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THE DESTINY OF NET OPERATING LOSSES

JAMES S. EUSTICE
GERALD G. PORTNEY

Two of the fundamental concepts in the tax system, (1) that each corporation is a separate taxpayer, and (2) that each tax year is a distinct reporting period-trigger the need to resolve how to deal with the averaging function for businesses that have operating losses in some years and profits in others, or businesses that have net losses over a period of years. Section 172 of the Code provides the averaging mechanism — the net operating loss carryover. When corporations change businesses, when shareholders change, and when one corporation acquires another (often lured by unused loss carryovers), Congress and the courts have imposed special restrictions on the use of these loss carryovers to offset other income.

Professor Eustice opens the discussion with a description of the 1976 amendments (not yet fully operative) to section 382, and the history of other provisions as a back-drop to the proposed changes by the Senate Finance Committee Staff Report. His outline, Appendix A to his talk, provides us with a comprehensive roadmap to the limitations proposed, including how they would operate in practice.

Mr. Portney then considers the reform proposals for the net operating loss carryover and the types of considerations that merit discussion in choosing the appropriate restrictions on carryovers. Mr. Portney presents a strong case in favor of simplicity. He argues also that the statute should restrict the use of corporate acquisitions for the purpose of obtaining loss carryovers and suggests methods for accomplishing that sort of restriction.

Professor Eustice then discusses alternatives for limiting loss carryovers, one based on the purchase price of the business and the

other based on the future income stream from the pool of capital in existence at the time of the acquisition. Noting that the former is his personal favorite, he nevertheless would be favorably inclined toward the latter if it is more politically feasible for the reason that he believes it is time for a conclusion to the long and exceedingly complicated struggle to define the limits on the use of net operating loss carryovers.

CARRYOVER OF CORPORATE TAX ATTRIBUTES

JAMES S. EUSTICE*

At this present moment (April 27, 1984), the status of section 382 limitations on loss carryovers is in a very interesting posture. When Gerry and I were deciding how to split up our topic, one of the suggestions was that Gerry would take the effective date extender of the House Ways and Means committee and I would take the Senate effective date extender. In that way, we could leave after about three minutes.

Technically, we presently have in place half of the 1976 Reform Act legislation under section 382(b). It became effective on January 1 of 1984; the other half, section 382(a), is due to become effective on June 30, 1984. However, both of those provisions are due to be extended in the pending legislation which will roll both aspects of section 382 forward two more years, to 1986.¹ At one time there was an interesting little statutory gap in section 381 and section 382. I don't think it would have been wise to exploit it, but for a short period of time in early 1984, there were no technical limitations on the type-G insolvency reorganization. The 1976 Act had become effective, but didn't mention the type-G reorganization by name (for the obvious reason that it was drafted before we had this type of reorganization). Some people were running around saying let's do insolvency acquisitions quickly before they find it. But, they found it, so that particular game is over before it really began.²

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1. This proposal passed; see Tax Reform Act of 1984, § 62(a), Pub. L. No. 98-369, § 861, 98 Stat. 494, 678 (1984) (amending § 806(g) of the Tax Reform Act of 1976 (26 U.S.C. 382)).

2. See Tax Reform Act of 1984, § 62(b), Pub. L. No. 98-369, § 861, 98 Stat.

Despite Assistant Secretary Pearlman's statement at lunch that the Treasury Department wants to do something about section 382 (anything just so they can stop thinking about it), we will attempt to explore some of the possible reform proposals that have been advanced on how to revise the loss carryover rules of present law. By present law, I mean the pre-1976 Act rules of sections 269 and 381. As some would say, this may well be the most punishing of all the Subchapter C related sports. The fundamental problem here, I believe, has been eluded to both publicly and privately. Other recent, more limited legislative efforts (i.e. the Installment Sales Revision Act of 1980,³ the Bankruptcy Tax Act legislation in 1980,⁴ even the Subchapter S Revision Act of 1982⁵) were, on the whole, essentially consensus group efforts; not totally, and not on every point, but there was a broad spectrum of agreement that this was the way to go, and certainly so on the fundamentals. That is not the case with net operating losses, despite the current flurry of proposals based on the ALI project. Even the ALI project was, initially at least, not a clear consensus product. This lack of consensus makes it extremely unlikely that Congress will be able to devise a solution to the loss carryover problem that everyone loves, or at least doesn't hate excessively. The important point here, as in many areas of the tax law, is that there probably is no "right answer." It is equally clear, however, that there should be *an* answer, which is definitely not the case now.

When talking about a corporation's tax history, one is really describing the obverse of its economic history. I'll elaborate on that. If you are having a bad economic year you are creating good tax history, with such things as loss carryovers, carrybacks, ITC carryovers and a host of other things that are valuable under our present tax system. If you are having a good economic year you are creating a bad tax history, i.e., earnings and profits, appreciated assets, etc. The question of course is what can we do, or what should we allow to be done, with that tax history? Is it assignable? Or is it perpetually locked into the persons or entity that generated it?

I'm going to talk primarily about tax losses, because that's the major element in this game. We really have three functionally different types of tax losses depending primarily on their maturation. By that I mean, if they have already been sustained and have not been currently consumed, in either the present year or by carryback, they create a carryover deduction for the future, which now lasts for

494, 678 (1984) (Retroactive technical amendment to § 382(b) adding type-G reorganization limitations).

3. Installment Sales Revision Act of 1980, Pub. L. No. 96-471, 94 Stat. 2247 (1980) (amending I.R.C. § 453 and § 453(B)).

4. Bankruptcy Tax Act of 1980, Pub. L. No. 97-34, 95 Stat. 172 (1980).

5. Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669 (1982).

fifteen years. Another element in the tax loss scene, however, is economically accrued potential, or "built-in" losses, viz., high-basis-low-value situations. These are somewhat fluid, in that a taxpayer can claim those losses whenever he decides to dispose of the property in a taxable event. Finally, the third type of losses are those that arise in the future from continuing operations. The tax rules of the present system and even those of future proposed systems deal differently with all three types of losses.

Moreover, the current tax regime and many of the reform proposals to be mentioned today as well, contain certain basic analytic themes and factors, such as the form or structure of the acquisition. That has always been a significant factor here. While not conclusive, it has been essential to the tax characterization of the transaction. Namely, whether the transaction is taxable or tax-free, whether it represents an acquisition of assets or of stock, and which particular entity survives the transaction, have all made a difference, still make a difference, and will probably continue to make a difference under any of the various reform proposals. Furthermore, the continuity of shareholder proprietary interest is, to a varying degree, an equally and in some respects, a more important consideration in this area, as is the continuity of historic business enterprise concept. Although the latter has occupied a somewhat lesser role. Here too, we have to think of this latter concept in three variations. One could focus primarily on the particular business unit, or division, a concept derived from the *Libson Shops*⁶ case, which first articulated that view. There is also a statutory business continuity rule which is still present in section 382(a). This rule, unlike *Libson Shops*, focuses on the character or type of business activity which must be continued. The regulations under section 368 impose an additional "historic" business continuity requirement as a condition for tax-free reorganization treatment. In many of the transactions to be discussed today, you cannot have a carryover (nor, for that matter, survival of the history) if you don't have an underlying tax-free reorganization. Finally, we have those general judicially based doctrines of business purpose, tax motive, tax windfall, and step transaction, stemming from the landmark *Gregory*⁷ decision. These doctrines attempt to limit overly aggressive transactions to prevent taxpayers from obtaining unwar-

6. *Libson Shops v. Koehler*, 353 U.S. 382 (1957) (no carryover of losses generated by one business to profits of another business).

7. *Gregory v. Helvering*, 293 U.S. 465 (1935) (transaction with no business purpose fails as tax-free reorganization).

ranted tax results.

The present statutory and regulatory regime limiting or dealing with the negotiability of tax benefits (particularly losses) can be classified broadly into two principal types of limitation. The so-called automatic, or rule-of-thumb, provisions, which do not depend for their application on state of mind or intent, and those where a tax avoidance intent is necessary for application of the statute. Foremost among the former type of limitation is section 382. Moreover, the consolidated return regulations are another example of automatic non-state-of-mind limitation provisions. On the other hand, section 269 is the paradigm of a tax-motive-based section. If you do something, or try to do something for the wrong tax motives, then the statute allows the Commissioner to take away the hoped for tax benefits. Section 367(a) was also (at least until recently) a tax avoidance-motive-based provision. Before getting into the details of these various limitations, however, I think a short page of history is instructive here. It's hard to remember where we are without recalling from where we've come.

Essentially, the chronology of the loss carryover area breaks down into at least three major geological periods. The pre-1954 code years, in which it is safe to say that form was triumphant. This was the age of "entity-identity" dominance, represented by the *New Colonial Ice*⁸ and *Metropolitan Edison*⁹ decisions. Starting in 1954, however, there was a significant downgrading of the entity theory. We are still operating (and are likely to continue to do so, at least through 1985) under the 1954 Code regime. This system is comprised of sections 381 and 382, which are both relatively mechanical provisions dealing with various forms of acquisition, both taxable and tax-free, back-stopped by the state-of-mind provisions in section 269. There has been no material change in those provisions for thirty years. There have been attempts, primarily in 1976, but no significant changes have yet been made in that structure.

Following the 1954 Code, however, we have several key dates. The decision in *Libson Shops*¹⁰ in 1957, which articulated what I call the "schedular" tax limitation regime (that each separate trade or business unit is forever locked with its own tax loss history). That, however, was a case involving a 1939 Code year, and it immediately became a point of controversy as to what extent *Libson Shops* applied under the 1954 Code. I think today it seems to be relatively well-settled that it probably doesn't apply, but there is a lurking possibility that it does. Certainly the Service thinks that there is still

8. *New Colonial Ice v. Helvering*, 292 U.S. 435 (1934).

9. *Helvering v. Metropolitan Edison Co.*, 306 U.S. 522 (1939).

10. *Libson Shops v. Koehler*, 353 U.S. 382 (1957).

some role for *Libson Shops*. The committee reports in 1976 refused to kill it completely, so I think you would be excessively optimistic to say you can forget about it altogether. It's still out there in the minds of the IRS and it's clearly lurking in several examples in the section 382(a) regulations. Moreover, until last year this principle was evident in the type "F" reorganization carryback cases,¹¹ but TEFRA repealed the multiple corporate "F" reorganization possibility in 1982. The Service had gradually conceded that you could have loss carrybacks in multiple corporate type "F" reorganizations, but they and several courts applied *Libson Shops* tracing limitations.

Another significant date during this period was the restructuring of the consolidated return regulations in 1966. These new regulations adopted an elaborate regulatory limitations system, the key to which is one of my favorite acronyms (in view of its function), the *SRLY* limitation. This concept is essentially a *Libson Shops*-type limitation applied to a subsidiary rather than to a division. The consolidated return regulations operate automatically, without regard to motive or intent, and clearly backstop the 381 and 382 provisions.

The year 1976, however, was the beginning of the third major phase of the loss carryover tax chronology, the complete rewriting (in conference) of section 382. This provision began as a relatively minor amendment to section 382 in the Senate bill, but came out of conference as a wonderously baroque and fearsomely intricate piece of legislation. It did, however, have a two-year delayed effective date so they could think about it some more. This is now turning into the longest delayed provision around. This process usually leads to eventual repeal, which is apparently going to happen with generation-skipping and in fact happened with the carryover basis rules. At least it put in place an alternative system for dealing with net operating loss carryovers. The dominant theme of this provision, in fact its only theme, was primacy of the shareholder continuity of interest test. Everything else was irrelevant: corporate identity, business continuity, and historic business no longer were important; the only thing that counted for tax history survival was shareholder continuity.

The Bankruptcy Tax Act of 1980¹² was also a significant event for the loss carryover system. Until the 1980 revision, an insolvent debtor could avoid taxation on its so-called negative profits, that is, the gain arising from extinguishment of its debts at a bargain price,

11. See, e.g., *Commissioner v. National Tea Co.*, 83 T.C. 8 (1984).

12. Bankruptcy Tax Act of 1980, Pub. L. No. 96-471, 94 Stat. 2247 (1980).

without any toll charge for that amnesty, other than a reduction of its bases (and you could finesse that problem in a variety of ways). The key to the 1980 bankruptcy amendments was that debtors now will have to pay a toll charge in order to exclude debt discharge income, other than merely reducing basis. This change consists of a reduction in the debtor's loss carryovers, followed, in a descending order of priority, by a reduction in other enumerated tax benefits. This system is analogous, in many respects, to the toll charge system that is imposed on outbound and inbound transfers under section 367.

In 1981, the life of loss carryovers was expanded to fifteen years, which gave taxpayers considerably greater time to take advantage of these benefits. Another key provision enacted in 1981, which is probably the engine that is really driving the attempts to revise section 382 was the ACRS cost recovery system. This legislation resulted in the allowance of huge depreciation deductions for capital intensive industries. As a result, many corporations quickly developed large pools of unusable tax losses, unlikely to be absorbed even over a fifteen year term. Safe harbor leasing (also enacted in 1981) provided a mechanism for the outright sale of these benefits. Its repeal in 1982 has resulted in renewed efforts by taxpayers to negotiate their tax losses that cannot be used effectively in the foreseeable future. Consequently, today we have a tax loss carryover system obviously ripe for review. There are at least five, and possibly more, different proposals for the reform of this area.

Before getting into those proposals, I would like to mention that the current law rules are summarized in Part III of the outline (see appendix). I don't want to spend any particular time on these provisions here, because that's not our function today; we are dealing with proposals to reform the loss carryover world, not describing the carryover world that is. I do want to call attention, however, to one particular gap in current law that is about to be fixed by the pending 1984 legislation. At section B(2) of Part III of outline, a situation is described where a profit corporation buys a loss company's stock, and then tries to bring those losses into conjunction with its profits, a situation strongly inhibited by our current loss carryover regime.

Congress bore down rather heavily on the obverse of that situation in the 1982 TEFRA legislation. Some would say that Congress focused so hard on the hole that they forgot the donut, because they concentrated totally on the tax avoidance potential from loss company acquisitions of profit companies. Briefly, if the loss company liquidated the acquired company under section 332 or under section 382, all of its recapture income would be triggered, the tax basis for its assets would be stepped-up, but the resulting recapture income would be sheltered by the loss company's carryovers. This device was

stopped by the TEFRA legislation. What was overlooked, however, was the fact that if a profit company bought the stock of a loss company (the paradigm potential loss trafficking problem), but didn't elect section 338, then under the new 1982 statutory regime there was a mandatory carryover basis result. This brought with it all of the target corporation's tax history on a subsequent liquidation. Even more importantly, the new law effected a clear overruling of the step-transaction doctrine represented by *Kimbell-Diamond*.¹³ Thus, it readily became apparent that taxpayers could have a profit company, buy stock of a loss company, not elect section 338 (which you obviously wouldn't do here because that would purge the company of its tax history), upstream the target's assets in a section 332 liquidation (neither section 269 nor section 382 applied to this transaction), and everything was simply wonderful. Congress, by closing a "pin-hole," had brilliantly succeeded in opening a mega-loophole in the loss carryover limitation defense system.

At Part III, section B(2)(b)(iii) of the outline, however, there is a reference to the Tax Reform Act of 1984. This provision was in the Technical Corrections Bill, which started out in 1983 and is now in the 1984 legislation.¹⁴ There is a specific amendment to section 269, which would retroactively plug this particular gap.

With that I would like to turn matters over to my colleague, Mr. Portney who will tell us how he plans to deal with the "destiny of loss carryovers;" it will be billed as the fatalistic approach.

13. *Kimbell-Diamond Milling Co. v. Commissioner*, 14 T.C. 74, *aff'd per curiam*, 187 F.2d 718 (5th Cir. 1950), *cert. denied*, 342 U.S. 827 (1951).

14. See section 26 U.S.C. § 269(b) as amended by the Tax Reform Act of 1984, Pub. L. No. 98-369, § 712(i)(8)(A), 98 Stat. 494, 952 (1984).

APPENDIX A
CARRYOVER AND SURVIVAL OF CORPORATE TAX
ATTRIBUTES*

JAMES S. EUSTICE

I. *General*

A. *Table of Abbreviations*

- | | |
|--|---|
| 1. L | (“Loss” corporation, i.e., corporation having potential tax benefits (PTB’s), such as net operating loss carryover (NOL), high basis, low value assets, E and P deficit, etc.). |
| 2. A | (Shareholders of L). |
| 3. P | (“Profit” corporation, i.e., corporation that can make use of L’s tax benefits). |
| 4. section 381 | (Provision allowing carryover of PTB’s in certain types of tax-free acquisitions). |
| 5. section 382(a) (old) | (Disallow NOL of L if stock purchase causes a 50% change of ownership of L and if L has a “change of business” character within a certain time). |
| 6. section 382(b) (old) | (Reduce NOL pro tanto if A ownership of L or P drops below 20% as a result of tax-free “asset reorganization”). |
| 7. section 269(a)(1) | (Disallow L’s PTB’s if control, 50%, of L acquired for principal purpose of tax avoidance). |
| 8. section 269(a)(2) | (Disallow L’s PTB’s if a carryover basis asset acquisition for principal purpose of tax avoidance). |
| 9. <i>Libson</i> | (Supreme Court decision denying offset of NOL’s from one “business unit” against profits of another “business unit”). |
| 10. <i>Gregory</i> | (Transaction must have business purpose or economic reality aside from saving taxes; “sham” or “step” transaction won’t be accepted for tax purposes). |
| 11. “Proposed Amendments” (Tax Reform Act of 1976) | (Greatly tighten section 382 rules; also, significantly downgrade section 269; but not effective initially until 1978; extended until 1986). |

B. *Factors and General Themes*

1. Tax “losses” vary in respect of their “maturation”, viz.:
 - (a) sustained losses (carryovers),

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- (b) potential losses (high basis),
- (c) future operating losses, expected or unexpected.
- 2. Factors of Analysis:
 - (a) Forms of acquisition:
 - (i) taxable or tax-free,
 - (ii) stock or assets,
 - (iii) who survives (entity-identity aspects);
 - (b) Continuity of proprietary interest (viz., shareholders' continuity):
 - (c) Continuity of business enterprise:
 - (i) *Libson* "units" aspects,
 - (ii) "Character" of business aspects,
 - (iii) Regs. section 1.368-1(d), historic business or historic business assets continued (necessary for reorganization status);
 - (d) Business purpose, tax motive, and tax windfall aspects.
- 3. Statutory and judicial defenses to negotiation of PTB's:
 - (a) Automatic rules of thumb (no "scienter" here):
 - (i) Sections 381, 382, 383, Con. Ret. Regs.;
 - (ii) *Libson Shops*;
 - (b) "State of mind", or rules of general principle (intent rules):
 - (i) Sections 269, 367;
 - (ii) *Gregory, Knetsch, Goldstein*, et al.

II. Historical Chronology—Key Dates

A. 1939 Code Years

1. 1934 - *New Colonial Ice* (entity emphasis)
2. 1939 - *Metropolitan Edison* (merger)
3. 1942 - Consolidated Return Regs.
4. 1944 - Section 269 (state of mind - tax avoidance)
5. 1948 - *Alprosa* interlude (form triumphant?)

B. 1954 Code Years

1. 1954 - Statutory system for attribute carryovers
 - (a) Section 381
 - (i) Transactions, section 381(a) (section 332 and section 334(b)(1), and section 368(a)(1) A, C, D, and F)
 - A. But not Bs and not "divisive" Ds.
 - (ii) Operating rules, section 381(b)
 - A. New importance for Type F reorg.
 - (iii) Specific items, §381(c) (selective list)
 - (b) Section 382 limitations (objective) (apply only to NOLs though)
 - (i) Stock purchase and business character change
 - (ii) Asset reorganization - minimum continuity line of 20% (relative size test)
2. 1957 - *Libson Shops* (division and business unit quarantine)
 - (a) *Rev. Rul. 58-603* (not apply if section 381)
 - (b) *Rev. Rul. 59-395* (application to '39 Code years)
3. 1963 - *Rev. Rul. 63-40* (*Libson* and '54 Code - no section 381) (*Textron* pattern)
4. 1964 - Multiples legislation, sections 1561-1563
5. *Maxwell Hardward* (*Libson* not apply to '54 Code)
 - (a) *TIR 773* contra (expanded section 382 notions)
6. 1966 - New Consolidated Return Regs. (SRLY et al.)
7. 1969 - Multiples tightened again

8. 1971 - Section 383 (expanded list of items subject to section 382)
 9. 1975 - IRS gives up on NOL carrybacks after "expanded type F", *Rev. Rul. 75-561*
 10. 1976 - TRA of 1976⁴ (*see generally*, JSE, 32 Tax L. Rev. 113 (1977))
 - (a) Tightened section 382 (but delayed effective date)
 - (b) Loosened section 172 (seven-year carryover; waiver of carryback)
 - (c) Comm. Rep. downplay section 269 and *Libson* - reserve for "special cases"
 - (d) Section 382 continues to be delayed (until 1985; but section 382(b) *now* effective)
 11. BTA of 1980
 - (a) Expand section 381 for insolvency Reorgs. (Type G)
 - (b) But debt discharge gain "absorbs" attributes, §108(b)
 - (c) *See generally*, JSE, 36 Tax L. Rev. 1 (1980)
 12. ERTA of 1981
 - (a) Expand NOL and ITC carryovers to fifteen years
 - (b) Section 168(f)(8) safe harbor leasing rules allow "negotiation" of certain tax benefits (ACRS deductions and ITC)
 13. TEFRA of 1982
 - (a) Section 338 for section 334(b)(2) (history purged)
 - (b) No section 338, then section 381
 - (c) Multiple F's gone (query *Aetna* and *Bercy Inds*?)
 - (d) Section 269A - anti-*Keller*
 - (e) Phaseout of safe harbor leasing rules
 14. 1983 - SFC Staff Report on Reform of Subchapter C
 - (a) New section 382 based on ALI "pool of capital" approach
 - (b) Repeal section 269
 15. 1984 - TRA of 1976 section 382(b) becomes effective
- III. *Transactions - General Patterns and Principles*
- A. *Tax-free Acquisitions*
1. P acquires L assets in tax-free "A" or "C" reorganization:
 - (a) Section 381 o.k. (but L's year "closes" so two years of NOL used up):
 - (i) Post-fusion carrybacks - generally no; section 381(b)(3); unless Type F (then allow, but *Libson* tracing limits, *Rev. Rul. 75-561*);
 - (ii) For "expanded" view of "F" where fusion of commonly controlled operating companies, *see Aetna Casualty*, and *Home Construction*;
 - (iii) But TEFRA limits "F" to single operating company;
 - (iv) *Bercy Inds.* (triangular "A" functional equivalent of "B" for carrybacks); maybe survive TEFRA amendments too?
 - (b) Section 382(b) if A owns less than 20% of P after reorganization (but can avoid by having an 80% subsidiary of P make the acquisition for stock of P, i.e., "triangular" merger deal):

- (i) Query section 368(a)(2)(E) reverse merger (functional “B” reorg.?), *see Bercy Inds.*;
 - (ii) Proposed Amendments to section 382(b) (raise continuity to 40%; also eliminate triangular escape);
 - (c) Section 269(a)(2) if P acquires L for tax avoidance;
 - (d) *Libson* not applicable because section 381, *Rev. Rul. 66-214*; but *see Rev. Rul. 75-561 (Libson still apply for carrybacks)*.
2. P acquires L stock in “B” reorganization and:
- (a) P and L file a consolidated return (CR):
 - (i) CR Regs apply SRLY *Libson*-type limits (*i.e.*, L’s PTB’s can only be used by L on a CR); but future losses generally usable in CR;
 - (ii) Section 269(a)(1) could either disallow use of CR by P and L or could disallow L’s use of its PTB’s (*Hall Paving Co.*);
 - (iii) Proposed Amendments to section 382(b) - apply 40% test here too;
 - (b) Or P liquidates L tax-free under section 332:
 - (i) Section 381 o.k. on P liquidation of L (purges SRLY and ELA);
 - (ii) IRS says (*Rev. Rul. 67-274*) “steps” a disguised “C” reorganization so section 382(b) and section 269(a)(2) apply — but if “steps” respected (*i.e.*, if transaction was a “B” reorganization followed by an independent section 332 liquidation), neither section 382(b) nor section 269 apply; *see Resorts Int’l, Inc.* Also, above step rule *not* preempted by TEFRA repeal of *Kimbell-Diamond*;
 - (iii) Query *Libson*? IRS says “yes” if “change of L business” ala section 382(a) but courts so far say “no”;
 - (iv) Note, Proposed Amendments to section 382(b) would dilute L’s NOL’s at first step;
 - (c) Or P merges “downstream” into L (same as (b) above), *Rev. Rul. 70-223*; *Rev. Rul. 76-36*;
 - (d) Or P “builds up” L by adding assets, feeding in new business, or general competence:
 - (i) Section 269(a)(1) or (2) could apply but “business purpose” ought to protect, *see Glen Raven Mills*;
 - (ii) Section 482 might “dilute” L’s PTB’s if dealings between P and L cause reallocation of income or deductions of either P or L; watch non-arm’s length terms - will trigger new prices per section 482 clear reflection;
 - (iii) Section 382 not applicable and *Libson* probably o.k. here too;
 - (iv) But Proposed Amendment to section 382(b) loses NOL’s pro tanto if continuity drops below 40%.
3. L acquires P assets in “A” or “C” reorganization:
- (a) Section 381 o.k. (*re* P’s attributes), but no “double” NOL year as in 1(a) above;
 - (b) Section 382(b) and section 269(a)(2) (“reverse” acquisition) apply;
 - (i) Proposed Amendments - raise continuity line to 40%;

- (c) *Libson* “no” says IRS. *But cf. Rev. Rul. 75-561* (for carrybacks).
 - 4. L acquires P stock in “B” reorganization and:
 - (a) L and P file CR:
 - (i) Section 269(a)(1) could deny CR or use of PTB’s if tax avoidance (*Hall Paving Co.*);
 - (ii) CR Regs silent here (*i.e.*, no *Libson*-type limits) unless transaction constitutes a “reverse acquisition” (*i.e.*, P in substance has acquired L because of relative size), which will trigger SRLY rules;
 - (iii) Proposed Amendments apply section 382(b) to “B” reorg. (and apply 40% continuity line);
 - (b) Or L liquidates P under section 332:
 - (i) Section 269(a)(2) and section 382(b) if “steps” collapsed and transaction a disguised “C”;
 - (ii) If separate steps respected, *Libson* only worry, and that’s nominal here;
 - (iii) but Proposed Amendments apply section 382(b) to “B” reorgs.;
 - (c) Or L merges “downstream” into P (same as (b) above).
 - 5. Note that in all of above transactions if reorganization (or other tax-free) status denied (or “rearranged”) ala *Gregory*, PTB’s could be lost because:
 - (a) No section 381 unless “A” or “C” reorg. or a section 382 liquidation:
 - (i) *See* Regs. section 1.368-1(d) (1980) (continuity of business enterprise);
 - (b) and collapsing integrated steps can trigger limits of section 269 and/or section 382 (*Rev. Rul. 67-274*).
 - 6. Post-fusion carrybacks if Type F (*see* section 381(b)):
 - (a) *Rev. Rul. 75-561* (yes, through *Libson* tracing limits);
 - (b) *Triangulars - cf. Casco, Aetna, and Bercy* (functional Bs);
 - (c) But TEFRA limits “F” to single *operating* company.
- B. *Taxable Acquisitions*
- 1. P buys L assets for cash (or debt); no section 381 so PTB’s stay with L.
 - 2. P buys L stock and:
 - (a) P and L file CR;
 - (i) Section 269(a)(1), section 382(a) (if L “change of business”), and CR Regs SRLY rules (limit PTB’s to L’s own profits on the CR), *see Hall Paving Co.*;
 - (ii) Proposed Amendments to section 382(a) drop business continuity test;
 - (b) Or P liquidates L under section 332;
 - (i) No section 381 if section 334(b)(2) liquidation (*i.e.*, P gets “cost” basis for L assets rather than carryover); (section 338 election - same);
 - (ii) If “delay” so no section 334(b)(2), then L’s PTB’s carryover per section 381 and no section 269 or section 382 if stock purchase and subsequent

ret.):

- (c) L merges "downstream" into P:
 - (i) L PTB's carryover per section 381:
 - (ii) Section 269(a)(2) o.k. and so is section 382(b). *But cf.* Regs. section 1.269-6, Ex. (3) (common control exception not applicable here).

IV. Summary of Current Law

- L - Loss
- P - Profit
- A - Shareholders of L
- B - Shareholders of P
- PTBs (Potential Tax Benefits): NOLs (Net Operating Losses), BIDs (Built-in Deductions), deficits, etc.

Transactions

Limitations

I. Tax-Free (Reorganization)

A. Assets ("A", "C", "G"):

- | | |
|--|--|
| <ul style="list-style-type: none"> (direct) 1. L to P for P stock 2. P to L for L stock (triangular) 3. L to P's sub for P stock 4. P to L's sub for L stock | <ul style="list-style-type: none"> 381, 382(b), 269(a)(2) 381, 382(b), 269(a)(2) 381, 382(b), 269(a)(2), SRLY, BID 381, 382(b), 260(a)(2), SRLY, BID |
|--|--|

B. Stock ("B", reverse merger)

- 1. A to P for P stock:
 - (a) P & L file C.R., SRLY, BID, 269(a)(1)
 - (b) P liquidates L:
 - (i) separate steps No limits
 - (ii) collapsed steps, Same as A.1.
 - (c) P merges down into L, Same as B.1.(b)?
- 2. B to L for L stock:
 - (a) L and P file C.R., If reverse acq., same as 1(a)
 - (b) L liquidates P, Same as A.2.

Transactions

Limitations

II. Taxable (Purchase)

A. Assets

- 1. L to P for cash:
 - (a) L stays alive, PTBs stay with L (no 381)
 - (b) L liquidates, PTBs disappear
- 2. P to L for cash, No limits (*Rev. Rul. 63-40*)

B. Stock

- 1. A to P for cash:
 - (a) P and L file C.R., SRLY, BID, 269(a)(1), 382(a)
 - (b) P liquidates L, Same as A.1.(b), (if 338)
 - (c) P merges down into L, 269(a)(1), 382(a)
- 2. B to L for cash:
 - (a) L and P file C.R., No limits (L 338 of P)
 - (b) L liquidates P, Same as A.2. (if 338)
 - (c) L merges down into P 381, 382(b), 269(a)(2)

V. WHAT SHOULD BE DONE?

A. Possible Approaches

1. Free Trade, viz., no limitations (NOL's become a recoupment mechanism)?
2. Total quarantine, viz., no assignability? (e.g., ALI):
3. Some limitations:
 - (a) Pure objective "rules of thumb" (ala sections 381, 382);
 - (b) Pure "state of mind" (ala section 269); tax avoidance motive focus;
 - (c) Combination (present system).
4. Keep present system as is? Known devil better than unknown?
 - (a) Seems to work (or does it)?
5. Modify present system:
 - (a) Focus on objective shareholder ownership continuity (TRA '76 model)? ALI focus.
 - (b) Focus on business continuity (ala section 382(a), or *Libson*)?
 - (c) Focus on section 269 in terrorem?
 - (d) Apply toll charge (ala sections 367, 108(b), and add-on mini-tax)?
6. Integrate corporate-shareholder taxes?
 - (a) Have we already for large companies (ACRS and leasing)?
 - (b) Elective for close corporations (Sub. S and debt leverage).
7. Current refund (recoup in year of loss); see 76 N.W.L.Rev. 709 (12/81); Tax Notes, Vol. 21, No. 3, p. 209 (Oct. 17, 1983).

B. Discussion Points Re Possible Modifications - In General

1. What is section 172 all about?
 - (a) Averaging convention (lean years against lush years);
 - (i) Back (cash refund);
 - (ii) Forward (tax shelter);
 - (b) Subsidy for special interests (especially carrybacks);
 - (i) See section 172(b)(1)(C)-(I)
 - (c) Incentive for risk-taking (Gov't safety net - risk shared);
 - (d) Other, e.g., recoupment? See 76 N.W.L.Rev. 709 (1981).
2. Why is section 172 necessary?
 - (a) Annual taxable year convention (unfair not to allow spreads);
 - (i) Compare transactional reporting systems, e.g., completed contract, §453, etc.
 - (b) Progressive rate structure;
 - (i) But less so for corporations, §11(b)
3. Who "owns" section 172 benefit (and who should be entitled to it)?
 - (a) First loser only? ALI view.
 - (i) Should loss history be bankable and salable?
 - (b) Multiplication of taxable entity effect caused by present corporate tax system:
 - (i) Corporation a separate taxpayer, and its owners can change;
 - (ii) Public vs. closely held distinctions; (traceability?);
 - (iii) Pass-through entity - Sub. S (losses flow through to shareholder-owners);
 - (c) Form and type of acquisition aspects:
 - (i) Stock acquisition;

- A. Reorg. (blending of ownership)
 - B. Purchase (new owner)
 - (ii) Asset acquisition;
 - A. Reorg. (blending of business and ownership)
 - B. Purchase (fresh start)
- 4. Interface with Consolidated Return Regulation rules:
 - (a) Special "universe" for dealing with member tax attributes (e.g., SRLY, CRCO, RA, BID, DIT, ELA, etc.)
 - (b) Argument that Regs. should preempt sections 269, 382 limitation system?
 - (c) Double-dip potential if no consolidated return - *cf.* section 165(g)(3), *Textron* (P section 165 loss on investment in S, and S got section 172 carryover vs. new business income under *Rev. Rul. 63-40*).
- 5. Interface with new BTA attribute consumption rules of section 108(b):
 - (a) Toll charge imposed for debt discharge gains;
 - (b) "Leftovers" negotiable to new owners under court supervised plan? Should section 269 apply here?
- 6. Other relevant features of tax system bearing on NOL rules:
 - (a) Ordinary loss preferable to capital loss;
 - (b) Capital gain preferable to ordinary gain;
 - (c) Death "purge" of potential gains and losses - §1014;
 - (d) Split rate system for corporations and individuals — §1 (progressive), §11 (flat);
 - (e) Realizable event required for taxable gain or loss;
 - (f) Worthless losses of corporate stock and securities are usually capital losses (limited use);
 - (i) *But see* §165(g)(3) "affiliates" - *cf. Textron*;
 - (ii) *Also* §1244 (small);
 - (g) New section 385 Regs. encouraged "leverage" by close corporations (75% debt capital safe harbor); asking for trouble? Regs. dropped in late 1983;
 - (h) Expanding scope of Sub. S rules creating bigger pass-through system for close corporations.
- C. *ABA Tax Section Proposals*
 - 1. Initial proposal - Separate section 382(a) from section 382(b); move former to section 269, and keep latter in Subchapter C.:
 - (a) Section 269(a) subjective rule of present law retained;
 - (b) New section 269(b) objective rule based on old section 382(a) with modifications;
 - (i) Test group increased to 25 (but no section 318 attribution);
 - (ii) Proportionate scale-down if exceed 50% line;
 - (iii) Many of '76 Act exceptions retained;
 - (iv) Ownership continuity measured by all stock (except pure preferred);
 - (v) Change of business test retained;
 - (c) Section 382 would be confined to reorganizations and section 351 transactions;

- (i) Three-party reorg. rules of '76 Act included;
 - (ii) "B" followed by section 332 within two years treated as "C";
 - 2. Other aspects of ABA proposal:
 - (a) Fold section 383 into sections 269 and 382;
 - (b) Specific provision that *both* section 269 and section 382 can apply;
 - (c) Continuity lines of existing law (50% and 20%) retained;
 - (d) But this proposal dropped in mid-1981.
 - 3. Revised ABA proposal (1982) - go to exclusive *Libson Shops* objective limitation (business unit quarantine); "objective" only too (*i.e.*, drop section 269):
 - (a) Single continuity threshold for purchases and mergers (50%);
 - (b) If threshold is exceeded, then a disproportionate scale-down of tax attributes (with total elimination at 20%);
 - (c) Change of ownership test group is the ten largest shareholders (with section 318);
 - (d) Limitation would cover built-in deductions and losses (but *not* post-acquisition losses).
 - 4. New ABA proposal (1983) - go back to 1958 Advisory Group approach:
 - (a) Limit survival of carryovers to half the price paid for the stock or assets;
 - (b) Purpose to take the tax profit out of the acquisition by denying carryovers for acquisitions where price is paid for the tax attributes rather than for the business;
 - (c) Carryover would be allowed where acquisition was of a going business and tax attributes merely incidental to that acquisition;
 - (d) Under this proposal, value of the business (apart from tax benefits to be derived from the carryovers) must be at least three times the tax benefit, or 1-1/2 times the amount of the carryovers;
 - (e) For later version of this approach, *see infra* Part G.
- D. *ALI Proposal*
1. Principal thrust: allocation of post-acquisition earnings among parties to the acquisition, and N allowed only against earnings traceable to old capital interests of loss company ("poll of capital or joint-venture approach").
 - (a) Shift focus away from the NOL, and instead to the future earnings stream against which it may be deducted.
 - (b) *Libson*-type restriction based on "old" ownership during period losses sustained.
 - (c) If stock of loss company acquired by purchase NOL deductions limited to a specified rate return on the purchase price.
 - (d) Limitations would also cover new stock issued by loss company (but an exception for cash issues would allow earnings attributable to new capital equal to those allocable to old capital).
 - (e) Built-in deductions (*i.e.*, potential losses would be subjected to same limitations as sustained NOLs).
 - (f) Basic theme of ALI proposals is that NOL history (sustained or potential) belongs only to the owners of the

loss company that include such loss; thus, to the extent that new owners enter the loss corporation, its NOL history will abate pro tanto.

- (i) In effect, negotiation of loss history absolutely barred.
 - 2. New limitation proposals have the following features:
 - (a) Would replace section 269 and section 382;
 - (b) Would be purely automatic (no tax avoidance test);
 - (c) Would ignore business continuity;
 - (d) Seem heavily inspired by SRLY notions of Consolidated Return Regs.;
 - (e) No change proposed for divisive transactions;
 - (f) Post-fusion carrybacks allowable without section 381(b) limitation.
 - 3. Likelihood of enactment (*see* SFC Staff, *infra* Part H, which generally adopt ALI approach):
 - (a) Note tie-in to general acquisition proposal;
 - (b) Any less complex than present system?
 - (c) Assumes rational Congress?
- E. *Integration of Corporate-Shareholder Taxes*
- 1. If corporate tax eliminated, no need for NOL carryover rules at corporate level?
 - (a) But necessary to preserve system in order to compute shareholder-level income?
 - (b) Unless loss flow-through as well?
 - 2. Maybe already a rough form of integration in place now:
 - (a) Large corporations have ACRS, ITC and leasing;
 - (b) Close corporations have elective Sub. S or section 385 safe harbor leverage;
 - (i) PCs can zero out if *Keller* stands up, and did, 723 F.2d 58 (10th Cir. 1983);
 - 3. Likelihood of passage now - nil.
- F. *Stark Bill - H.R. 6295 (May, 1982)*
- 1. New focus on shareholder ownership continuity for loss generation year; viz., shareholders in loss year must maintain 60% ownership continuity to avoid denial of carryover. Thus, shareholders in loss year are only permitted owners of carryover.
 - (a) If drop below 20%, loss carryover totally eliminated; between 60% and 20% lines, lose 2-1/2 points of carryover per point of lost continuity.
 - (b) Continuity tests the same for taxable stock purchases and tax-free reorganizations:
 - (i) Also cover ownership shifts by redemptions and split-off divisions;
 - (ii) Only exception is for ownership changes by gift or death.
 - (c) Shareholder test group only deals with 5% or greater shareholders (with section 318).
 - 2. Technical details:
 - (a) Strong resemblance to TRA '76 special technical rules in section 382 (which provision would be repealed by new

- section 382 rules);
 - (b) Purpose of new section 382 is to prevent any significant (more than 40%) traffic in loss corporation ownership;
 - (c) Operative provisions are in section 382(a), (b) and (—)
 - (d) Special definitions - §382(d);
 - (e) Operating rules for stock acquisitions - §382(—);
 - (f) Operating rules for section 382 reorganizations - §382(f);
 - (g) Definitions of “stock” - §382(g).
 - 3. But this portion of Stark Bill deleted from later (July, 1982) scaled down version on grounds of prematurity and lack of time to adequately consider.
- G. *Bacon-Tomasulo (Purchase-Price Limitation)*
- 1. Based on the 1958 Advisory Group limitation approach which was keyed to the price paid for the acquired stock or assets, *supra*, part C. 4.
 - (a) Advisory Group proposed to limit carryover survival to only 50% of acquisition price, while this proposal would allow survival of carryovers in amount equal to the full acquisition price.
 - (b) Same limitation would apply taxable acquisitions of stock, tax-free reorganization acquisitions of stock or assets, to new issues of stock in exchange for new money or property, and to changes in control by redemption or recapitalization exchanges of existing shares.
 - (c) Limitation would be triggered by major control shift within a limited time period (*e.g.*, 50% within a three-year period).
 - (d) If less than total shift of control, price would be grossed-up to determine entire value of loss company.
 - (e) Purchase price limitation would be reduced by loss company's cash or liquid assets, by business assets contributed to capital within two years of triggering event (“anti-stuffing” rule to block inflation of acquisition price), and by proceeds of assets sales (other than in ordinary course of business) within five years after such event (business continuity limitation).
 - 2. For description of this proposal, including draft statutory language, *see* Tax Notes, Vol. 20, No. 11, p. 385 (Sept. 12, 1983).
 - 3. General comments:
 - (a) Simple to apply - mechanical and uniform as to stock and asset acquisitions;
 - (b) Limitation theory based on capital value of loss company, rather than income stream, business continuity or shareholder continuity;
 - (c) Query - too liberal (permits purchase of tax benefits in amount up to half of overall acquisition value - *compare* 1958 Advisory Group, *supra*, which was more restrictive).
- H. *Senate Finance Committee Staff Proposal*
- 1. Generally accepts ALI pool of capital approach, *supra* part D.
 - 2. Principal function of loss carryover rule is averaging:
 - (a) But proposal requires that loss carryovers must appropriately relate to the income that it offsets (*i.e.*, match carryover to the income stream from the pool of capital existing at the time of the acquisition);

- (b) Free trade in carryovers rejected as resulting in economic distortions and inefficient capital allocations.
- 3. Present law thought to be both too loose and too tight in its application (*i.e.*, allow some carryovers that shouldn't, and block others that shouldn't).
- 4. General goals of proposal:
 - (a) Tax neutrality;
 - (b) Limit carryovers to the same pool of capital that generated the loss (*i.e.*, no shift of benefits to "new capital" interests);
 - (c) Objective rules (greater administrative certainty); would replace subjective rule of section 269.
- 5. Dual limitation, depending on type of acquisition:
 - (a) "Purchase" rule (applies to stock acquisitions, redemptions, and carryover basis asset acquisitions for non-stock consideration);
 - (b) "Merger" rule (applies to qualified stock and asset acquisitions for stock consideration, and to ownership shifts by new issue of stock);
 - (c) Different rules for each, and both can apply to same acquisition if overlap.
- 6. Purchase rule (section 382(a) analogue).
 - (a) Transactions covered:
 - (i) Significant purchases of outstanding stock after a loss year (more than 50%, counting only five percent shareholders, with attribution);
 - (ii) Carryover basis asset acquisitions (of substantially all of target's assets) for consideration other than stock;
 - (iii) Redemptions (including *Zenz* combined purchase and redemption deals).
 - (b) If limitation threshold triggered, carryovers limited to an assumed rate of return based on price paid for acquired stock:
 - (i) Limitation starts in year following change of ownership trigger;
 - (ii) Unusable carryovers roll forward to following year (*i.e.*, deferred, not denied), and unused *limitation* for a year added to limitation in the following year;
 - (iii) Suggested rate of return, 125% of section 6621 rate;
 - (iv) Shareholder can increase his ownership by 50% without limitation as to such increase (except for purposes of the general 50% threshold trigger rule).
 - (c) Questions:
 - (i) Any time limit for measuring control shift?
 - (ii) Do recapitalization control shifts trigger limitation under redemption rule?
 - (iii) How about non-pro rata split-offs?
- 7. Merger rule (section 382(b) analogue).
 - (a) Transactions covered:
 - (i) Qualified asset acquisitions for stock with a carryover basis (*i.e.*, acquisition of "substantially all");

- (ii) Qualified stock acquisitions for stock (*i.e.*, acquisitions of “control”), including, for this purpose, triangular acquisitions; and
- (iii) Substantial ownership shifts through new issues of stock.
- (iv) Merger rule and purchase rule can overlap, *i.e.*, acquisition of assets for stock and cash - merger rule applies to stock portion, purchase rule to cash portion.
- (b) Exceptions to new stock issue rule:
 - (i) Pro rata stock issues,
 - (ii) Control shifts of 50% or less from loss year,
 - (iii) Stock issue worth less than 20% of all the corporation’s stock.
- (c) Qualified stock and asset acquisitions:
 - (i) Carryovers allowed against post-acquisition income stream attributable to loss corporation’s assets, based on portion of acquiring corporation’s stock issued in the acquisition (reduced by a statutory table).
 - (ii) *E.g.*: If 10% of acquiring corporation’s stock issued in the acquisition, allowable income percentage would be 5%; if 20% issued, allowable income percent is 10%; if 40% issued, income percent is 25%; if 50% issued, income percent is 35%; if 60% issued, income percent is 45%; and if 80% issued, income percent is 70%.
 - (iii) If preferred stock issued, carryovers limited to total annual yield on the preferred.
 - (iv) If the issuing corporation already has outstanding preferred stock, the allowable income limitation must be reduced by the grossed-up annual yield on that stock.
 - (v) Special rules to be provided to deal with hybrid stock, convertible debt, options, warrants, etc.
 - (vi) Acquiring corporate groups (*i.e.*, triangulars) apply limitation by including income of corporation issuing the stock and its direct and indirect subsidiaries (per stirpes).
 - A. If consolidated return filed by acquiring group, the limitation would be computed on a consolidated basis;
 - B. If consolidated returns not filed by group, limitation applied separately to the loss corporation.
 - (vii) Acquisitions by loss corporations trigger the merger limitation if loss company shareholder continuity drops below 80%.
- (d) New stock issues:
 - (i) Table limitation applied to percentage interest in loss company’s common stock remaining with loss year shareholders (*e.g.*, if loss corporation issues 25% of its stock to new investors, allowable post-issue income percentage would be 63.75%).
 - (ii) Initially exempted new issues can be subjected to new issue limitation if stock is subsequently transferred to outsiders.
 - (iii) New issues of preferred stock to outsiders will reduce

- offsetable income by the grossed-up annual yield on such stock.
- (e) Special rules:
 - (i) Built-in gains and losses: net built-in gains at time of acquisition will increase limitation in year of recognition; net built-in losses to be limited by regulations.
 - (ii) Query definition of built-in gain or loss (Report uses section 453, but how about long term contracts, order backlogs and the like?).
 - (iii) Stock issued to creditors - if loss year creditor, treat as a purchase of outstanding stock; if post-loss year creditor, treat as new issue of stock.
8. General comments:
- (a) Wither simplicity under this system? Note requirement to trace loss year shareholders, and value individual assets at time of acquisition.
 - (b) Query application where complex capital structure (*i.e.*, multiple classes of common, preferred, convertible debt, warrants, etc.)?
 - (c) Query whether repeal of section 269 is warranted or advisable?
 - (d) Treatment of creditor workouts contra to policy of recent Bankruptcy Tax Act amendments in 1980?
 - (e) Substituting a new and unknown mess for an old, but well-known, mess?

NET OPERATING LOSS CARRYOVER: REFORM PROPOSALS

GERALD G. PORTNEY*

INTRODUCTION TO NET OPERATING LOSSES

Each dollar of tax deductions claimed by a corporation currently saves 46 cents in federal income tax. Thus, the acquisition of a corporation with accumulated unused deductions (net operating loss carryovers (NOLs)) represents the potential for effectively earning tax-exempt income. The NOLs will offset the earnings resulting in no federal income tax liability. Thus, the stakes often involve substantial tax savings.

The survival and utilization of corporate NOLs involve many fundamental policy decisions including the taxation of the corporation separate and apart from its shareholders. To comprehend the debate on the implementation of limitations on NOLs in corporate acquisitions, it is at least helpful to understand the reasons for allowing NOL deductions, to consider who should benefit from the utilization of the NOL deductions and to discern the effects various limitations have on corporate acquisitions.

PURPOSE OF NOL CARRYOVERS

Annual Accounting Periods

Section 172¹ allows taxpayers a deduction for losses generated in future years (carrybacks) and prior years (carryforwards) to miti-

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1. All references and citations to sections are to sections of the Internal Revenue

gate the effect of the annual accounting period. Under tax accounting rules, the timing of expense deductions may not coincide with that of the income to which they relate. The carryover of losses recognizes the impreciseness of the annual accounting period. In *United States v. Bliss Dairy, Inc.*,² Justice O'Connor writing for the Court said: "Strict adherence to an annual accounting system would create transactional inequities. Often an apparently completed transaction will reopen unexpectedly in a subsequent tax year, rendering the initial reporting improper."³ The Court concluded that cattle feed correctly deducted under section 162 must be recaptured when distributed on liquidation — overriding section 336. Section 172, therefore, allows an averaging, albeit over a limited time frame, of a taxpayer's income and deductions.

Business Risk

NOL carryovers are intended to encourage business by allowing a partial recoupment of losses against past and future income. However, the NOL carryovers provide an advantage to established businesses because established businesses have prior taxable income to offset and receive immediate tax reimbursement. On the other hand, new business start-ups must wait until taxable income is realized before tax reimbursement. Thus, in the latter case, their NOLs have a value less than NOLs generated by an established business. Further, we note that this fact encourages conglomeration and consolidation as these allow for an immediate recovery of taxes by reducing taxes currently payable.

Government Partnership

Most businesses feel as if the taxation of their income is equivalent to having the government as a partner. Thus, the government must share in both good and bad times.

The Loss Itself

Since the government taxes business income, any business loss should be subsidized by the government regardless of what business incurred the loss and irrespective of who owned the business. Thus, any business expenditure should be available for tax refund. Subscribers to this theory believe that limitations on NOLs are unnecessary. No NOLs would exist since the government immediately refunds a portion of the loss — the notion of recoupment.

Code of 1954, as amended, unless otherwise indicated.

2. 460 U.S. 370 (1983).

3. *United States v. Bliss Dairy, Inc. decided with Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370, 377 (1983).

Recoupment supporters argue that if an unsuccessful company cannot claim the tax value of its unrecovered expenses (if the NOL expires under present law), then a taxation of future earnings is in reality a taxation of capital. Since a firm's capital is obtained from the investment of after-tax income of its shareholders, a double tax results when losses do not generate a tax benefit. Further, recoupment supports risk taking. Since losses are immediately subsidized there is no doubt or cost associated with whether or when the NOLs will generate a tax savings.

Opponents point out that recoupment encourages unprofitable businesses. In fact, businesses that represent economically unsound investments, will be encouraged. The current tax system encourages investments in businesses that are economically not viable. Recoupment would carry this to the Nth degree. Further, from a practical standpoint, recoupment is a budgetary impossibility.

OWNERSHIP OF NET OPERATING LOSS CARRY FORWARDS

The Business Owners

Of the possible "owners" of the NOLs, a strong argument can be made in favor of ownership by the shareholders of the corporation that generated the losses.

Since the shareholders are the ones with the capital at risk, are not they the ones who own the NOLs? In a proprietorship situation, the current tax system places the ownership of the NOLs with proprietor, regardless of whether or not the business that generated the NOLs is still owned by that proprietor. In theory, a loss corporation's shareholders stock value reflects the impact of the losses. Thus, to the extent the losses have any value, should not the shareholders receive that value?

Current law under section 382(b) (1954 version) adopts the view that the shareholders own the losses. Thus, in tax-free reorganizations, losses survive to the extent the shareholders of the loss company still own stock. The 1976 version of section 382⁴ ties NOLs to the corporation's shareholders for both purchases and reorganizations. The ALI⁵ and Senate Finance Committee⁶ adopt this view for

4. Tax Reform Act of 1976, Pub. L. 94-455, § 806(e), 90 Stat. 1520, 1599 (1976).

5. AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT SUBCHAPTER C: PROPOSALS ON CORPORATE ACQUISITIONS AND DISPOSITIONS (1982).

6. STAFF OF SENATE COMM. ON FINANCE, 98TH CONG., 1ST SESS., THE REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS (Comm. Print 1983).

reorganizations.

To some extent, those who advocate the free transferability of NOLs feel that the shareholders own the NOLs. If NOLs were freely transferable, then the shareholders would receive full compensation for the NOLs. With the current law uncertainty (e.g., section 269 and section 382(a)(1)(C) - same trade or business), shareholders of the loss corporation get very little value for their corporation's NOLs.

The Corporation

The necessary definition of a corporation includes these four criteria at Regulation section 301.7701-2(a)(1):⁷

- Continuity of Life
- Centralization of Management
- Liabilities Limited to Corporate Assets
- Free Transferability of Stock.

These features make the corporation an entity separate and distinct from its owners. As a result, the federal government taxes the income of corporations separate from the income of their shareholders. Thus, NOLs generated by the corporation are owned by the corporation to offset corporate income. Section 381 recognizes corporate ownership by providing for carryover in corporate combinations that are poolings for tax purposes.

In *New Colonial Ice Co. Inc. v. Helvering*,⁸ the assets of the loss corporation were absorbed by a new corporation, organized solely to take over the business of the loss corporation. The new corporation attempted to deduct the NOLs of the acquired corporation pursuant to what was probably an "F" reorganization. The NOL deductions were denied since the corporate charter of the loss corporation was surrendered and the new corporation was not the same taxpayer as the loss corporation, even though the business and the capital structure were identical.

In *Alprosa Watch Co. v. Commissioner*,⁹ all of the taxpayer's stock was sold to new owners, the historic business was discontinued (womens' gloves) and a new business started (jewelry). Since the corporate charter remained intact, losses generated by the discontinued business were allowed to reduce income generated by the new business.

7. All references and citations to regulations are to Treasury regulations under the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

8. 292 U.S. 435 (1934).

9. 11 T.C. 240 (1948).

Thus, NOL survival in corporate acquisitions was strictly tied to the survival of the corporate charter. Section 381, adopted with the 1954 Code, while tying ownership of NOLs to the corporation, did not base survival of losses on charter survival, but on the general requirements for a tax-free reorganization.

The Corporate Business

Since the business generates the losses and pays the tax, if section 172 is to ameliorate the annual accounting period, and if section 172 is to encourage risk taking, then the business that lost the money should be the business that benefits from the loss deduction.

In *Libson Shops v. Koehler*,¹⁰ statutory mergers of sixteen brother-sister corporations, each operating separate retail stores, were completed. Three of the corporations had NOLs that the surviving corporation attempted to deduct against post-merger income. The NOL deduction was denied since the stores that generated the NOLs continued to lose money after the merger and the losses would only be allowed to the business that incurred the loss.

Whether or not the death knell has been rung for *Libson* is not known. The Ninth Circuit stated *Libson* is not applicable to 1954 Code years in the decision *Maxwell Hardware Co. v. Commissioner*.¹¹ However, the IRS took a more limited view in Revenue Ruling 63-40 and agreed not to apply *Libson* if the shareholders of the loss corporation were substantially unchanged.¹²

Current section 382 (1954 version) provides NOLs of a corporation will survive a 100% stock purchase as long as the same trade or business is continued. However, the uncertainty in defining the same trade or business has left the standard in a state of flux. Regulation section 1.382(a)-1(h) states that all facts and circumstances determine if the business is unchanged. Thus, employees, plant, equipment, location, and customers are all factors to be considered. Example 2 continues the *Libson* theory. Also, current section 382, in asset acquisitions treated as reorganizations under section 368, indirectly adopts a business continuity standard—perhaps less stringent than that for stock purchases. Regulation section 1.368-1(d) requires business continuity in reorganizations.

10. 353 U.S. 382 (1957).

11. 343 F.2d 713 (9th Cir. 1965).

12. Rev. Rul. 63-40, 1963-1 C.B. 46.

MEASURING THE SURVIVAL OF NET OPERATING LOSSES

Recoupment of Losses

Immediate tax refunds for losses eliminates the need of section 172 and thus for any limitation measurement on NOLs in corporate transactions.¹³

Free Transferability of Losses

While losses would only generate tax savings when income is offset, no restrictions would apply. Thus, NOLs could be sold just like any other asset. This adopts the premise that the loss has separate existence and the stockholders are the owners of the loss.

Some Limitations on Loss Carryovers

Type of Limitations

On the assumption that section 172 is meant to perform an averaging function, some limitations are needed — whether by reference to the continuity of shareholders, business continuity or state of mind (section 269) or as under the present system, a combination of all of the above.

Objective Standards

Measuring the continuity of shareholders involves determining the period over which a change in shareholders should be measured. Further, how much continuity is required for NOL survival? Are NOLs like dividends paid pro rata on each share of stock or should some shareholder shifts be allowed in recognition that corporations are separate from the shareholders? Consider the tracing problems in publicly-held corporations as opposed to closely-held corporations.

Measuring business continuity could be made an objective standard.¹⁴ However, business continuity, whether as under current section 382(a)(1)(C) (1954 version) or *Libson* becomes a subjective analysis. Maybe safe harbors should be considered.

Subjective Standards

Section 269 looks to a taxpayer's state of mind to determine if NOLs still survive. However, see recent cases for problems in applying section 269.¹⁵ More recently, the 1984 legislation expanded 269

13. Campisano & Romano, *Recouping Losses: The Case for Full Loss Offset*, 76 Nw. U. L. REV. 709 (1981).

14. See, e.g., Rev. Proc. 84-22, 1984-1 C.B. 449, (for ruling purposes, in partial liquidations, a 20% reduction in employees, revenues and assets is required).

15. Princeton Aviation Corp. v. Commissioner, 47 TCM 575 (1983) and Fairfield Communities Land Co. and Affiliated Subsidiaries v. Commissioner, 47 TCM 1194

to apply to corporate liquidations within two years of a purchase of 80% or more of a corporation's stock by another corporation.

Transactions Limitations Should Consider

Limitations on NOL carryovers should apply both to taxable transactions such as purchases of corporate stock and purchases of corporate assets, which involve new business owners, and to tax-free stock acquisitions under section 368(a)(1)(B) and asset acquisitions under section 368(A)(1)(a), (C), (D), (G).

No Limitation, But Toll Charge

In sections 367, 108(b) and 56, in transfers to foreign corporations, in debt discharge in bankruptcy or insolvency, and in allowing certain tax benefits, a "price" can be extracted for favorable tax treatment. Perhaps NOLs should not be limited but, when utilized, a tax collected for allowing the utilization.

SUMMARY

The difficulties in determining the objective of NOL carryovers and in determining who should benefit from their utilization sets the stage for the current discussion surrounding the special limitations on NOLs under section 382. These alternative theories, in effect, "justify" the existence of the current complexity surrounding limitations in corporate acquisitions. Perhaps the approach should be to recognize that, for practical reasons, limitations will be implemented on NOLs so that acquisitions are not completed due to the tax benefits available. The NOLs are not the motivation for the transaction. Until an overall tax reform is completed, any limitation proposal should confine itself to that approach. Further, since the current law is frequently complex to implement and the 1976 changes to section 382 certainly expanded on that complexity, the proposal should contain one standard to be used for both taxable and tax-free acquisitions. The standard should simply and objectively apply to prevent acquisitions from being completed on the basis of the NOL deductions available.

ALTERNATIVES FOR LIMITING LOSS CARRYOVERS

JAMES S. EUSTICE*

On the loss carryover reform scene, we have a full plate of alternatives, including, of course, the possibility that we do nothing, on the grounds that at least we're reasonably familiar with what we currently have under the existing regime. Nobody is sure we can ever draft a statute that astute practitioners won't be able to get around pretty quickly. At least, we've had the benefit of 30 years of experience with the present version. It's far from perfect, but it's not the worst thing that could happen here. On the other hand, we do have a wide range of reform proposals that are at least worth summarizing.¹

Starting with the various ABA Tax Section Proposals,² which pretty well cover the waterfront here, the drafters initially began with a relatively minor project focused on a technical tune up of section 382 and section 269, but did not envision anything terribly radical. This proposal consisted mainly of moving sections around to different places in the code and revising various technical features of those sections. It was not, however, a major conceptual revision of the loss carryover rules. But in 1982, they came up with something that was considerably more radical; they proposed adoption of a pure business continuity limitation, based essentially on the *Libson Shops*³ case approach. What Gerry would call the "owner" of the

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1. See Nichols, *Net Operating Loss Carryovers and Section 382*, 22 TAX NOTES 609 (1984).

2. ABA Tax Section Proposals (unpublished) (discussed at part V.C. of the outline *infra*).

3. *Libson Shops v. Koehler*, 353 U.S. 382 (1957).

tax loss under this approach would be the particular business unit that produced it. The net effect of this proposal would be similar to adopting a schedular tax system for business profits and losses. These limitations would be triggered, however, only if certain statutory thresholds were exceeded. In fact, all of these proposals to limit loss carryovers require certain triggering thresholds, i.e., major changes of ownership within a defined period of time. That will be common to everything mentioned this afternoon. If it is the same corporation with the same shareholders, none of these proposed limitations will change anything; by that I mean no new capital infusions, no redemptions, and no indirect shifts of ownership. Normal stock trading would be permitted, so long as a major control shift did not occur within a relatively short time frame.

This second phase ABA proposal⁴ lasted about one year, after which they reached back into the mists of time to the 1958 Advisory Group Report on Subchapter C.⁵ This proposal, like the 1958 Advisory Group Report, was essentially a purchase price limitation. In other words, the acquiring company would be entitled to claim loss carryovers of the acquired company equal to one half of the purchase price paid for that company. This limitation would insure that taxpayers would only be buying a business, rather than favorable tax benefits of the target, based on the economics of the acquisition. With this type of limitation, taxpayers would be “overpaying” if they were just trying to buy tax losses.

I would like to skip the ALI proposal for a moment, because that blends in with the current thinking of the staffs of the Joint Committee and Senate Finance.⁶ Another possibility here would approach the loss carryover problem from an entirely different perspective. If you had basic corporate tax reform, which in a major way (not a minor way) integrated the corporate and shareholder tax systems, the corporate loss carryover problem would be eliminated. Adoption of the full flow-through rule would turn corporations into pass-through entities. Then you would find out who the true owner of the tax losses are. They are not the corporation, but the owners of the corporation would obtain the direct and immediate benefits of those losses. That is, of course, what happens in the case of a sole proprietorship. That is also what happens in the partnership arena in Subchapter K; and it is also what happens to a pass-through entity such

4. ABA Tax Section Proposals “second phase” (unpublished)(discussed at part V.C. of outline, *infra*).

5. *Revised Report of the Advisory Group on Subchapter C* [December 8, 1958] SPECIAL (CCH) (March 3, 1959).

6. STAFF OF JOINT COMM. ON TAXATION, 98TH CONG., 2D SESS., DESCRIPTION OF PROPOSAL ON CARRYOVERS OF NET OPERATING LOSSES (Comm. Print 1983); STAFF OF SENATE COMM. ON FINANCE, 98TH CONG., 2D SESS., THE REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS (Comm. Print 1983).

as a Subchapter S. The losses pass through to the owners and are claimed directly by them to the extent that they have sufficient income to absorb these losses (if not, the losses carry forward at the owner level).

We may, in a sense, already have a crude form of integration in place under current law. Large corporations have ACRS and the investment tax credit, which go a long way towards eliminating the corporate tax, particularly for capital intensive corporations. Safe harbor leasing is gone, together with the possibility to sell the benefits to those who could use them. Under that regime, it was possible to say that we had created the chance for corporate America to have one gigantic consolidated return. That is what safe harbor leasing in effect accomplished. This, of course, created a severe perception problem, regardless of how much the economists were pained by its demise. I think that is why something had to be done to the safe harbor leasing rules and why something has to be done to the loss carryover area as well. I doubt if you will ever see free transferability of tax losses, for the same reason that you did not see the continuation of safe harbor leasing; it just looks bad, regardless of whether it is bad. It looks bad and therefore free transferability just isn't going to happen.

For the small corporations, of course, we have a wide variety of de facto integration techniques, all of the self-help variety. Election of Subchapter S, which is now much easier and covers a much wider range of possibilities, is the most straightforward path to eliminating taxability at the corporate level. If you want to play games with debt leverage, which one does now at one's peril after the demise of the section 385 regulations, large portions of corporate level income can be sheltered by the interest deduction. I could never understand the tax bar's resistance to the section 385 regulations. I didn't see how it was possible for the Treasury to give away any more that it gave on those regulations. That is what makes me nervous about some current reform proposals. Whenever I see the tax bar more or less united (by more or less united, I mean not open and rampant hostility), then I start to get worried. I think that we may be giving away too much of the store. The abortive section 385 regulations seem to me to have been a classic example of that process. But if you want to take a chance on high debt leverage, a significant portion of corporate income can be sheltered by interest deduction. Personal service corporations, on the other hand, can still effectively zero out. That's

the message of the *Keller* case:⁷ put everything possible in the pension plan and take the rest of the corporate profits as compensation. Thus, the corporation is merely a "funnel." Although we now have section 269A to restrain this practice for the future, everybody that was in the trough was grandfathered so they can cheerfully keep feeding.

The likelihood of formal integration passing, at least this year, is nil. I am not so sure about the future; but present indications are that integration involves a major loss of revenue, which renders this an extremely remote prospect for the near term at least. Once we get the deficits down under a couple of trillion, maybe then they will think about it.

Finally, I want to mention the Stark Bill,⁸ part of an earlier version of the 1982 TEFRA legislation, that was being generated by the House during the summer of 1982. I call this the "Son of the 1976 Act" because it was based largely, if not predominantly, on the 1976 provisions, with some technical tightening of those provisions. The key for survivability of carryovers under that proposal was shareholder continuity. Like the 1976 proposals, it also adopted a unitary test for all forms of acquisition, a single continuity line. If you violated that line you started a disproportionate consumption of the corporation's tax history. It didn't make any difference how the acquisition was structured. Due to the excessive legislative activity that was in progress, however, this legislation was tabled on the grounds of being premature, and more time was necessary to think about the loss carryover problems. We have all been thinking about this problem for some time, but in any event it was shelved.

We are left with the combination of the ALI reform proposal and the Finance Committee Staff proposal. This proposal is heavily, if not predominantly, based on the ALI proposal, to which I would like to turn after mentioning briefly one other alternative reform proposal.

I mention it only briefly because the current congressional staff thinking (and perhaps even at Treasury as well) is not infatuated with this proposal, on the grounds that it may give up too much. But I find, on simplicity grounds alone, it is my personal number one (including the present system). This is the proposal discussed in section G of part V of the outline, based on an article by Richard Bacon and Nicholas Tomosulo, described more fully in the *Tax Notes*⁹ publication. This proposal also contains a draft statute, which is what I have yet to see from any of the other reform proposals. My

7. *Keller v. Commissioner*, 723 F.2d 58 (10th Cir. 1983).

8. H.R. 6295, 97th Cong., 2d Sess., 128 CONG. REC. 1928 (1982).

9. Bacon & Tomosulo, *Net Operating Loss Carryovers: The Search for Corporate Identity*, 20 TAX NOTES 836 (1983).

mind doesn't get activated until I see what the legislation actually looks like, and this one at least has something that looks like legislation. In any event, I call this provision "Son of the 1958 advisory group," or maybe even "twins," because it's twice as good as the 1958 advisory group proposal. The 1958 advisory group would have limited the acquisition of loss carryovers to one half of the acquiring corporation's purchase price.¹⁰ The Bacon-Tomosulo proposal goes the whole way, and would limit loss carryovers by the full purchase price paid for the loss company. They argue, persuasively to me at least, that this limitation would do enough of a job to effectively restrain whatever bad things are going on in this loss acquisition area.

The criticism of this approach is that it allows the use, or consumption, of the loss carryovers more rapidly than some of the other reform proposals, and hence is subject to what the congressional staffs feel is an excess of liberality. Despite the economic argument that one still wouldn't buy a loss business under this type of limitation solely for the tax benefits, some tax incentive for the acquisition may exist because of the accelerated timing benefits. In any event, the basic thrust of the Bacon-Tomosulo proposal is to eliminate the purely tax-motivated acquisition transaction, and even the dominantly tax-motivated transaction as well. In effect, only transactions involving an acquisition of a loss company for its business will be viable economically under this proposal. Basically, this is what all of these loss carryover limitations are about. Moreover, the Bacon-Tomosulo proposal is by far the simpler of any of the various reform regimes, both to comprehend and to apply in practice. Hence, on both those scores, I would vote for this one.

The Finance Committee staff proposal, as I mentioned previously, is grounded essentially in the ALI approach. Basically, what is going on here are two concepts; they clearly allow transferability of tax losses, but instead of concentrating on the loss itself, they concentrate on a future income stream from a historic pool of capital existing at the time of the acquisition against which that loss can be absorbed.¹¹ As compared with Bacon-Tomosulo, which concentrates on a capital value purchase price limitation, this limitation operates in the context of matching the carryover to a future stream of income from the pool of capital of the loss company at the time of its acquisition. Unlike the Bacon-Tomosulo approach and the 1976 approach, however, this proposal adopts a dual limitation. We would

10. *Report of Advisory Group, supra* note 5.

11. SENATE COMM. ON FINANCE, *supra* note 6.

have two separate limitation rules here; one for “purchases” and one for “mergers.” Moreover, these limitations would operate in different ways, and could also overlap in a given transaction. In other words, these limitations could operate simultaneously in the same acquisition (which in my view is a negative feature of this approach) and they could operate for 15 years for the life of the loss (because the key to this provision is who are the major stockholders in the year the loss was sustained). Since the basic limitation under this provision is shareholder identity in the year of the loss, you are going to have to keep track of those shareholders for the life of the loss. If you have a relatively active loss corporation that has undergone ownership changes, engaged in acquisitions and mergers, has a complex capital structure, does recapitalizations, and/or issues new stock, you are in for a lot of fun under this provision. I would look forward or, maybe dread is a better word, to the statutory language; this is not going to be an easy statute to put into print. The principal contours of this proposal are described at section H of part V of the outline.

This leaves me with a final basic question; how much do you want to strive for in the way of perfection here, and how much do you want to concede to the practicalities of the real world? How one answers that question may well explain the disparity of opinions on how to deal with the loss carryover problems. For my part, I don't believe there is a “right answer” here. Rather, what the tax world needs is *an* answer, even *any* answer, so long as the regime that is finally selected is generally perceived as a fair and reasonable one that can't be egregiously abused. High on my priority scale here would be the simplicity factor, although it is fairly obvious by now that the loss carryover question does not readily yield to simple answers. I do agree, however, that it is time to do something, even if that something is to stand pat with one existing system. The present state of “suspended animation” with its attendant uncertainties has to stop, and the business of finally deciding, which is after all, Congress' principal role, must be done.

Two final points: I have some doubts on whether dropping the business-continuity limitation is the proper way to go in view of the fact the business that generated the loss is arguably the taxpayer that should be deemed to own that loss. It may well be that the business history should most appropriately follow the particular business that gave rise to that history. Finally, I also have strong reservations about the wisdom (which all of these proposals share) of dropping section 269, on the grounds that I am convinced as we will never be able to draft the perfect statute and it's always nice for section 269 to be lurking out there to restrain the overly zealous. I find this section to be a very useful defense mechanism in practice for restraining excessively aggressive transactions.

In summary, it's clear that we haven't come close to answering any of the numerous questions noted today; in fact we probably have raised more problems and are more confused than when this session began; but at least I think we are confused about more important things on a higher level.

