule adopts by reference the "continuity of business enterprise" requirement applicable to corporate reorganizations under section 368. See Conference Report at 11-189.

There is a small amount of law relating to the application of this requirement in the reorganization

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* At least in the case of built-in losses, the existing statutory grant of regulatory authority to the Treasury appears to be broad enough to permit treating such items in this manner. See section 382(h)(6).

area where the target is an affiliated group and the target's common parent is a holding company. Revenue Ruling 85-197, 1985-2 C.3. 120, and Revenue Ruling 85¬198, 1985-2 C.B. 120, both involved pure holding companies whose wholly-owned subsidiaries were engaged in businesses. In analyzing whether the continuity of business enterprise standard was satisfied with respect to acquisitions of the holding companies, the Service ruled that the relevant business was that of the subsidiaries, and that the requirement was satisfied so long as the business was continued either directly or through subsidiaries (including through transfers of the business to subsidiaries of the acquiror). Thus, at least in the case where the subsidiary is wholly-owned and the parent is a pure holding company, the Service seems to have adopted a “look-through” approach to the continuity of business enterprise test.

In incorporating by reference the standard applied in the reorganization area, Congress appears to have implicitly adopted this look-through rule for section 382 purposes as well. However, even this approach does not deal adequately with some common situations in the section 382 area. For example, assume that a subsidiary has NOL carryovers, and that its business is not continued but that its parent's business is. It would not make sense to conclude that the subsidiary's NOLs are eliminated in such a situation, whereas in the reverse situation (subsidiary's business continued, but parent's business terminated) they are preserved, although this conclusion might follow from a strict look-through approach.*

One reason why the subsidiary's losses should not be eliminated when its business is discontinued but its parent's business is not is that, if the parent and the subsidiary had merged prior to an ownership change (regardless of the direction of the merger), the subsidiary's losses would not be eliminated under the business continuity rule following the ownership change (at least if the pre-change merger were independent of the ownership change). The parent’s business would presumably provide a sufficient continuing business enterprise. It is not sound policy to place a premium on the formality or happenstance of an intragroup pre-change date merger.

* Under a strict look-through rule, a parent holding company would be viewed as being in the business of its subsidiaries but not vice versa. It is not entirely clear how Revenue Ruling 85-197 and Revenue Ruling 85-198 would apply in the case where the parent is not a pure holding company but has a historic business of its own.

While reducing the importance of such formalisms is always a salutary objective, ultimately the method of application of the continuity of business enterprise requirement to an affiliated group should depend upon the requirement's purpose. If, as seems likely, the continuity of business enterprise requirement was intended to be an anti-abuse provision that serves to distinguish purely tax motivated acquisitions from transactions in which real businesses are being purchased, then the continuity of business enterprise standard should be applied on a consolidated basis. Under such a rule, the business enterprise standard would be satisfied with respect to the group (i.e., no member corporation's NOLs would be eliminated) so long as either (i) a significant business historically conducted somewhere within the group continued to be conducted, or (ii) significant historic business assets of a business anywhere within the group continued to be used in a business. A separate member approach carries the potential for unnecessarily harsh results for taxpayers who have legitimate reasons for operating businesses through corporate subsidiaries.*

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* Cf. section 382(1)(4)(E) which adopts a "look-through" rule for purposes of the "substantial non-business assets" test.

If, alternatively, the continuity of business enterprise rule in section 382 rested on the theory that losses should only be available to offset income from the particular business which generated such losses, cf. Libson Shops v. Koehler, 353 U.S. 382 (1957), then the appropriate rule would be one that looked to whether the business of each loss corporation in the group is continued, either directly or by another group member.* However, the legislative history of TRA 1986 indicates that Libson Shops is dead as applied to transactions subject to section 382. See Conference Report at 11-194. Moreover, a rule which applied the continuity of business enterprise test business-by-business would be inconsistent with the basic purpose of section 382 of permitting loss utilization following an ownership change to the same extent that such losses would have been usable had a change not occurred. In addition, any analysis of which particular business produced what amount of losses would raise complex issues of intercompany pricing and section 432 adjustments which would otherwise not arise in this

* This approach would be somewhat similar to that adopted in the regulations under prior law, which provided that, in determining whether a discontinued business was more than minor, consideration was given to whether such business had in fact produced loss carryovers. Treasury Regulation section 1.382(a)-1(h)(7).

context. For all these reasons, a business-by-business approach should not be followed.

F. “Anti-Stuffing” Rules

Section 382(1)(1) provides that capital contributions made within two years prior to a change date are disregarded in determining the value of the loss corporation. If a separate member-by-member approach is taken to determine the value of each loss member in an affiliated group, the anti-stuffing rule might be applied where, for example, within the two-year period, a parent has incorporated a new subsidiary, substantially expanded an existing subsidiary or simply made a capital contribution to a loss subsidiary. In fact, a transfer to a newly-organized subsidiary could result in a valuation of zero.

The purpose of the anti-stuffing rule apparently is to prevent the artificial inflation of the value of a loss corporation by pre-ownership change infusions of capital which the statute conclusively presumes represent the buyer's capital.* This should not be a concern where no additional capital is added to a change group and the value of the group is determined on an aggregate basis. Accordingly, the Committee believes that intra-group transfers of value should not be taken into account in applying the anti-stuffing rules of section 382(1)(1).

G. SRLY and CRCO Rules

The Committee wishes to take this opportunity to urge the Treasury to reconsider whether the SRLY and CRCO rules continue to be appropriate in the context of transactions governed by section 382. See 1986 Report at 1220.

In the event that an affiliated group acquires another affiliated group in a transaction that is an ownership change, then we believe that section 382 should be applied to the acquired group in the manner discussed in Part C.4. above, treating the acquired group as the change group and the acquiring group as the non-change group. As a result, the pre-change losses of the acquired group could be used only to offset

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* If, contrary to our recommendation, a loss parent's value is calculated without taking into account its equity in a subsidiary, then the abuse which the anti-stuffing rules are intended to avoid would also appear to arise where a subsidiary has transferred assets, by dividend or otherwise, to a loss parent.

the hypothetical income of the acquired group (but would not be limited to the income of any particular corporation or group of corporations within the post-acquisition affiliated group). We believe that this is an appropriate result and that the imposition of further limitations under the SRLY rules is inadvisable. Similarly, if an affiliated group experiences an ownership change and subsequently acquires a new member, the section 382 limitation would limit the losses of the “old” group to the hypothetical income of the “old” group and the imposition of further limitations under the CRCO rules is not warranted.

If the Treasury determines that the SRLY rules should continue to apply, the Committee would still be in favor of a rule which computes and applies the section 382 limitation to a change group on a consolidated basis, and which avoids separate member-by-member section 382 limitations. Accordingly, each loss corporation would be permitted to use its SRLY losses only to the extent of the lesser of its own income or the unused portion of the consolidated section 382 limitation amount.

H. Bankruptcy Exception

Section 382(l)(5) provides special rules for a loss corporation in a “title 11 or similar case.” In general, section 382(l)(5) applies where a loss corporation under the jurisdiction of a court in a title 11 or similar case undergoes an ownership change but the shareholders and “old and cold” creditors of the loss corporation own, immediately after the ownership change, at least fifty percent of the value and voting power of the stock of the loss corporation (or stock of a controlling corporation also in bankruptcy). If section 382(l)(5) applies, the loss corporation is generally exempted from the section 382 limitation; however, section 382(l)(5) requires certain reductions in the NOLs and tax credits of the loss corporation. Several aspects of this rule in the context of related companies remain unclear.

1. First, why does the parenthetical language in section 382(l)(5)(A)(ii) use the phrase “in bankruptcy” rather than in a “title 11 or similar case”? There is no apparent reason to single out bankruptcy in this one situation. It is likely that the phrase “in bankruptcy” was intended simply as a shorthand reference to a “title 11 or similar case.” We recommend that the reference be clarified in accordance with

this interpretation. This could best be accomplished by a statutory amendment.

2. Second, how is the fifty percent test applied where creditors of a parent and subsidiary receive stock of the parent? For example, assume that pursuant to a joint plan of reorganization under chapter 11 of the Bankruptcy Code, forty-five percent of the stock of a parent corporation P is issued to “old and cold” creditors of P and forty-five percent to “old and cold” creditors of its wholly-owned subsidiary S (with the remaining ten percent either going to other creditors or being issued to new investors). By its terms, section 382(1)(5)(A)(ii) applies to S if the shareholders and creditors of S receive at least fifty percent of the stock of P or S. However, the section does not provide expressly that P creditors will be treated as S creditors for this purpose. Also, the statute does not expressly treat creditors of S as creditors of P for purposes of applying the fifty percent test to P. Accordingly, it is possible that the special rules of section 382(1)(5) would be unavailable to either P or S. This seems to be the wrong result, at least with respect to S.

The basic premise of section 382(1)(5) is that creditor claims against a loss corporation in a title 11 or similar case represent disguised equity, and it is therefore appropriate to count debt that is exchanged for stock as if it had always been stock in measuring continuing ownership of the corporation. Section 382(1)(5) treats debt of S that is exchanged for stock of P the same as if such debt had been exchanged for stock of S, presumably on the ground that the stock of P represents an indirect continuing interest in S (because P controls S). This reasoning would suggest that “old and cold” creditors' claims against P that become stock of P should also count favorably toward the fifty percent test as applied to S because those creditors have a continuing indirect interest in S through P. By contrast, creditors of S who receive stock of P did not have an interest in P before the exchange (assuming P did not guarantee S's debt), so that arguably it would not be appropriate to take account of the P stock they acquire for purposes of applying section 382(1)(5) to P. We recommend that “old and cold” creditors' claims against any corporation that is in a title 11 or similar case be counted toward the fifty percent test as applied to any loss corporation that is in such a case to the extent that those claims are exchanged for stock of the loss corporation or a controlling corporation and would have represented direct or indirect ownership interest in the loss corporation prior to the exchange if they had been stock rather than debt.

The argument for treating creditors of S as creditors of P for purposes of applying the fifty percent test to P is perhaps somewhat stronger if S and P file a consolidated return than if they do not. However, given our general view that the ownership change definition should be applied separately to each member of an affiliated group, we do not believe that the filing of consolidated returns as such should be given much weight in resolving this issue.

If one corporation guarantees a debt of another corporation, the Committee believes that the holder of that debt should be treated as a creditor of the guarantor as well as of the primary debtor for purposes of applying the fifty percent test to each regardless of the relationship between the corporations. This approach takes account of the economic reality that a guarantee claim is equivalent to a primary obligation where the issuer of the guaranteed obligation is in a title 11 or similar case. To determine whether the guaranteed creditor is an “old and cold” creditor of the guarantor corporation, the eighteen month holding period (if relevant) should be computed by looking to the underlying debt but should not commence prior to the granting of the guarantee. Thus, in the above example, if P had originally guaranteed the obligations of S, the “old and cold”- creditors of S would also be treated as if they were “old and cold” creditors of P (assuming P did not file its title 11 or similar case before S or that the eighteen month holding period requirement is otherwise met as to P).

3. The reference in section 382(1)(5)(A)(ii) to “shareholders” of the loss corporation should be interpreted to include indirect shareholders, or at the very least shareholders of a controlling corporation. Clearly, ownership of stock of a controlling corporation that continues through a title 11 or similar case should count favorably toward the fifty percent test as applied to the controlled corporation.

Also, the term “shareholder” should be read to include holders of preferred stock that is described in section 1504(a)(4), notwithstanding that such stock is generally not treated as “stock” for purposes of measuring an ownership change.(see section 382(k)(6)). It would be absurd to count claims of creditors and holders of “stock” favorably for purposes of the fifty percent test, but not to count holders of straight preferred stock. Because section 382(k)(6) defines “stock” but not shareholder, it is easy to reach the proper result even under a literal reading of the statute.

4. The meaning of “controlling corporation” in section 382(1)(5)(A)(ii) should be clarified. Is control for this purpose fifty percent, eighty percent or some other number? Is only voting power taken into account, or is value also important? When must the requisite control exist? Section 382(c) defines the term “control” for purposes of part V of subchapter C, which includes section 382, but does not, in so many words, define a “controlling corporation.” Cf. sections 368(a)(2)(D) and (E). We believe that a controlling corporation should include a corporation that controls a subsidiary (however control is defined) indirectly through intermediate corporations, at least if the parent owns an indirect interest in the subsidiary that would amount to control if it were held directly.

5. Finally, suppose that some members of an affiliated group are in a title 11 or similar case and meet the eighty percent test in section 382(1)(5)(A)(ii), but other members of the group are financially sound. How should the ownership change definition be applied to those other members? As stated above, we believe that the ownership change definition should be

applied separately to each group member. Such a member-by-member approach might suggest that section 382(1)(5) should be ignored in deciding whether solvent corporations have experienced ownership changes. However, if the theory underlying the provision is that creditor claims against a corporation in a title 11 or similar case that are exchanged for stock should be treated as if they had always been stock for purposes of measuring changes in ownership of that corporation, there is no obvious reason why that theory would not apply for purposes of measuring indirect changes in the ownership of subsidiaries of that corporation even though the subsidiaries are financially sound.

The comments in paragraph 1 through 5 above suggest that the exception for title 11 or similar cases should be rewritten to apply the normal definition of ownership change, with the exception that all stock of, and “old and cold” creditor claims against, corporations in a title 11 or similar case would be treated as “stock.” This is the general approach that we recommended in our earlier report.[*] If this is not done, it may be necessary to incorporate into section 382(1)(5) many

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[*] 1986 Report at 1240.

of the features of the general ownership change definition in order for the section to work properly in complex circumstances.

I. Proration of Income For the Year of Change

Section 382(b)(3) provides that if a change date occurs during a taxable year, section 382 will not apply to limit the use of pre-change losses against the taxable income allocable to the period during the year before the change date. Until regulations are issued, taxpayers must allocate taxable income ratably to each day in the taxable year unless they obtain a private letter ruling permitting them to close their books as of the date of the ownership change. See I.R.S. Notice 87-79.

In the case of an affiliated group, the issue arises as to whether, in the case of an ownership change affecting more than one member of the group, the ratable allocation method should be applied based on the taxable year of the common parent of the group and the group's consolidated income or loss, or to the taxable year and income or loss of each member. The question becomes relevant, for instance, where a new member joins or an old member leaves a consolidated group, where a new member is formed by the contribution of assets formerly held directly by an old group member, or where an old member is liquidated into another old member that remains in the group. The Committee believes that the ratable allocation method should be applied at the group level.

A consolidated group approach would be consistent with our general recommendations regarding the application of section 382 to affiliated groups. See Part IV. C., above. It would also be consistent with the rule that permits a consolidated group to use the NOLs of a subsidiary for the group's full taxable year, even when the subsidiary leaves the group in the middle of the year and its year terminates.

A member-by-member approach could encourage manipulation because it would result in different tax consequences depending on whether assets are held directly by the common parent corporation or through subsidiaries. The acquisition or sale of directly held assets does not affect the taxable year of the acquiror or seller and all income generated from the assets would be allocated with reference to the full taxable year of the group. By contrast, in the case of assets held through a separate subsidiary, the taxable year begins and ends when the corporation joins or leaves the group of that subsidiary. If the pro rata allocation were made based on the taxable year of each member, a profitable subsidiary could be liquidated shortly after an ownership change in order to avoid any allocation of its income to the post-change period.

J. Non-Consolidated Groups

How should section 382 be applied to affiliated groups of corporations that do not file consolidated returns. This can occur either because the group does not elect to file a consolidated return, or because one or more members of the group are described in section 1504(b) and hence are not "includible corporations."

The rationale for our proposed consolidated approach to the members of a change group that file consolidated returns is to approximate the results that would have applied had an ownership change not occurred. However, where a parent corporation P and its subsidiary S do not file consolidated returns, S is a separate taxpayer from P. More particularly, S is subject to tax on its own income and neither S nor P can offset its losses against the income of the other. Accordingly, in order best to match the result that would have obtained absent an ownership change, we recommend that section 382 limitations should be calculated and applied separately to S and P even if they both experience an ownership change at the same time.

In applying section 382 on a separate-company basis, S would have a section 382 limitation based on the net value of its assets. The calculation of the section 382 limitation for P is more troublesome. One approach would be to calculate P’s limitation based on the value of all of P's assets, including its S stock. This approach might be criticized on the ground that the value of S's business would then be counted twice, toward the separate limitations applicable to each of P and S. An alternative approach, which avoids any “double-counting,” would be to exclude the value of unconsolidated subsidiaries in computing a parent corporation's section 382 limitation.

The Committee favors the first approach. We see no reason to distinguish between equity in an unconsolidated subsidiary and any other asset of a loss parent corporation. While the value of the unconsolidated subsidiary would be counted both for purposes of its own limitation and that of its parent, this is not objectionable where each corporation is a separate taxpayer, whose income is determined separately and may only be offset by its own losses.

It could be argued that a non-consolidated parent and its eighty percent owned subsidiary are effectively one taxpayer because the parent may be entitled to a one hundred percent deduction for dividends received from the subsidiary. However, this deduction is not equivalent to allowing either corporation to offset its losses against the other's income. Moreover, the argument proves too much. A rule that excluded assets that do not currently produce fully taxable income from the value used in determining the owner's section 382 limitation would indicate that tax-exempt bonds and (to the extent of the ‘seventy percent or eighty percent dividends-received deduction) portfolio stock should be similarly excluded. There is no hint in the text or legislative history of section 382 that this result was intended.

If two or more affiliated corporations that did not join in a consolidated return (either because they were ineligible or did not elect to so file) subsequently file a consolidated return, some adjustment may be necessary to avoid the double-counting if during the consolidation period both of the corporations are subject to separately computed pre-consolidation section 382 limitations. For example, assume that in 1988 P owns one hundred percent of S, and that P and S do not file consolidated returns. The value of the equity of S is $100, and P has net assets of $100 in addition to its interest in S. Assume further that P and S both have NOLs. At the beginning of 1988, there occurs an ownership change with respect to both P and S. Assuming a long-term tax-exempt rate of ten percent, the section 382 limitation is $10 for S and $20 for P. If, for subsequent taxable years, P and S elect to file consolidated returns and are permitted to offset their pre-change losses against all income of the group,* (or if they are combined into a single entity by means of a merger or otherwise) an adjustment should be made to ensure that a maximum of $20 of pre-change NOLs per year can be used to offset post-change income.

V. Additional Issues Related to Valuation of Stock

A. Per Share Value

The examples in the Regulations assume that each share of stock of a corporation has the same fair market value as each other share of the same class. We recommend that this principle

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* Under current law, the SRLY rules would prevent S from offsetting its losses against income of P. P could offset its losses against S's income under the "lonely parent" rule.

be adopted as a substantive rule to avoid disputes as to the effect of different concentrations of ownership of stock or transfer restrictions on per share values. The test of an ownership change is arbitrary and mechanical, and we believe that the advantages in terms of simplicity of assuming that each share of stock of a given class represents the same proportion of the total value of that class are overwhelming.

The Conference Report at 11-187 states that where a block of stock of a corporation is purchased at a price that reflects a control premium, it would not be appropriate simply to gross up the amount paid for the premium block to determine the value of the entire class of stock. We believe that the approach in the Conference Report is correct for purposes of determining the value of an entire class of stock. In suggesting that each share of a class be considered equal for purposes of measuring an ownership change, we are not denying the fact that control premiums exist, but rather suggesting that, solely in determining whether an ownership change has occurred, the administrative cost of attempting to measure differences in per share values is not worth the bother.

B. Fluctuations in Value

Section 382(1)(3)(D) states that except as provided in regulations “any change in proportionate ownership which is attributable solely to fluctuations in the relative fair market values of different classes of stock shall not be taken into account.” The Regulations do not include any regulations limiting the scope of this rule. Two points are worth noting about this rule. First, it applies except to the extent it is limited in regulations; thus, it is currently in effect. Second, the rule appears to be a very narrow one because of the use of the word “solely.” If it is true that it is a narrow rule in the first instance, we do not think that it should be further limited through regulations. On the other hand, it would be useful to include some examples in the final regulations illustrating the rule.

To illustrate how the rule appears to operate, suppose that L has outstanding two classes of stock: common and participating preferred. There are one thousand shares of preferred stock outstanding. All of the L stock is owned by A and has been for some years. B purchases all of the common stock at a time when its value is forty percent of the aggregate value of both classes of stock. The common stock increases in value over time with the result that, two years after the purchase by

B, the common stock comes to represent more than fifty percent of the value of all outstanding stock. Because the change in the proportion of the value of all outstanding stock owned by B is attributable solely to a change in value, under section 382(1)(3)(D), no ownership change results. This result might also be reached by examining the definition of ownership change. Under section 382(g), an ownership change can occur only if there is an equity structure shift or an owner shift involving a 5- percent shareholder. The change in value of the preferred stock is clearly not an equity structure shift, and it would be an owner shift involving a 5-percent shareholder only if the increase in value were considered to be a “change in the respective ownership of stock” within the meaning of section 382(g)(2)(A). It is un-likely that a change in value would be treated as a change in ownership for this purpose. The effect of section 382(1)(3)(D) appears to be only to confirm that something more than a fluctuation in value is needed in order to have an ownership shift. This approach is followed in the Regulations in that a testing date does not occur solely because of fluctuations in value.

To illustrate the narrow scope of section 382(1)(3)(D), suppose in the example above that two years after the date of purchase of the common stock by B, B purchases a single share of preferred stock from A. It appears that an ownership change would occur in these circumstances (combining the purchase of the common stock and preferred stock) because the change in proportionate ownership by 5-percent shareholders is not attributable “solely” to the increase in the value of the common stock. Suppose instead that the one share of preferred stock is purchased by C, who is unrelated to A or B. Apparently, the result would be the same. The purchase by C (a “public” 5-percent shareholder) requires that the increase in ownership by 5-percent shareholders be tested anew, and it would make sense to use the current values of the L stock in determining whether an ownership change has occurred. Such an approach would be consistent with Example (3) in the Conference Report at 11-175. To simplify the facts somewhat, in that example, an investor purchased stock of L that represented less than fifty percent of its outstanding stock. Subsequently, L re-deemed part of its stock and the redemption increased the percentage of the outstanding stock purchased by the investor to the point where an ownership change occurred; thus, the proportionate interest represented by the purchased stock was measured based on conditions at the time of the later owner shift.

If the reading of section 382(1)(3)(D) above is correct, then the revaluation of stock may be required because of a trivial change in ownership — an extreme example being that posed above where a single share of stock was purchased. We recommend that consideration should be given to a *de minimis* exception, which could probably be adopted through regulations. Such exception could provide, for example, that no revaluation is required unless and until the ownership shifts that would otherwise trigger the revaluation (together with all prior shifts subject to the exception) exceed, say, two percent.

VI. Corporate Contractions

Section 382(e)(2) states that if a redemption occurs in connection with an ownership change, the value of the loss corporation shall be determined after taking such redemption into account (*i.e.*, shall be reduced by the value of the assets distributed by the corporation in the redemption). A similar rule, of uncertain purpose, applies under section 382(h)(3)(A)(ii) in determining net unrealized built-in gains and losses.[*] Section 382(m)(4) authorizes the issuance of regulations “providing for the treatment of corporate contractions as redemptions for purposes of subsections (e)(2) and (h)(3)(A).” The Conference Report offers no guidance as to the likely content of these regulations.

The Bluebook indicates that the term redemption in section 382 will be given a broader than normal construction. Footnote 35 at page 316 reads as follows:

> It was intended that the redemption provisions would apply to transactions that effectively accomplish similar economic results, without regard to formal differences in the structure used or the order of events by which similar consequences are achieved. Thus, the fact that a transaction might not constitute a “redemption” for other tax purposes does not determine the treatment of the transaction for purposes of this provision. As one example, a “bootstrap” acquisition, in which aggregate corporate value is directly or indirectly reduced or burdened by debt to provide funds to the old shareholders, could generally be subject to the provision. This may include cases in which debt used to pay the old shareholders remains an obligation of an acquisition corporation or an affiliate, where the source of funds for repayment of the obligation is the acquired corporation. See section 382(m)(4), relating to corporate contractions.

Instead of relying on regulations to implement the principles described in the Bluebook, the Technical

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[*] Part III of this report comments on this rule.

Corrections Bill would amend section 382 by adding “or other corporate contraction” after “redemption” each place it appears in subsections (e)(2) and (h)(3)(A), effective as if included in TRA 1986.* The explanation of the provision in the House Ways & Means Committee report on the House-passed version of H.R. 3545 follows the footnote in the Bluebook.**

Ordinarily, the value of a loss corporation is determined immediately prior to an ownership change. Thus, if a loss corporation redeems its stock before the change date, the resulting decrease in the corporation's net worth is automatically taken into account in determining its value under section 382(e). Apparently, the original purpose of the redemption rule was to reduce the significance of the order in which related steps occur by treating a redemption that was contemplated at the time of an ownership change as if it had taken place prior to the change date. The corporate contraction rule outlined in the Bluebook goes further and in some cases effectively treats as an obligation of the loss corporation debt

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* We question whether this is appropriate for a technical correction (with an effective date as if including in TRA 1986), since it really does represent a substantive change.

** H.R. Rep. No. 100-391 at 1179.

that was actually incurred by someone else.

We have a number of comments on the redemption/corporate contraction rules. First, we believe it would be unfair to shrink the value of a loss corporation by the amount of assets distributed in a redemption without also taking account of any related contributions to capital. For example, suppose that P purchases sixty percent of the stock of L, resulting in an ownership change. Pursuant to a plan, L incurs short-term debt to redeem the remaining forty percent and subsequently P contributes additional capital to L (not attributable to any borrowing) to permit L to repay the debt. If the reduction in L's net worth resulting from the redemption is temporary, we believe that it would not be appropriate to reduce its value (except possibly for the period in which the value is in fact reduced). Stated differently, the redemption should be offset by the related capital contribution.* Although capital contributions that are made in anticipation of an ownership change are normally ignored under the anti-stuffing rule out of a concern

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* The 1986 Report at 1235 similarly recommended that the amount of capital contributions that is eliminated under the anti-stuffing rule be reduced by the amount of distributions. The Conference Report at II-189 authorizes such offsets under regulations.

that they may artificially inflate the value of L, that concern is not present where the purpose of a capital contribution is to replace funds used to effect a redemption.

Our second comment relates to the scope of the corporate combination rule. The Bluebook suggests that the corporate contraction doctrine will be applied to transactions that accomplish results that are economically similar to a redemption, and gives as one example a case where (1) debt is incurred by an acquisition corporation or an affiliate, (2) to provide funds to the loss corporation’s' shareholders, and (3) the loss corporation is the source of funds for repayment of the obligation. These three tests raise a number of interpretative questions.

Ah unstated premise of the redemption rule is that redemptions reduce the taxable income of the loss corporation that can potentially be offset by its losses. In a case where assets of the loss corporation are used to effect the redemption, those assets are no longer available to generate income for the corporation; where the redemption is funded through a borrowing by the loss corporation, its taxable income will be reduced by interest deductions.* In light of this premise, a strong argument can be made that the corporate contraction rule should be applied to debt incurred by an "acquisition corporation or affiliate" only where the borrower will join in a consolidated return with the loss corporation. Only in those cases would the purchase of L stock and the borrowing be "economically similar" on an after-tax basis to a redemption by L.

The second of the three tests suggested in the Bluebook (that debt be incurred to provide funds to old shareholders) is presumably needed to satisfy the statutory requirement that a redemption (or under the Technical Corrections Bill, corporate contraction) occur "in connection with an ownership change." The standards used in applying the definition of corporate acquisition indebtedness in section 279(b)(1)(A) may be of some help here. Needless to say, a test that looks to the reasons

* The Bluebook at 296 explains that the purpose of the section 382 limitation is to restrict the use of losses to an amount of income approximating the income that would have been earned if there had been no ownership change. It states that consideration was given to calculating the section 382 limitation based on the gross value of the loss corporation's assets, but that this approach was rejected because interest on debt is deductible (and thus reduces the taxable income generated by a given amount of assets).

for incurring debt is inconsistent with the notion that money is fungible and may be difficult to administer. On the other hand, if the purpose of the corporate contraction doctrine is only to catch cases that closely resemble a redemption, then it may be useful to have a purpose test in addition to the source of repayment test.

The last of the three tests is that the loss corporation be directly or indirectly burdened by the debt in question, or, stated differently, that it be the source of funds for repayment of the debt. Obviously, from the standpoint of the acquiror, an acquired corporation will always be viewed as the source of repayment of additional debt incurred to buy its stock; otherwise, the acquisition would not have taken place. In order to make sense of the third test, it should be applied from the perspective of the debt holders. Are these holders lending against the stock or assets of the loss corporation or against the borrower's other assets? If the borrowing is secured, the nature of the security would be one factor indicating the expected source of repayment. To the extent that debt is unsecured (or is secured by the stock or assets of the loss corporation and other assets), we suggest that the debt be offset first against the assets of the borrower other than the loss corporation. Thus, debt would be used to reduce the value of the loss corporation only to the extent such debt exceeds the value of those other assets. Under this rule, if P borrows to buy stock of L and P has no substantial assets other than L stock, the debt (if it otherwise falls within the corporate contraction rules) would be offset almost entirely against the value of L. On the other hand, if P has other assets with a value equal to the amount of the debt, then none of the debt would reduce L's value. Obviously, a rule that offsets debt first against other assets is more favorable to taxpayers than a pro rata rule or one that offsets debt first against the loss corporation's value. We believe that the more lenient rule is all that is needed to identify cases that are truly similar to redemptions.

One consequence of the corporate contraction rule is that it creates a significant tax bias in favor of acquisitions of loss corporations by substantial companies, or foreign companies that can finance an acquisition outside the United States, and against bids by management or venture capitalists. We have some doubts as to whether this policy was consciously adopted by Congress in enacting section 382.

If debt that otherwise falls within the corporate contraction rule is replaced by equity pursuant to a plan in effect at the time of the ownership change, then we believe that the debt should be ignored (or the value of the loss corporation should be restored when the debt is eliminated). This might occur, for example, if P purchases one hundred percent of the stock of L, finances the purchase with equal amounts of equity and debt, sells fifty percent of the L stock to another investor and uses the sale proceeds to retire the debt. Also, P might borrow with the intention of retiring the debt with a new stock offering.

If the purchase of L stock with debt of P is treated as a redemption where the transaction is economically equivalent to a redemption, then perhaps an actual redemption of stock by L should not be subject to the redemption rule where the transaction is economically equivalent to a purchase of L stock by P with its own capital (for example, where the redemption is funded with a loan made by P to L out of unborrowed funds and P owns one hundred percent of L stock following the redemption).

Appendix A

Comparison of Proposed Rules Defining a 5-Percent Share-holder with Regulations.

This appendix describes the differences between the Regulations and the five rules proposed in part B.1 of the report relating to the definition of a 5-percent shareholder and outlines the changes in the Regulations that would be required if those rules were adopted.

Paragraph (f): Under the proposed rules, the definitions of first tier entity, higher tier entity, and all of the variations thereon, public owner and 5-percent owner would be dropped. The same concepts would be preserved by proposed rule 2.

Paragraph (g)(1): The definition of 5-percent shareholder would be simplified as described in rule 1. There seems to be no need to refer in the definition to the different types of public groups. Also, the limitation on the need to identify individual owners indicated in paragraph (g)(1)(i) would follow from substantive rules and would not have to be repeated as part of the definition of 5-percent shareholder.

Paragraph (g)(2): This paragraph generally states that a person shall be treated as constructively owning stock of the loss corporation pursuant to paragraph (h)(2) only if the loss corporation stock is attributed to such person in the person's capacity as a higher tier entity or a five percent owner of the first tier entity or higher tier entity from which such stock is attributed. However, the paragraph also states that nothing therein shall limit the attribution of loss corporation stock under section 318(a)(2) and paragraph (h) to a public owner. This paragraph is somewhat confusing, in that the categories of small owners for which attribution is restricted would be public owners. Perhaps the intent is to say that those small owners will not be separately identified. If so, this result would follow directly from proposed rule 2a, and the statement would be unnecessary.

Paragraph (g)(3): This paragraph states that, in the absence of actual knowledge, any direct or indirect ownership interest of a 5-percent shareholder will be counted only if each such interest amounts to five percent or more. This result would follow directly from proposed rule 2a, and the statement would be unnecessary.

Paragraph (h)(2)(iii)(A): This paragraph states in effect that any entity that is not the loss corporation, or the owner of five percent or more of the stock of the loss corporation, will be treated for purposes of section 1.382-2T as an individual who is unrelated to any other other owner (direct or indirect) of the loss corporation. This rule is the same as the second sentence of proposed rule 2.

Paragraph (j)(1)(ii): This paragraph states that each public group that is treated as a 5-percent shareholder will be treated as one individual. Its purpose is uncertain. If it is intended to ensure that it will not be necessary to- inquire into the identities of members of a public group, that purpose would be achieved by proposed rule 4.

Paragraph (j)(1)(iii): This paragraph generally provides that the members of each public group are presumed to be unrelated to any other owners of stock of the loss corporation, and thus is similar to proposed rule 4. The rule could be stated much more simply than in paragraph (j)(1)(iii).

Paragraph (j)(1)(iv)(A)-(B): These paragraphs provide for the identification of public groups of first tier or higher tier entities that own at least five percent, and the combination of those groups with the public group of the next higher tier entity. We do not understand why it is necessary as a general matter to separately identify different public groups that own stock of the loss corporation through an entity. Also, as noted above, we disagree with the approach of combining stock held by a public group of a first tier entity with a public group of the loss corporation. Thus, we would eliminate these paragraphs.

Paragraph (j)(1)(iv)(C): This paragraph provides for the aggregation of the public shareholders of the loss corporation into a public group. Such a rule is needed. The paragraph goes on to state that such a group will be treated as a 5-percent shareholder without regard to the amount of stock which it owns. This result would follow directly from the definition of 5-percent shareholder and is unnecessary here. The last sentence of the paragraph calls for the combination of a public group of a first tier entity that owns less than five percent of the stock of the target with the public group of the target. As already noted, we disagree with this result.

Paragraph (j)(2): We would retain the segregation rules in this paragraph with a few changes. First, there would be no need to state here that a direct public group will be treated as a 5-percent shareholder (paragraph (j)(2)(iii)(A)), or that different public groups are presumed to have no common ownership (paragraph (j)(2)(iii)(B)) since these results would follow already from proposed rules 1 and 4.

Paragraph (j)(3)(i): The segregation rule that applies in paragraph (j)(3)(i) to dispositions by individuals that own directly five percent or more of the stock of the loss corporation or by first tier entities would be the same except that the reference to first tier entity would be changed to any entity owning stock in the loss corporation (because any entity owning less than five percent would be treated as an individual under proposed rule 2(a)). It would be helpful to clarify that in the case in which an ownership interest in a higher tier entity that owns five percent or more of the loss corporation, or a first tier entity, is transferred to a public owner or five percent owner who is not a 5-percent shareholder, "applying the principles" of paragraph (j)(3)(i) means counting only transfers by 5-percent shareholders, and not all transfers by five percent owners of the entity.

Paragraph (j)(3)(iii): Paragraph (j)(3)(iii) (other transactions affecting direct public groups of a first tier entity or higher tier entity) would be replaced with a rule stating that for purposes of measuring changes in the ownership of any entity (after applying proposed rule 2a) following a segregation transaction affecting that entity, public groups of that entity will be segregated in the same manner as if it were the loss corporation, provided the loss corporation has actual knowledge of that transaction.