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# LIMITATIONS IMPOSED BY THE TAX REFORM ACT OF 1986 ON A CORPORATION'S USE OF NET OPERATING LOSS CARRYOVERS AFTER AN OWNERSHIP CHANGE

William M. Davidow, Jr.†

## I. INTRODUCTION

Section 172 of the Internal Revenue Code of 1986<sup>1</sup> (the "Code") provides the general rule that a corporation is entitled to deduct from income in a profitable year a net operating loss ("NOL") incurred in certain other years. For most corporations, a NOL for a particular year can be carried back to the three taxable years immediately preceding the taxable year of loss. To the extent any loss remains after the carryback, the NOL may be carried forward to the fifteen taxable years following the year of the loss and deducted from income in those years.<sup>2</sup> Any taxpayer entitled to carry back a NOL has the option to forgo the right to carryback the NOL and, instead, to carry the NOL forward.<sup>3</sup> The purpose for enacting the NOL carryover rules was to provide an income averaging mechanism allowing a corporation to minimize the adverse impact of reporting year to year fluctuating profit and loss on an annual basis.<sup>4</sup>

The availability of a NOL deduction has been an attractive attribute for a corporation to have. The inherent value of the deduction for the NOL carryover and the desirability of transferring it led to what is commonly referred to as "trafficking" in losses. Through the acquisition of the stock of a corporation with a NOL carryover, or through a merger with such a corporation, taxpayers sought the benefit of offsetting their profits with the NOL carryover. Prior to the enactment of the Revenue Act of 1943,<sup>5</sup> the only limitations imposed on trafficking in NOLs were imposed by the courts.<sup>6</sup> Congress first attempted to deal with the loss trafficking problem in the Revenue Act of 1943,<sup>7</sup> which enacted the predecessor to section 269 of the Internal Revenue Code of 1954.

Section 269 generally provides that if a person or persons acquire control of a corporation and the principal purpose of the acquisition was

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1. All section references herein are to sections of the Internal Revenue Code of 1986, unless otherwise indicated.
2. I.R.C. § 172(b)(1)(A),(B) (1982 & West Supp. 1988).
3. *Id.* § 172(b)(3)(C) (1982 & West Supp. 1988).
4. S. REP. NO. 313, 99th Cong., 2d Sess. 225 (1986) [hereinafter "SENATE REPORT"].
5. Pub. L. No. 78-235, 58 Stat. 21 (1944).
6. *See* *New Colonial Ice Co. v. Commissioner*, 292 U.S. 435 (1934); *see also* *Libson Shops, Inc. v. Koehler*, 353 U.S. 382 (1957) (decided under the Internal Revenue Code of 1939).
7. Pub. L. No. 78-235, 58 Stat. 21 (1944).

to evade or avoid tax by securing the benefit of a deduction it would not otherwise enjoy, the deduction will be disallowed.<sup>8</sup> The same rule applies to the acquisition of the assets of one corporation by another (which neither the acquiring corporation nor its shareholders previously controlled), if the acquiring corporation's basis in the assets is determined with reference to the transferor corporation's basis in those assets, e.g. in a tax-free reorganization.<sup>9</sup> Section 269 focuses primarily on the intent of the acquiring party.<sup>10</sup> If the purpose of avoiding tax exceeds any other purpose in importance to the acquiring party, the deduction of the acquired losses will be disallowed.<sup>11</sup> The determination of the subjective intent of the acquiring party creates a difficult standard for a taxpayer to use in tax planning, and a difficult standard, as well, for the government to employ in its battle against trafficking in NOL carryover deductions. Hence, as part of the Internal Revenue Code of 1954, Congress enacted section 382 ("old section 382") providing an additional method for disallowing NOL carryover deductions.<sup>12</sup>

Old section 382(a)<sup>13</sup> provided a more objective standard than the "principal purpose" standard of section 269 by focusing on change of ownership and discontinuance of business. It provided for disallowance of NOL carryover deductions if, subject to certain exceptions, a specified percentage of the corporation's ownership changed within a defined period of time by virtue of a "purchase" of stock and the business of the corporation was not continued.<sup>14</sup> Old section 382(b) generally provided that where a change of ownership resulted from an enumerated tax-free reorganization,<sup>15</sup> the NOL carryover deduction would be reduced or eliminated, depending on the extent of the interest of the loss corporation's shareholders in the acquiring or surviving corporation.

Prior to the enactment of the Tax Reform Act of 1986,<sup>16</sup> ("TRA'86") section 269 and old section 382 were the major exceptions

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8. I.R.C. § 269(a) (1982). As used in section 269, control means the ownership of stock possessing at least 50% of the total combined voting power of all classes of stock entitled to vote or at least 50% of the total value of shares of all classes of stock of the corporation. *Id.*

9. *Id.* § 269(a)(2) (1982).

10. *Id.* § 269(a) (1982). Section 269(a) expressed both an objective and subjective test. The objective test relates to the acquisition of control of property. The subjective test is that such acquisition must have the "principal purpose" of evading or avoiding federal income tax.

11. Treas. Reg. § 1.269-3(a)(2) (1968).

12. H.R. REP. NO. 1337, 83d Cong., 2d Sess., reprinted in 1954 U.S. CODE CONG. & ADMIN. NEWS 4067; S. REP. NO. 1622, 83d Cong., 2d Sess., reprinted in 1954 U.S. CODE CONG. & ADMIN. NEWS 4684.

13. References throughout this article to § 382 prior to the Tax Reform Act of 1986, *infra* note 16, shall be to "old section 382."

14. I.R.C. § 382(a) (1982) (repealed 1986).

15. The tax-free reorganizations to which old section 382(b) applied were those reorganizations referred to in I.R.C. § 381(a)(2) (1982 & West Supp. 1988), i.e., tax-free reorganizations under I.R.C. § 368(a)(1)(A),(C),(D) or (F).

16. Pub. L. No. 99-514, 100 Stat. 2085 (1986) [hereinafter TRA'86].

to the deductibility of a NOL carryover by a corporate taxpayer. TRA'86 left section 269 undisturbed, but entirely rewrote section 382, making substantial changes to the law relating to the availability of a NOL carryover deduction after a change of ownership of the stock of a corporation.<sup>17</sup>

This article examines the most important changes resulting from new section 382 and the temporary regulations promulgated thereunder (the "regulations"),<sup>18</sup> as well as the impact of the changes on the availability of the NOL carryover deduction following stock acquisitions and other transactions, whether taxable or tax-free, in the future.

## II. PRIOR LAW

Until the enactment of the TRA'86, old section 382 was bifurcated in its approach to limiting NOL carryovers after a change of ownership applying one standard for taxable acquisitions, and another for tax-free reorganizations. Old section 382(a) pertained generally to taxable acquisitions and required that an acquired corporation's NOL carryover to the current or subsequent taxable years be disallowed if at the end of the corporation's taxable year:

(i) any one or more of the ten largest stockholders owned a percentage of the total fair market value of the corporation's stock which was at least fifty percentage points more than they owned at the beginning of the taxable year or the prior taxable year;

(ii) the increase in percentage points was attributable to either a purchase by those stockholders or a decrease in outstanding stock, except for decreases for redemptions to pay death taxes; and

(iii) the corporation did not continue to carry on a trade or business substantially the same as that conducted before the change in ownership.

While old section 382(a) did result in the disallowance of NOL carryover deductions in many cases, there were numerous situations where the carryovers were not disallowed because any one of the three elements of old section 382(a) was missing. In some cases, the change of ownership would not involve the ten largest shareholders or would occur over a slightly longer period than the maximum two year period. In other cases, the change in ownership may have resulted from a transaction other than a purchase. Finally, in many cases, substantially the same business was conducted by the corporation following the change of ownership; even in the case of a complete change of ownership by a purchase of stock during the two year look back period, the NOL carryovers would not be disallowed after the ownership change if substantially the same business was conducted by the corporation after the change.

An entire set of separate rules applied under old section 382(b) to

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17. *Id.* at § 621, 100 Stat. at 2254.

18. T.D. 8149, 1987-38 I.R.B. 7.

changes of ownership resulting from certain tax-free reorganizations.<sup>19</sup> Generally, if the shareholders of the loss corporation owned 20% or more of the stock of the surviving corporation after the reorganization as a result of their stock ownership in the loss corporation, the NOL carryover deduction of the loss corporation could be used by the surviving corporation. On the other hand, if the continued interest of the loss corporation's shareholders in the surviving corporation dropped below 20%, the NOL carryover was subject to a reduction. For each percentage point below 20% of the surviving corporation's stock owned by the loss corporation shareholders, the NOL carryover of the loss corporation was reduced by 5%.<sup>20</sup>

These rules were harsher in some respects than those applicable to taxable acquisitions and in some respects less harsh, depending on the circumstances. Unlike a taxable transaction, continuation of the business of a loss corporation after a tax-free reorganization was irrelevant; the only issue was whether the requisite change of ownership had occurred. Accordingly, if a large corporation acquired a small loss corporation in a tax-free reorganization, the NOL carryovers would be reduced if the loss corporation's shareholders' stock was worth less than 20% of all of the surviving corporation's stock, even if all the shareholders of the loss corporation retained ownership in the surviving corporation and the surviving corporation continued substantially the same business as before the reorganization. If the requisite continuity of interest of the loss corporation's shareholders was present with respect to the surviving corporation, the NOL carryover deduction would be allowed even though an entirely different business was conducted by the surviving corporation.

In the Tax Reform Act of 1976<sup>21</sup> ("TRA'76"), Congress unsuccessfully attempted to deal with this inconsistent treatment of taxable and tax-free transactions. The effective date of the TRA'76 amendments, however, was repeatedly postponed during the decade after enactment<sup>22</sup>

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19. See *supra* note 15.

20. I.R.C. § 382(b)(2) (1982) (repealed 1986).

21. Pub. L. No. 94-455, 90 Stat. 1520 [hereinafter TRA'76]. While the rules relating to ownership changes resulting from taxable acquisitions and tax-free reorganizations were not completely aligned by the TRA'76, many of the distinctions were eliminated. Continuation of the loss corporation's business became irrelevant in both cases. Instead, the principal focus was on the extent of the change of ownership. In the case of taxable acquisitions, a 60% change of ownership triggered the limitation. The limitation was a reduction of the NOL carryover of 3.5% for each percentage point increase by the new owner in excess of 60% of all the corporation's stock, up to 80%, up to 100%. In the case of tax-free reorganizations, there would be no reduction of the NOL carryover if the loss corporation's shareholders continued to own 40% or more of the acquiring corporation. If their continued interest dropped below 40%, the NOL carryover was reduced by 3.5% for each percentage point less than 40%, down to 20%, and 1.5% for each percentage point less than 20%, down to zero.

22. The effective date was subsequently amended by § 368(a) of the Revenue Act of 1978, Pub. L. 95-600, 92 Stat. 2763, 2857; Fringe Benefit Regulations Prohibition Act, Pub. L. 96-167, § 9(e), 93 Stat. 1275, 1279 (1979); Pub. L. 97-119, § 111, 95

and the amendments were finally repealed by section 621(e) of the TRA'86.

### III. PRESENT LAW

In the years following the enactment of the TRA'76, various professional groups and committees, including the American Bar Association, the American Law Institute and the Senate Finance Committee, reviewed the NOL deduction limitation rules and made recommendations for reform.<sup>23</sup> Substantial revisions to the old section 382 were recommended by the staff of the Senate Finance Committee in its Report on Proposed "Subchapter C Revision Act of 1985" (the "Revision Report"), released in May, 1985.<sup>24</sup> Although the Subchapter C Revision Act of 1985 was never enacted, the recommendations made in the Revision Report with respect to the disallowance of NOL carryover deductions were, in large part, adopted by Congress in the TRA'86.<sup>25</sup>

As explained in the Senate Report, the overall purpose of the changes made to section 382 by the TRA'86 is to preserve the integrity of the income averaging function for which the NOL carryover rules were originally intended.<sup>26</sup> According to the Senate Finance Committee, one of the principal inadequacies of prior law was that the NOL carryforward could be used by a corporation after a substantial ownership change, notwithstanding a complete change of ownership.<sup>27</sup> This enabled new shareholders to contribute income producing assets or redirect

Stat. 1635, 1640 (1981); and Deficit Reduction Act of 1984, § 62(a), Pub. L. 98-369, 98 Stat. 494, 583.

23. See AMERICAN BAR ASSOCIATION TAX SECTION COMMITTEE ON CORPORATE STOCKHOLDER RELATIONSHIPS, LEGISLATIVE RECOMMENDATION 1985-1; AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: SUBCHAPTER C PROPOSALS ON CORPORATE ACQUISITIONS AND DISPOSITIONS (1982).

24. STAFF OF THE SENATE COMM. ON FINANCE, 99th Cong., 2d Sess., REPORT ON THE SUBCHAPTER C REVISION ACT OF 1985, 47-49, 55-57 (Comm. Print 1985) [hereinafter "REVISION REPORT"].

25. SENATE REPORT, *supra* note 4, at 230. The Senate Report states:  
Reasons for Change

The committee bill draws heavily from the recommendations regarding limitations on NOL carryforwards that were made by the Finance Committee Staff as part of its comprehensive final report regarding reform of subchapter C of the Internal Revenue Code. (See S. Prt. 99-47, 99th Cong., 1st session (1985), "The Subchapter C Revision Act of 1985, A Final Report Prepared by the Staff").

26. *Id.*

27. The Senate Report states:

[T]he committee bill addresses three general concerns: (1) the approach of present law (*viz.*, the disallowance or reduction of NOL and other carryforwards), which is criticized as being too harsh where there are continuing loss-corporation shareholders, and ineffective to the extent that NOL carryforwards may be available for use without limitation after substantial ownership changes, (2) the discontinuities in the present law treatment of taxable purchases and tax-free reorganizations, and (3) defects in the existing rules that present opportunities for tax avoidance.

*Id.* at 231-32.

income producing opportunities to the loss corporation and obtain greater utilization of the NOL carryovers than if there had been no change of ownership. The ultimate result was to allow, in certain circumstances, for the free transferability of tax benefits and to have the federal government providing recoupment of a portion of all corporate tax losses. At the same time there was a recognition that a complete disallowance when less than 100% of the stock changed hands was too harsh with respect to the continuing shareholders.<sup>28</sup>

In response to these problems, Congress adopted the "limitation on earnings" approach,<sup>29</sup> whereby the amount of the NOL carryover deduction is not limited, but the income against which the deduction may be used is limited. The NOL deduction may be carried forward in its entirety, but only that amount equal to the fair market value of the loss corporation's stock multiplied by the "long-term tax-exempt rate" may be used in each year.<sup>30</sup> This approach is intended to limit the use of NOL carryovers by allowing such carryovers to offset only the income which could be generated by the assets owned by the loss corporation prior to the ownership change.<sup>31</sup> Conceptually, the income generated by the capital or assets of the new shareholder or shareholders should not be offset by the loss corporation's NOL carryover.

In addition to the adoption of the limitation on earnings approach, there are also substantial changes in determining when the section 382 limitations apply. The more significant of these changes are the following: (1) the broadening of the class of those persons whose increase in ownership interest are considered, (2) the lengthening of the look back period, (3) the de-emphasis of the continuity of business requirement after a taxable acquisition, and (4) the complete alignment of the treatment of taxable acquisitions and tax-free reorganizations. New section 382 focuses only on whether there has been the requisite ownership change, without regard for whether the ownership change occurred as a result of a purchase, redemption, or tax-free reorganization.

The following examination of the present law under section 382 is divided into four parts: (1) a discussion of the rules relating to when the section 382 limitation applies; (2) an explanation of the amount of the limitation; (3) a summary of the identification and information reporting requirements; and (4) a discussion of the new section 382 effective date.

#### *A. When the Section 382 Limitation Applies*

The change of ownership of the stock of a loss corporation continues to be the trigger for the purpose of imposing the section 382 limitation. According to the Senate Report, change in control of a loss corporation's

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28. *Id.* at 231.

29. *Id.* at 232.

30. For an explanation of the "long-term tax-exempt rate," see text accompanying note 121.

31. SENATE REPORT, *supra* note 4, at 232.

stock is the best indicator of a potentially abusive transaction because of the possibility that the new shareholders will contribute income producing assets or redirect income producing activities to the loss corporation.<sup>32</sup> As was the case under prior law for taxable acquisitions, an increase of more than fifty percentage points in stock ownership over a prescribed period will trigger the section 382 limitation.<sup>33</sup> The method of measuring the percentage ownership change, the more extensive definition of shareholders whose increased interests are relevant, an extended look back period, and a new treatment of options with respect to the loss corporation's stock under the new rules, however, are likely to result in many more situations where the section 382 limitation will apply than under prior law.

Generally, the section 382 limitation applies when an ownership change has occurred with respect to a loss corporation.<sup>34</sup> An ownership change occurs with respect to a loss corporation, if, on a "testing date," the percentage of stock owned by one or more "5-percent shareholders"<sup>35</sup> has increased by more than fifty percentage points over the lowest percentage of stock of such corporation owned by such shareholders at any time during the "testing period."<sup>36</sup>

**TESTING DATE.** Until there is a "testing date," the issue of the section 382 limitation will not arise. A testing date occurs when there has been an "owner shift," or when certain option transactions are entered into by the loss corporation or entities which directly or indirectly own an interest in the loss corporation.<sup>37</sup> When a testing date occurs, the loss corporation must make a determination as to whether an ownership change has also occurred.<sup>38</sup>

**OWNER SHIFT.** An "owner shift" is generally any change in the ownership of the stock of the loss corporation that affects the percentage of stock owned by any person who is a 5-percent shareholder before or after the ownership change.<sup>39</sup> The temporary regulations provide a non-exclusive list of transactions which constitute owner shifts:<sup>40</sup>

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32. *Id.*

33. I.R.C. § 382(g) (West Supp. 1988).

34. The term "loss corporation" is defined as a corporation entitled to use a NOL carryover. *Id.* § 382(k)(1) (West Supp. 1988). The temporary regulations of § 382 include a more specialized definition which refers to a corporation entitled to use a NOL carryover or having a NOL for the taxable year in which an owner shift, equity structure shift or certain option transactions occur. Temp. Treas. Reg. § 1.382-2T(f)(1)(i) (1987).

35. For a discussion of "5-percent shareholder," see text accompanying notes 56-106.

36. Temp. Treas. Reg. § 1.382-2T(a)(1) (1987). For a discussion of "testing period," see text accompanying notes 51-55.

37. For a discussion of the option transactions which will result in a testing date, see text accompanying note 49.

38. Temp. Treas. Reg. § 1.382-2T(a)(2)(i) (1987).

39. I.R.C. § 382(g) (West Supp. 1988); Temp. Treas. Reg. § 1.382-2T(e)(1)(i) (1987).

40. Temp. Treas. Reg. § 1.382-2T(e)(1)(i) (1987).



- (A) a purchase or disposition of the loss corporation's stock by a 5-percent shareholder,
- (B) a section 351 exchange that affects the percentage of stock owned by a 5-percent shareholder,
- (C) a redemption or a recapitalization that affects the percentage of stock owned by a 5-percent shareholder,
- (D) an issuance of loss corporation stock that affects the percentage of stock owned by a 5-percent shareholder, and
- (E) an equity structure shift that affects the percentage of stock owned by a 5-percent shareholder.

An "equity structure shift" is defined as a reorganization within the meaning of section 368, except for reorganizations under section 368(a)(1)(F) and under section 368(a)(1)(D) and (G) which do not meet the requirements of section 354(b)(1).<sup>41</sup> The inclusion in the definition of owner shift in the temporary regulations of an equity structure shift that affects the percentage of stock owned by a 5-percent shareholder is at variance with the terms of the statute itself. The statute implies that a determination as to whether an ownership change has occurred is made at the time of an equity structure shift, whether or not the shift involves a 5-percent shareholder of the loss corporation.<sup>42</sup> Under the Temporary Regulations, an equity structure shift in and of itself is not an owner shift and, therefore, does not cause a testing date to occur.<sup>43</sup> A testing date would occur, however, if the reorganization alone affects the percentage interest of a 5-percent shareholder.

Transfers of stock of the loss corporation between persons who are not 5-percent shareholders are disregarded.<sup>44</sup> The purpose for the 5% threshold is to relieve publicly-held companies of the record keeping burden of tracking acquisitions by less than 5-percent shareholders.<sup>45</sup>

In addition to equity structure shifts not involving a 5-percent shareholder, there are other stock transactions which are not owner shifts resulting in a testing date. Owner shifts do not include transfers in which the basis of the stock in the hands of the owner is determined under section 1014 (relating to property acquired from a decedent), section 1015 (relating to property acquired by gift or transfer in trust), or section 1041(b)(2) (relating to transfer of property between spouses incident to divorce), or transferred in satisfaction of a right to receive a pecuniary bequest or pursuant to a divorce or separation instrument.<sup>46</sup> The person receiving the stock as a result of any such transfers shall be treated as owning the stock during the period it was owned by the person from

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41. *Id.* § 1.382-2T(e)(2)(i) (1987).

42. I.R.C. § 382(g)(1) (West Supp. 1988).

43. Temp. Treas. Reg. § 1.382-2T(a)(2)(i) (1987).

44. *Id.* § 1.382-2T(e)(1)(ii) (1987).

45. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess., II-176 [hereinafter "CONFERENCE REPORT"].

46. I.R.C. § 382(j)(3)(B) (West Supp. 1988).

whom acquired.<sup>47</sup> Certain acquisitions by employee stock ownership plans are also disregarded for purposes of determining whether an ownership change has occurred.<sup>48</sup>

**OPTION TRANSACTIONS.** The option transactions which trigger a testing date are those in which an option on the stock of the loss corporation is either (i) transferred to (or by) a 5-percent shareholder (or a person who would be a 5-percent shareholder if the option were treated as exercised) or (ii) issued by the loss corporation or granted by a first tier entity or a higher tier entity which owns 5% or more of the stock of the loss corporation.<sup>49</sup> Options granted to or by individuals who are not 5-percent shareholders of the loss corporation do not trigger a testing date. The reason that option transactions trigger a testing date is because the option transactions can result in a deemed acquisition.<sup>50</sup> An ownership change may result if the requisite increases occur as a result of the deemed acquisition.

**TESTING PERIOD.** Once a testing date has occurred as a result of the requisite owner shift or option transaction, the next step is to establish the testing period. Generally, the testing period is the three-year period ending on the testing date.<sup>51</sup> In certain circumstances, however, the testing period may be shorter than three years. In the event there is an ownership change, the testing period for any subsequent testing date does not begin before the date of the ownership change.<sup>52</sup> Example: X and Y each own 50% of Loss Corporation's stock. Z acquires 50% of Loss Corporation's stock from Y on January 1, 1990. Z acquires 20% of the Loss Corporation's stock from X on January 1, 1991. The testing period with respect to the January 1, 1990 and 1991 testing dates is the three-year period ending on each date. Since an ownership change occurs on January 1, 1991, the testing period taken into consideration on any subsequent testing dates shall not be earlier than January 1, 1991.

Notwithstanding the general rule, the testing period does not begin before the earlier of the first day of either the first taxable year from which there is a NOL (or excess credit) carryover or the year in which the testing date occurs, unless the loss corporation has a "net unrealized built-in loss."<sup>53</sup> If the corporation has a net unrealized built-in loss, the three-year testing period rules will apply, unless the corporation can establish the taxable year in which the net unrealized built-in loss accrued.<sup>54</sup> If the year of accrual can be established, the testing period does

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47. *Id.* § 382(1)(3)(B) (West Supp. 1988); Temp. Treas. Reg. § 1.382-2T(a)(2)(i) (1987).

48. I.R.C. § 382(l)(3)(C) (West Supp. 1988).

49. Temp. Treas. Reg. § 1.382-2T(a)(2)(i)(A) and (B) (1987). For the definition of "first tier entity" and "higher tier entity," see text accompanying notes 59-61.

50. See text accompanying notes 69-73.

51. Temp. Treas. Reg. § 1.382-2T(d)(1) (1987).

52. *Id.* § 1.382-2T(d)(2) (1987).

53. *Id.* § 1.382-2T(d)(3)(i) (1987). For a discussion of net unrealized built-in loss, see text accompanying notes 140-141.

54. Temp. Treas. Reg. § 1.382-2T(d)(3)(ii) (1987).

not begin before the first day of such year.<sup>55</sup>

**FIVE-PERCENT SHAREHOLDER.** The next step in determining whether an ownership change has occurred during the testing period is to identify all the 5-percent shareholders of the loss corporation at the close of the testing date and to aggregate the increases in their interests in the loss corporation's stock during the testing period.<sup>56</sup> If the aggregate increase is more than 50%, an ownership change has occurred.<sup>57</sup> There are two types of 5-percent shareholders which must be identified in order to make the necessary determination: (i) individuals, and (ii) "public groups."<sup>58</sup>

An individual is considered a 5-percent shareholder if he directly or indirectly owns 5% or more of the loss corporation's stock. An individual indirectly owns stock of a loss corporation by virtue of his ownership interest in a "first tier entity" or a "higher tier entity." A first tier entity is an entity<sup>59</sup> which owns a 5% or more direct ownership interest in the stock of the loss corporation.<sup>60</sup> A higher tier entity is an entity which owns a 5% or more direct ownership interest in a first tier entity or another higher tier entity.<sup>61</sup> Example: X Corporation directly owns 20% of Loss Corporation's stock. Y Corporation owns 10% of X Corporation's stock. Z Corporation owns 4% of Y Corporation's stock. No other entity owns 5% or more of Y Corporation stock. X Corporation is a first tier entity because it directly owns more than 5% of Loss Corporation's stock. Y Corporation is a higher tier entity as a result of its 10% interest in X Corporation, a first tier entity. Y Corporation is also a "highest tier entity" because no other entity owns 5% or more of its stock.<sup>62</sup> Z Corporation is not a higher tier entity because it does not own 5% or more of the stock of a first tier entity or higher tier entity. An individual who owns a direct interest in X Corporation or Y Corporation would have an indirect ownership interest in Loss Corporation (as a result of his interest in the first tier entity or higher tier entity, respectively). An individual who owns an interest directly in Z Corporation would not, by virtue of that interest, be an individual owner of Loss Corporation because Z Corporation is not a higher tier entity.

An individual's indirect ownership interest by virtue of his ownership interest in a first tier entity or higher tier entity is determined under

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55. *Id.* Additional rules relating to testing periods are discussed in connection with the effective date of the new law in the text accompanying notes 168-178.

56. Temp. Treas. Reg. § 1.382-2T(c)(1) (1987).

57. *Id.* § 1.382-2T(a)(1) (1987).

58. *Id.* § 1.382-2T(g)(1) (1987).

59. "Entity" is broadly defined to include "any corporation, estate, trust, association, company, partnership or similar organization." *Id.* § 1.382-2T(f)(7) (1987).

60. *Id.* § 1.382-2T(f)(9) (1987).

61. *Id.* § 1.382-2T(f)(14) (1987). The ownership interest is based on the fair market value of the loss corporations outstanding stock rather than the number of outstanding shares. See text accompanying note 107.

62. Temp. Treas. Reg. § 1.382-2T(f)(16) (1987).

the constructive ownership rules of section 318(a), subject to certain modifications.

The principal exception to these attribution rules is that attribution from a first tier entity or a higher tier entity is determined without regard to the 50% ownership requirement of section 318(a)(2)(C).<sup>63</sup> Instead, in determining whether an individual is a 5-percent shareholder, the individual is treated as owning his proportionate share of the loss corporation stock owned (directly or indirectly) by the first tier entity or higher tier entity, unless the individual directly owns less than 5% of the stock of the first tier entity or higher tier entity. If the individual owns less than 5% of the stock of the first tier or higher tier entity, he will not be treated as owning any of the stock of the entity.<sup>64</sup> Example: X Corporation owns 90% of Loss Corporation's stock. Z owns 20% of X Corporation's stock. Z indirectly owns 18% ( $20\% \times 90\% = 18\%$ ) of Loss Corporation's stock and is, therefore, a 5-percent shareholder of Loss Corporation. If, however, Z only owned 4% of X Corporation's stock, the constructive ownership rules would not apply to make Z the owner of any Loss Corporation's stock individually. The same result would occur even if Z also owned 5% or more of Loss Corporation's stock directly or 5% or more indirectly through another entity.

The direct and indirect ownership interests of an individual are aggregated only if each interest separately constitutes 5% or more of the stock of the Loss Corporation.<sup>65</sup> Example: X Corporation owns 60% of Loss Corporation's stock. Y Corporation owns 20% of Loss Corporation's stock. Z owns 10% of X Corporation's stock. Z also owns 10% of Y Corporation. After application of the constructive ownership rules, Z indirectly owns 6% of Loss Corporation's stock through his ownership of X Corporation's stock ( $10\% \times 60\% = 6\%$ ). However, Z's interest in Loss Corporation's stock through Y Corporation is disregarded because it is less than 5% of the Loss Corporation's stock ( $10\% \times 20\% = 2\%$ ).

The rules which allow a loss corporation to disregard an individual's constructive ownership of the loss corporation's stock through a first tier entity or higher tier entity when the individual owns less than 5% of such entity, or when his ownership interest in the loss corporation is less than 5% in each separate case, do not apply if the corporation has actual knowledge of the ownership<sup>66</sup> or if the ownership interests have been

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63. *Id.* § 1.382-2T(h)(2)(i)(B) (1987).

64. *Id.* § 1.382-2T(g)(2) (1987).

65. *Id.* § 1.382-2T(g)(3) (1987).

66. There are numerous instances in which general rules set forth in the temporary regulations, particularly with respect to determining stock ownership and ownership changes, will not apply if the loss corporation has actual knowledge of stock ownership on the testing date or acquires such knowledge before the date the income tax return is filed for the year of the testing date. In such cases the stock ownership, which would otherwise be disregarded, will be taken into account. *Id.* § 1.382-2T(k)(2) (1987) [Hereinafter, these rules will be referred to as the "Actual Knowledge Rules."].

structured to avoid treatment as a 5-percent shareholder "for a principal purpose of circumventing the Section 382 limitation."<sup>67</sup>

Unlike the usual rules of section 318(a) relating to family member attribution, an individual is not considered to own the stock owned by other members of his family. Instead, all members of a family described in section 318(a)(1) are treated as one individual, provided that if a family member would not be a 5-percent shareholder standing alone, then he is not among the members of the family considered to be the 5-percent shareholder, subject to the Actual Knowledge Rules.<sup>68</sup>

The stock owned by an individual through a first tier entity or a higher tier entity, directly and indirectly, is not the only stock the individual is considered to own for purposes of determining whether an ownership change has occurred; options held by the individual also may be considered. Likewise, the individuals who directly or indirectly through first tier or higher tier entities own the loss corporation's stock subject to an option may not be the stockholders taken into account on a testing date. Stock of the loss corporation which is subject to an option is treated as exercised on the testing date if such deemed exercise would result in an ownership change.<sup>69</sup> If no ownership change would result, the underlying stock is not considered to be acquired by the holder of the option. Treating certain option transactions as exercised represents a significant departure from prior law. Formerly, the issuance of an option was not considered in a change of ownership calculation; but if the option was eventually exercised, the shareholder was considered to have acquired the stock on the issuance date of the option.<sup>70</sup>

Once the stock underlying an option is considered to have been acquired (because the "deemed" acquisition resulted in an ownership change), a new testing period begins and the option will continue to be

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67. In the event ownership interests in a loss corporation are structured by a person with a direct or indirect ownership interest in the loss corporation to avoid treatment as a 5-percent shareholder for a principal purpose of circumventing the limitation of I.R.C. § 382, certain general rules relating to determining ownership interests will not be applicable. Temp. Treas. Reg. § 1.382-2T(k)(4) (1987). [Hereinafter, these rules will be referred to as the "Avoidance Rules"]. The Avoidance Rules, however, will only be applied if their application would result in an ownership change. *Id.*

68. Temp. Treas. Reg. § 1.382-2T(h)(6) (1987); see *supra* note 66. The other exceptions to the application of I.R.C. § 318 constructive ownership rules relate to limitations on attributions (i) as a result of certain preferred stock interests and other interests not treated as stock, (ii) from certain entities and trusts, and (iii) to corporations, partnerships, estates and trusts from their owners or beneficiaries. Temp. Treas. Reg. § 1.382-2T(h)(2)(ii)(iii), and (h)(3) (1987). Section 106(d)(5)(A) of the Technical Corrections Act of 1987, H.R. 2636, 100th Cong., 1st Sess. (1987) [hereinafter Tech. Corr. Act] being considered by Congress at the time of publication makes it clear that, as already stated in the temporary regulations, there is no attribution from stock which is not treated as stock. For a discussion of the definition of "stock," see text accompanying notes 110-15.

69. I.R.C. § 382(1)(3)(A)(iv) (West Supp. 1988); Temp. Treas. Reg. § 1.382-2T(h)(4) (1987).

70. Treas. Reg. § 1.382-1(a)(2) (1987).

considered as having been exercised on the earlier testing date and thus will be disregarded on any subsequent testing date (unless the option is transferred to another 5-percent shareholder prior to exercise). If an option is actually exercised by the same person who held it on the date of the ownership change, the exercise is disregarded for purposes of section 382.<sup>71</sup> Example: As of December 31, 1987, Z owns 40% of Loss Corporation's stock. Y owns 60% of Loss Corporation's stock. On January 1, 1988, Z grants X an option to acquire all of his stock. On January 1, 1989, Y sells 20% of his stock to W. January 1, 1988, is a testing date, but X is not considered to have acquired Z's Loss Corporation stock because the deemed exercise of the option would not result in an ownership change. January 1, 1989, is also a testing date and X is considered to have acquired Z's Loss Corporation stock in accordance with the terms of the option because the deemed exercise, when combined with the actual acquisition by W, would result in an ownership change. No new testing period will begin before January 2, 1989. The option will not again be deemed to have been exercised on any subsequent testing date, unless transferred by X to a 5-percent shareholder (or person who would be a 5-percent shareholder if exercised). In the event of a subsequent exercise of the option by X, the exercise will not result in a testing date or ownership change. If an unexercised option which has been treated as exercised lapses or is forfeited, the option will be treated as if it had never been issued and the loss corporation can file an amended return for prior years if section 382 would have been inapplicable but for the treatment of the option.<sup>72</sup>

The option attribution rules will not apply if the NOL carryovers, net unrealized built-in loss, and losses for the portion of the year preceding the testing date are *de minimis*. Generally, if the aggregate of the losses is less than the amount which could be carried forward for two years if there were an ownership change, it is *de minimis* and the option attribution rules will not apply.<sup>73</sup>

The definition of option for these purposes is expansive and includes options subject to contingencies, options to acquire options, and interests "similar to options" (e.g. warrants, convertible debt and other instruments convertible into stock, a put, a stock interest subject to forfeiture, and a contract to acquire or sell stock).<sup>74</sup> The following, however, are

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71. Temp. Treas. Reg. § 1.382-2T(h)(4) (1987). These regulations also require that the deemed exercise rule be applied both separately to each class of options and each 5-percent shareholder, and together, for purposes of determining whether an ownership change has occurred. *Id.* § 1.382-2T(h)(4)(i) (1987). *See id.* § 1.382-2T(h)(4)(ii) Example 2 (1987).

72. *Id.* § 1.382-2T(h)(4)(viii) (1987).

73. The option attribution rules will not apply if the loss would be less than twice the product of (A) the value of the corporation, and (B) the long-term tax exempt rate for the calendar month in which the testing date occurs. *Id.* § 1.382-2T(h)(4)(ix) (1987).

74. *Id.* § 1.382-2T(h)(4)(iii)-(v) (1987).

examples of the numerous types of options and instruments which will not be considered options under the option attribution rules: certain options for stock actively traded on an established securities market; the right to receive stock upon the maturity of certain debt; stock issued to non 5-percent shareholders subject to the loss corporation's right of redemption; options between owners of an entity exercisable only upon the death, complete disability, or mental incompetency of the owner; any right to receive, or obligation to issue, stock in payment of interest or dividends by the issuing corporation; rights of certain taxpayers to acquire the stock pursuant to default in a loan agreement; and certain "buy-sell" agreements.<sup>75</sup> Such "buy-sell" agreements are those entered into between noncorporate owners of the same entity (or with the entity itself) if (i) the owners actively participate in the trade or business of the corporation, (ii) the corporation is not a loss corporation when the option is issued, and (iii) the option is exercisable solely upon retirement of such owner.<sup>76</sup>

After the individual 5-percent shareholders of the loss corporation have been ascertained, it is then necessary to review the corporation's ownership to identify "public groups." A "public group" is a group of individuals, entities, or other persons each of which owns, directly or indirectly, less than 5% of the loss corporation's stock.<sup>77</sup> Each public group is considered to be a separate 5-percent shareholder. A public group may arise at any level in the loss corporation's hierarchy, from direct ownership in the loss corporation to the first tier entity level to any higher tier entity level.<sup>78</sup> A loss corporation may have more than one public group<sup>79</sup> and, under certain circumstances, each first tier entity or higher tier entity may have more than one public group.<sup>80</sup> The purpose for establishing public groups is to disregard corporate ownership and to provide a mechanism for identifying the ultimate beneficial owners of the corporation.<sup>81</sup> At the same time, however, the identification and separate treatment of public groups provides a means for a far more exact tracking of ownership changes than under prior law.

In the public group analysis, each owner of the highest tier entity who is not a 5-percent shareholder of the loss corporation after applica-

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75. *Id.* § 1.382-2T(h)(4)(x)(A)-(H) (1987).

76. *Id.* § 1.382-2T(h)(4)(x)(H) (1987).

77. *Id.* § 1.382-2T(f)(13) (1987).

78. *Id.* § 1.382-2T(g)(1)(ii)-(iv) (1987).

79. *See id.* The general rule is that all stock owned by shareholders of a corporation who are not 5-percent shareholders shall be treated as stock owned by one 5-percent shareholder of the corporation. I.R.C. § 382(g)(4)(A) (West Supp. 1988). The temporary regulations, based on I.R.C. § 382(g)(4)(B)-(C) (1986) (West Supp. 1988), provide for detailed rules for fracturing the non 5-percent shareholders into different "public groups," each of which is treated as a separate 5-percent shareholder. *See infra* text accompanying notes 82-106.

80. Temp. Treas. Reg. § 1.382-2T(j)(3) (1987).

81. CONFERENCE REPORT, *supra* note 45, at II-184.

tion of the modified constructive ownership rules<sup>82</sup> is considered a member of the public group of the highest tier entity.<sup>83</sup> If the public group indirectly owns 5% or more of the loss corporation, it is a 5-percent shareholder of the loss corporation. If the indirect interest in the loss corporation is less than 5%, the public group is not a 5-percent shareholder in and of itself, but instead, the group "drops down" and is considered part of the public group of the next lower tier entity.<sup>84</sup> The same analysis is applied to the next lower tier entity, except that the public group which has dropped down from the higher tier entity is counted in determining whether the public group of the next lower tier entity is a 5-percent shareholder of the loss corporation.<sup>85</sup> If the public group of the first tier entity, including public groups dropped down from higher tier entities, is not a 5-percent shareholder, it will again drop down and be included in the public group comprised of the public shareholders of the loss corporation, i.e., those shareholders of the loss corporation who directly own less than 5% of the loss corporation.<sup>86</sup> The public group of the loss corporation itself is treated as a 5-percent shareholder, even if it does not own 5% of the stock of the loss corporation.<sup>87</sup> Example: 1000 unrelated individuals own equal interests in X Corporation. X Corporation owns 50% of Y Corporation and 100 unrelated individuals own equal interests in the remaining 50%; Y Corporation owns 20% of Loss Corporation. Since none of the shareholders of X Corporation owns indirectly 5% or more of Loss Corporation, each shareholder is a member of X Corporation's public group. The public group of X Corporation owns 10% of Loss Corporation through X Corporation's shares of Y Corporation ( $50\% \times 20\% = 10\%$ ) and is, therefore, a 5-percent shareholder of Loss Corporation. Any future acquisition within the testing period by X Corporation of Loss Corporation's stock, e.g., by increasing its ownership in Y Corporation, would be an increase of the ownership interest of X Corporation's public group's interest in Loss Corporation and would be considered in any determination of ownership change. If, on the other hand, Y Corporation only owned 9% of Loss Corporation, X Corporation's public group would only own 4.5% of Loss Corporation's stock and would not be in and of itself a 5-percent shareholder.

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82. See *supra* text accompanying notes 63-73.

83. Temp. Treas. Reg. § 1.382-2T(j)(1)(iv)(A) (1987). The constructive ownership rules are applied differently for determining whether a person is a 5-percent shareholder than they are applied for determining the ownership interest of a public group. For purposes of determining whether a person is a 5-percent shareholder, the constructive ownership rules only apply if the loss corporation's stock is attributed to the person as a higher tier entity or as an individual who owns 5% of the stock of a first tier entity or higher tier entity. See *supra* text accompanying notes 59-60. There is, however, no ownership threshold in determining the ownership of a member of a public group. Temp. Treas. Reg. § 1.382-2T(g)(2) (1987).

84. Temp. Treas. Reg. § 1.382-2T(g)(1)(ii) and (j)(1)(iv)(A) (1987).

85. *Id.* § 1.382-2T(j)(1)(iv)(B) (1987).

86. *Id.* § 1.382-2T(f)(ii) (1987).

87. *Id.* § 1.382-2T(j)(1)(iv)(C) (1987).



Instead, X Corporation's public group would "drop down" and become part of Y Corporation's public group.

The relative stock interests of a loss corporation's public groups may change because a lower tier entity or higher tier entity with a public group acquires more of the loss corporation's stock. It is also possible, under certain circumstances, for the number of public groups of a loss corporation, first tier entity, or higher tier entity, to increase, resulting in the loss corporation or entity having more than one public group. There are numerous situations in which the overall "public group" of an entity, which might otherwise appear to be one large group, will be segregated into separate public groups for purposes of determining whether an ownership change has occurred, even though the members of this public group as a whole may become indistinguishable as a result of a particular transaction.

The direct public group of the loss corporation will be segregated for purposes of determining whether an ownership change has occurred if any of three different types of transactions occur.<sup>88</sup> The first type of transaction includes (i) certain tax-free reorganizations in which the loss corporation is a party,<sup>89</sup> or (ii) a transfer of the stock in the loss corporation or any other transaction to which section 1032 applies (relating to the nonrecognition of gain or loss to a corporation on the receipt of money or property in exchange for its stock). The public groups of the loss corporation that exist immediately after such a transaction shall be segregated so that each group that existed immediately before the transaction is treated separately from the group that acquires the stock from the loss corporation in the transaction.<sup>90</sup> For these purposes, in the case of the tax-free reorganization, shareholders of the acquiring or surviving corporation are considered to have acquired the stock of the loss corporation.<sup>91</sup> Example: On January 1, 1988, 1% of all of the stock of Loss Corporation is owned by each of 100 unrelated individuals. All the stock of X Corporation is owned similarly by a different 100 unrelated individuals. On January 2, 1989, Loss Corporation merges into X Corporation in a tax-free reorganization under section 368(a)(1)(A), with the public group of the Loss Corporation prior to the merger receiving 40% of the stock of X Corporation. Since the direct public group which existed before the merger must be segregated from any direct public group which resulted from the merger, the pre-existing public group of Loss Corporation is treated separately from the public group comprised of shareholders of X Corporation. The sixty percentage point increase of X

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88. *Id.* § 1.382-2T(j)(2)(iii) (1987).

89. The tax-free reorganizations that will result in separate public groups are the reorganizations described in I.R.C. § 368(a)(1)(A),(B),(C),(F), (G) (1982 and West Supp. 1988).

90. Temp. Treas. Reg. § 1.382-2T(j)(2)(iii)(B)(1) (1987).

91. *Id.*

Corporation's public group's interest in Loss Corporation constitutes an ownership change.

The second type of transaction where the direct public group of a loss corporation will be segregated involves redemptions. The public group that exists immediately before the redemption is segregated so that the stock acquired in the transaction is treated as owned by a separate group from each public group that owns the stock which is not acquired in the redemption.<sup>92</sup> Example: One percent of the stock of Loss Corporation is owned by each of 100 unrelated individuals. On January 1, 1988, Loss Corporation redeems the stock of sixty shareholders for cash. The direct public group of Loss Corporation is segregated into two public groups immediately before the redemption, one comprised of the group of redeeming shareholders and one comprised of the group of remaining shareholders. Since the remaining shareholders' public group increased its interest from 40% to 100% as a result of the redemption, an ownership change has occurred.<sup>93</sup>

The third type of transaction occurs when there is a deemed acquisition of the stock of the loss corporation under the option attribution rules. Each direct public group which exists immediately after the acquisition shall be segregated so that each public group that existed before the acquisition is treated separately from the group deemed to have acquired the stock.<sup>94</sup>

For purposes of these rules, the members of the acquiring direct public group are presumed not to be members of the other groups, subject to the Actual Knowledge Rules<sup>95</sup> and the Avoidance Rules.<sup>96</sup> Any direct public group identified under these rules is treated as a 5-percent shareholder, without regard to whether it actually owns 5% of the loss corporation's stock.<sup>97</sup> Once an ownership change has occurred, the direct public groups are no longer segregated.<sup>98</sup> Also, when sufficient time has passed so that the transaction which resulted in the segregation is not within a testing period, the groups are no longer segregated for purposes of determining an ownership change.<sup>99</sup>

In the future, any acquisition by the loss corporation or by a 5-percent shareholder will be considered to be made proportionately from each direct public group, unless a different proportion is otherwise estab-

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92. *Id.* § 1.382-2T(j)(2)(iii)(C) (1987).

93. *Id.* § 1.382-2T(j)(2)(iii)(C)(2), Example 1 (1987).

94. *Id.* § 1.382-2T(j)(2)(iii)(D) (1987). For an illustration of the application of these rules, see the example in Temp. Treas. Reg. § 1.382-2T(j)(2)(iii)(D)(2) (1987).

95. *Id.* § 1.382-2T(j)(2)(iii)(A)-(D) (1987); see also Actual Knowledge Rules, *supra* note 66.

96. *Id.*; see also Avoidance Rules, *supra* note 67. There may also be other transactions which will require segregation of direct public groups if designated in the future in the Internal Revenue Bulletin. Temp. Treas. Reg. § 1.382-2T(j)(2)(iii)(E) (1987).

97. *Id.* § 1.382-2T(j)(2)(iii)(A) (1987).

98. *Id.* § 1.382-2T(j)(2)(i) (1987).

99. *Id.*

lished by the Internal Revenue Service or the loss corporation.<sup>100</sup>

New public groups may arise not only from transactions entered into by the loss corporation itself, but also from transactions entered into by direct or indirect owners of the loss corporation's stock.<sup>101</sup>

When an individual or a first tier entity having a direct ownership interest of 5% or more in the loss corporation transfers the direct ownership interest to persons owning less than 5% of the corporation's stock, a new public group will be created and will be treated separately from any public groups existing prior to the transaction.<sup>102</sup> Example: X Corporation owns 20% of Loss Corporation's stock. The remainder of Loss Corporation's stock is owned by 100 unrelated individuals, each of whom owns less than 5% of Loss Corporation's stock. On January 1, 1988, X Corporation sells its Loss Corporation stock to a group of 200 investors who will own the stock evenly. The 100 unrelated individuals who own 80% of Loss Corporation's stock comprise a direct public group prior to the transfer by X Corporation. Since X Corporation is a first tier entity transferring to persons who will each own less than 5% of Loss Corporation's stock, the group of 200 investors will be a separate public group and will be treated as a separate 5-percent shareholder. The same result would occur if X Corporation were an individual, rather than an entity.

Likewise, if an ownership interest in a higher tier entity which owns 5% or more of the stock of the loss corporation or a first tier entity is transferred to individuals who are not 5-percent shareholders or to persons or entities which do not have a 5% or greater interest in a higher tier entity or first tier entity, the new public group which results from the transfer of the entity's stock is treated separately from any groups existing immediately before the transfer.<sup>103</sup>

Transfers of the stock of first tier and higher tier entities which own 5% or more of the loss corporation's stock are not the only transactions involving those entities which can result in creation of new public groups. The same types of transactions which, if entered into by a loss corporation, would result in a new public group of the loss corporation also will result in a new public group if entered into by such higher tier entities and first tier entities.<sup>104</sup> That is, if any of the entities engage in the tax-free reorganizations specified in temporary regulations section 1.382-2T(j)(2)(iii)(B), an issuance of stock, a redemption, or an option transaction resulting in an ownership change, the transaction will result in the creation of a new public group of that entity which will be a separate 5-percent shareholder of the loss corporation.<sup>105</sup>

As in the case of direct public groups of the loss corporation itself,

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100. *Id.* § 1.382-2T(j)(2)(vi) (1987).

101. *Id.* § 1.382-2T(j)(3)(i), (iii) (1987).

102. *Id.* § 1.382-2T(j)(3)(i) (1987).

103. *Id.*

104. *Id.* § 1.382-2T(j)(3)(iii) (1987).

105. *Id.*

any future acquisition by such an entity or from the entity by a 5-percent shareholder will be considered as being made proportionately by or from, as the case may be, the separate public groups.<sup>106</sup>

**OWNERSHIP CHANGE.** The final step is to determine whether the 5-percent shareholders, including the public group 5-percent shareholders, have increased their percentage ownership interest by fifty percentage points during the relevant testing period. The percentage ownership determination is made by comparing the fair market value of the stock in question to the fair market value of the outstanding stock of the corporation.<sup>107</sup> The loss corporation must identify each 5-percent shareholder whose percentage of stock ownership in the loss corporation immediately after the close of the testing date has increased compared to such shareholders lowest percentage interest during the testing period. Any 5-percent shareholders whose interest, as of the close of the testing date, is less than the testing period low is disregarded.<sup>108</sup> Additionally, whether or not the increases are a result of related or unrelated events is irrelevant.<sup>109</sup> All increases are then added together. If there has been a fifty percentage point increase an ownership change has occurred.

It is important to note that if a shareholder's interest fluctuates during the testing period, the percentage increase is measured by using the lowest percentage interest during the testing period. Example: X owns 60% of Loss Corporation's stock at the beginning of the testing period. One year after the testing period began, X owned only 10% of Loss Corporation's stock. On the testing date, X owned 40% of Loss Corporation's stock. Notwithstanding the fact that X owns less stock on the testing date than he did at the beginning of the testing period, he has increased his percentage interest by thirty points (40%-10%) during the testing period. The fact that his interest has decreased on an overall basis during the testing period is not considered in the ownership change determination.

**STOCK.** The definition of "stock" in the statute for purposes of determining whether an ownership change has occurred is straightforward. Stock means stock, other than preferred stock described in section 1504(a)(4); i.e., stock which (i) is not entitled to vote; (ii) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent; (iii) has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium); and (iv) is not convertible into an-

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106. *Id.* § 1.382-2T(j)(3)(v) (1987). If the transfer is between members of the separate public groups, it is disregarded for purposes of the section 382 limitation. *Id.* § 1.382-2T(j)(1)(ii) (1987).

107. *Id.* § 1.382-2T(f)(18)(i) (1987). A change of ownership percentage attributable solely to fluctuation in the relative fair market value of different classes of stock will be disregarded. I.R.C. § 382(1)(3)(D) (West Supp. 1988).

108. Temp. Treas. Reg. § 1.382-2T(c)(1) (1987).

109. *Id.* § 1.382-2T(c)(3) (1987).

other class of stock.<sup>110</sup> Preferred stock that is not described under section 1504(a)(4) solely because it is entitled to vote in the event of dividend arrearages is not considered stock.<sup>111</sup>

Congress realized that, without this broad definition of stock, there would be too many possibilities of avoiding the intent of the section 382 rules by fashioning stock interests which would effectively pass the beneficial ownership of NOL carryovers to new owners without resulting in an ownership change under section 382.<sup>112</sup> Accordingly, the Secretary of the Treasury has been given a broad grant of authority to treat various instruments as stock and "to treat stock as not stock."<sup>113</sup> In this regard, the Temporary Regulations provide that, if, at the time of issuance or transfer to (or by) a 5-percent shareholder, the likely participation of stock in future corporate growth is disproportionately small when compared to the relative value of the stock, the stock will not be treated as stock. This rule will not apply unless treating the stock as not stock would result in an ownership change and the NOL carryover is more than *de minimis*.<sup>114</sup> Additionally, if preferred stock which would otherwise not be treated as stock has the potential for a significant participation in corporate growth, it will be treated as stock for these purposes, if doing so would result in an ownership change and the NOL carryover is more than *de minimis*.<sup>115</sup>

## B. Explanation of the Section 382 Limitation.

### 1. General Rules.

Once it has been established that an ownership change has occurred with respect to a loss corporation's stock, the section 382 limitation will be imposed.<sup>116</sup> The extent of the limitation will depend, in part, on whether or not the loss corporation's business is continued for two years following the change of ownership.

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110. I.R.C. §§ 382(k)(6), 1504(a)(4) (1982 & West Supp. 1988).

111. Temp. Treas. Reg. § 1.382-2T(f)(18)(i) (1987).

112. CONFERENCE REPORT, *supra* note 45, at II-173.

113. I.R.C. § 382(k)(6)(B) (West Supp. 1988).

114. Temp. Treas. Reg. § 1.382-2T(f)(18)(ii) (1987). For the rules to apply, the NOL carryover must be more than twice the amount of the annual limitation which would otherwise apply. *Id.*

115. *Id.* § 1.382-2T(f)(18)(iii) (1987).

116. As a literal matter, section 382 provides that taxable income of a loss corporation for any "post change year," which may be offset by "pre-change losses" shall not exceed the section 382 limitation for such year. I.R.C. § 382(a) (West Supp. 1988). "Post-change year" means any taxable year after the "change date." *Id.* § 382(d)(2) (West Supp. 1988). "Change date" is the date on which an owner shift occurs resulting in an ownership change. *Id.* § 382(j) (West Supp. 1988). "Pre-change losses" means any net operating loss carryforward to the taxable year ending with the ownership change or in which the change date occurs, and the net operating loss for the taxable year in which the ownership change occurs to the extent such loss is allocable to the period in such year on or before the change date. *Id.* § 382(d)(1) (West Supp. 1988).

Generally, if the corporation does not continue the business of the corporation at all times during the two-year period after the change of ownership is complete, NOL deductions will not be allowed.<sup>117</sup> According to the Conference Report, the new continuity of business requirement is the same requirement that must be satisfied to qualify a transaction as a tax-free reorganization under section 368; i.e., the acquiring (or surviving) corporation must continue the loss corporation's historic business or use a significant portion of the loss corporation's assets in a business.<sup>118</sup> Changes in key employees or in the location of the loss corporation's business will not defeat the business continuity test. Also, the Conference Report indicates that the requirements will be satisfied, notwithstanding the fact that the loss corporation may discontinue more than a minor portion of its historic business.<sup>119</sup> This new standard will be easier to meet than the standard under prior law, which required the acquiring (or surviving) corporation to continue "substantially the same" business.

In certain circumstances, however, NOL deductions will be allowed even though the two-year continuity requirement has not been met. To the extent the corporation has either "recognized built-in gains" within the prescribed five-year period following the ownership change, or gain recognized as result of a section 338 election, the NOL carryover may be used even though the business is not continued for two years following the change.<sup>120</sup>

In the event the corporation satisfies the continuity of business requirement, the focus is on the amount of the NOL carryover that may be utilized. Generally, in any year after the change of ownership is complete, the maximum amount of income which can be offset is limited to the amount determined by multiplying the value of the loss corporation immediately before the ownership change by the "long-term tax exempt rate."<sup>121</sup> Value is simply defined in the statute as fair market value.<sup>122</sup> The value of the loss corporation stock includes certain non-voting preferred stock which is not considered in determining whether an owner-

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117. *Id.* § 382(c)(1) (West Supp. 1988).

118. CONFERENCE REPORT, *supra* note 45, at II-189; Treas. Reg. § 1.368-1(d)(2) (as amended 1980). In this regard, the Senate Report referred to the difficulty of identifying a particular business where assets and activities are constantly combined, separated or rearranged and noted a concern that the prior law's requirement might induce taxpayers to continue "uneconomic" businesses. SENATE REPORT, *supra* note 4, at 234. Although some of the problems inherent in the prior law have been mitigated by the continuity of business change, they have not been eliminated. Continuity of business is still determined by the facts and circumstances, and will not always be easy to make. In addition, uneconomic businesses will invariably still be continued, even if modified in operation more than under prior law. Since the NOL deduction has been, in concept, limited to the earnings from the liquidated assets of the loss corporation, a question arises as to whether the continuity of business requirement, albeit a two year requirement, was necessary at all.

119. CONFERENCE REPORT, *supra* note 45, at II-189.

120. I.R.C. § 382(c)(2) (West Supp. 1988).

121. *Id.* § 382(b)(1) (West Supp. 1988).

122. *Id.* § 382(k)(5) (West Supp. 1988).

ship change has occurred.<sup>123</sup> According to the Conference Report, the value at which the stock is acquired in an arm's length transaction is evidence, though not conclusive, of the value of the stock.<sup>124</sup> Example: Loss Corporation has \$1,000,000 in NOL carryovers and its sole shareholder Z sells all of the Loss Corporation stock to Y on January 1, 1988 for \$500,000. Loss Corporation continues in the same business for at least two years after January 1, 1988. A portion of the \$1,000,000 NOL carryover may be used by Loss Corporation during each year of the carryover period. The usable portion is the amount determined by multiplying \$500,000 (the value of the corporation at the time of the ownership change) by the long-term tax exempt rate. If the applicable rate were 10%, the usable portion of the NOL carryover in 1988 (and each year thereafter) would be \$50,000.

"Long-term tax exempt rate" is defined as the highest of the adjusted federal long-term rates in effect for any month in the three-calendar month period ending with the calendar month in which the ownership change occurs.<sup>125</sup> The "adjusted" federal long-term rate is the long-term rate determined under section 1274(d), adjusted for differences between rates on long-term taxable and tax-exempt obligations.<sup>126</sup> This downward adjustment of the applicable federal rate compensates for the fact that, due to the NOL carryover, the value of the loss corporation is greater than the value of its assets considered separately. Therefore, the annual earnings (the effective amount of the limitation under section 382 based on the value of the stock) would be greater than the earnings from the corporation's assets. The NOL deduction in such case could be used by the new corporation faster because the section 382 limitation would be higher as a result of the higher purchase price for the assets, plus the NOL carryover. To eliminate this incentive to acquire a loss corpora-

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123. *Id.* § 382(e)(1) (West Supp. 1988). Temp. Treas. Reg. § 1.382-2T(f)(18)(i) (1987). When a redemption occurs in connection with an ownership change, the value of the stock of the loss corporation is determined after taking the redemption into account. I.R.C. § 382(e)(2) (West Supp. 1988). In addition to redemptions, "other corporate contractions," must be considered in determining value. Tech. Corr. Act, *supra* note 68, at § 106(d)(1)(A). Where the value of a corporation is burdened by debt to pay the former shareholders or where the debt is an obligation of an affiliate, but where the loss corporation will be the source of the funds, the value of the stock should be accordingly reduced. STAFF OF THE JOINT COMM. ON TAXATION, 100th Cong., 1st Sess., DESCRIPTION OF THE TECHNICAL CORRECTIONS ACT OF 1987, H.R. 2636, 32 (Comm. Print 1987).

124. CONFERENCE REPORT, *supra* note 45, at II-187. The Conference Report singles out the following structure as one in which the amount paid for the stock is not necessarily the value to be used in calculating the limitation of I.R.C. § 382 (West Supp. 1988). If 40% of the stock of the loss corporation is acquired over a 12 month period and the remaining 20% is thereafter acquired, and a premium paid therefor, the acquisition price for all the stock cannot be grossed up to determine valuation. The Conference Report does indicate, however, that the regulations should be drafted to allow a gross up when control is acquired if all the acquisitions are within a 12 month period. *Id.*

125. I.R.C. § 382(f) (West Supp. 1988).

126. *Id.*

tion, the return on the value of the corporation is lowered through adjustments for the tax-exempt obligations.<sup>127</sup>

Once an ownership change has occurred, the section 382 limitations will continue to be imposed even if the loss corporation ceases to exist under state law as a result of a liquidation into a parent corporation under section 332, or if the loss corporation otherwise merges with another corporation in a tax-free reorganization referred to in section 381(a)(2).<sup>128</sup> Any NOL carryovers of the loss corporation or net unrealized built-in losses at the time of the liquidation or reorganization will be accounted for separately from the losses of the acquiring corporation.<sup>129</sup> Example: Loss Corporation has \$100,000 of NOL carryovers subject to the section 382 limitations as a result of an ownership change on January 1, 1988. On March 1, 1989 Loss Corporation merges into X Corporation in a transaction in which an ownership change does not occur. Notwithstanding the fact that Loss Corporation ceased to exist as a legal entity at the time of the merger, and that X Corporation is otherwise entitled to use Loss Corporation's NOL carryover under section 381, X Corporation is considered to be a loss corporation and its use of the predecessor loss corporation's NOL carryover is subject to the section 382 limitation.

## 2. Special Rules.

The terms of section 382 and of yet-to-be promulgated regulations include numerous exceptions and special rules with respect to the section 382 limitation. These special rules and exceptions address, among other things, the treatment of losses in the year of the ownership change, the carryforward of the limitation amount, the built-in gain or loss at the time of the ownership change, the gain resulting from a section 338 election, the valuation of the loss corporation's stock in special circumstances, and the treatment of a corporation involved in bankruptcy proceedings.

**TREATMENT OF LOSS IN YEAR OF OWNERSHIP CHANGE.** In the event the loss corporation has taxable income for the year in which the ownership change occurs, the income which is allocable to the portion of the year preceding the date of the ownership change can be offset by the NOL carryovers without limitation.<sup>130</sup> The allocation of taxable income in the year of the ownership change will be made ratably to each day of the year, unless regulations provide otherwise.<sup>131</sup> Future regulations may provide for an election by the loss corporation to determine its taxable income allocable to the portion of the year prior to the change of ownership by closing its books on the date of the ownership change, rather than by allocating income ratably through the

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127. CONFERENCE REPORT, *supra* note 45, at II-188.

128. Temp. Treas. Reg. § 1.382-2T(f)(1)(ii) (1987).

129. *Id.* § 1.382-2T(f)(1)(iii) (1987).

130. I.R.C. § 382(b)(3)(A) (West Supp. 1988).

131. *Id.*



year.<sup>132</sup> The regulations also could exclude from the ratable allocation income attributable to discrete sales of assets realized prior to the date of the ownership change and could allow such gain to be offset completely by the NOL carryover deduction.<sup>133</sup> The section 382 limitation for the remainder of the year of the ownership change is the usual limitation proportionately reduced in accordance with the length of time during that taxable year prior to the ownership change.<sup>134</sup>

**SECTION 382 LIMITATION CARRYOVER.** If the section 382 limitation for a year exceeds that year's taxable income, the difference is carried forward and added to the section 382 limitation for the next year.<sup>135</sup> While there is no limit on the number of years to which the unused limitation may be carried, the carryover of the NOLs themselves is subject to the fifteen year time limitation.<sup>136</sup> The section 382 limitation, whether or not fully used each year, has no impact on the NOL carryforward period under section 172. It is possible, and even likely, that in many instances the annual limitation will be so low as to make it impossible to use the entire NOL carryover before the carryover period expires.

**BUILT-IN GAINS AND LOSSES.** Congress recognized that inherent in the assets of a loss corporation on the date of an ownership change there could be unrealized losses or gains and that these losses and gains merited special treatment under the new rules.<sup>137</sup> Since the gains from the sale of the loss corporation's assets could have been offset in full by the NOL carryover deduction if the sale had taken place prior to the ownership change, they should be able to be offset after the change.<sup>138</sup> On the other hand, losses which have economically accrued, but have not yet been realized were viewed by Congress as the "economic equivalent" of NOL carryovers which should be treated as such in the event of an ownership change, regardless of the fact that they are realized after the ownership change.<sup>139</sup> Congress attempted to solve this problem by incorporating the built-in gain and loss rules into the Code.

With regard to gain, if certain requirements are satisfied, the section 382 limitation for any of the prescribed years shall be increased by the amount of gain recognized that year attributable to the gain inherent in

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132. CONFERENCE REPORT, *supra* note 45, at II-186. The IRS has indicated that the regulations will provide for an election to allocate income by closing the books as of the date of the change, but that until the new rules are issued, the income or loss of the year closing is allocated ratably over the entire tax year, unless a private letter ruling provides otherwise. I.R.S. Notice 87-79, 1987-52 I.R.B.

133. CONFERENCE REPORT, *supra* note 45, at II-186.

134. I.R.C. § 382(b)(3)(B) (West Supp. 1988).

135. *Id.* § 382(b)(2) (West Supp. 1988).

136. *Id.* § 172(b)(1)(B) (West Supp. 1988).

137. STAFF OF THE JOINT COMM. ON TAXATION, 99TH CONG. 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, 298 (Comm. Print 1987) [hereinafter GENERAL EXPLANATION].

138. SENATE REPORT, *supra* note 4, at 235.

139. *Id.*

the corporation's assets at the time of the ownership change. The requirements are as follows:

(i) the loss corporation must have a "net unrealized built-in gain;" i.e., the fair market value immediately before the ownership change of its assets in excess of the aggregate adjusted basis of its assets;<sup>140</sup>

(ii) the net unrealized built-in gain must be in excess of 25% of the value of the loss corporation's assets (cash, cash items, and marketable securities whose value does not substantially differ from the adjusted basis are excluded for this computation);<sup>141</sup>

(iii) the gain must be recognized by the disposition of an asset within five years from the date of the ownership change;<sup>142</sup> and

(iv) the loss corporation must establish that it held the asset immediately before the ownership change and that the gain (which will increase the section 382 limitation) is the amount of gain inherent at the time of the ownership change.<sup>143</sup>

Since the net unrealized built-in gain is a net amount after consideration of built-in losses, not every sale of built-in gain assets will increase the section 382 limitation. The limitation can be increased only to the extent of the net unrealized built-in gains.<sup>144</sup>

A similar set of rules applies to determine, and limit the use of, built-in losses. These rules make it especially important for a loss corporation which incurs an ownership change to review and record its assets at the time of the change and obtain appraisals in order to substantiate the use of the NOLs when the assets are sold in the future.

If the analysis indicates that the fair market value at the time of the ownership change of the assets is less than the aggregate adjusted basis of the assets, there is net unrealized built-in loss. Again, as with net unrealized built-in gains, if the amount of the built-in loss does not exceed 25% of the value of the corporation's assets it will be disregarded.<sup>145</sup>

Any recognized built-in loss is subject to the section 382 limitation as if it were a NOL carryover from the period prior to the ownership change. As in the case of built-in gains, an appraisal at the time of the ownership change should be considered because, unless the corporation establishes that the assets were not held immediately prior to the change of ownership or that the loss exceeds the actual built-in loss, any loss

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140. I.R.C. § 382(h)(3)(A) (West Supp. 1988).

141. *Id.* § 382(h)(3)(B) (West Supp. 1988).

142. *Id.* § 382(h)(2)(A) (West Supp. 1988). The five-year period is referred to as the "recognition period." *Id.* § 382(h)(7)(A) (West Supp. 1988).

143. *Id.* § 382(h)(2)(A) (West Supp. 1988).

144. *Id.* § 382(h)(1)(A)(ii) (West Supp. 1988).

145. Section 382(h)(8) includes a special valuation rule for purposes of determining net unrealized built-in loss. I.R.C. § 382(h)(8) (West Supp. 1988). That is, if 80% or more of the value of the stock of a corporation is acquired in one or a series of related transactions, the fair market value of the corporation's assets shall not exceed the "grossed up" amount paid for the stock, properly adjusted for corporate liabilities (and "other relevant items"). *Id.*

during the relevant five-year period is considered a recognized built-in loss.<sup>146</sup>

The regulations to be promulgated concerning the built-in loss rule are likely to treat certain deferred deductions which accrued prior to the change but which are deductible after the change as built-in losses.<sup>147</sup> No reference is made for similar treatment (as built-in gain) for income items which have economically accrued but have not yet been realized.

The annual section 382 limitation may also be increased to take into account gain resulting from an election under section 338 to treat stock acquisitions as assets acquisitions.<sup>148</sup> As enacted, section 382(h)(1)(C) provides that the increase resulting from a section 338 election is the excess of the gain recognized under section 338 over the portion of the same gain taken into account as recognized built-in gains for the year. Section 106(d)(3)(A) of the Technical Corrections Act, however, would make a change to provide that the income is equal to the lower of the section 338 gain or the net unrealized built-in gain without regard to the 25% threshold requirement.<sup>149</sup>

**VALUATION RULES.** There are special anti-abuse rules included in section 382 to prevent transactions which circumvent the section 382 limitations and which, if applicable, will impact the valuation of the loss corporation's stock.<sup>150</sup>

Capital contributions received by a corporation as part of a plan the principal purpose of which is to avoid or increase any section 382 limitation will not be taken into account for purposes of the limitation.<sup>151</sup> In other words, increases to the value of the corporation prior to the ownership change by a contribution to capital will be disregarded if made pursuant to such plan. Any contribution during the two years prior to the ownership change will be treated as part of such plan, unless regulations provide otherwise.<sup>152</sup> The regulations may make an exception for capital contributions received on formation of a loss corporation (as long as they are not accompanied by assets with net unrealized built-in loss), as well as those received before the first year from which there is a NOL (or excess credit) carryover, or in which a net unrealized built-in loss arose.<sup>153</sup> In addition, contributions made to continue basic operations of the corporation's business, such as to meet monthly payroll and to fund

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146. *Id.* § 382(h)(2)(B) (West Supp. 1988).

147. CONFERENCE REPORT, *supra* note 45, at II-191. The types of deferral deductions specifically referred to in the Conference Report are deductions taken in connection with I.R.C. §§ 267 and 465 (West Supp. 1988).

148. I.R.C. § 382(h)(1)(C) (West Supp. 1988).

149. *See* Tech. Corr. Act, *supra* note 68.

150. SENATE REPORT, *supra* note 4, at 233.

151. I.R.C. § 382(l)(1)(A) (West Supp. 1988).

152. *Id.* § 382(l)(1)(B) (West Supp. 1988). Capital contribution is to be interpreted broadly to encompass any "direct or indirect infusion of capital" into a loss corporation, including the merger of one corporation into a commonly held loss corporation. CONFERENCE REPORT, *supra* note 45, at II-189.

153. CONFERENCE REPORT, *supra* note 45, at II-189.

other operating expenses of the corporation may also be excepted from the section 382 limitation.<sup>154</sup>

The regulations to be promulgated may also take into account distributions to the shareholders subsequent to the capital contributions made in connection with the contributions.<sup>155</sup> The distributions would be allowed to offset the contributions and, therefore, result in less of a decrease in the value of the corporation's stock.

The value of the loss corporation's stock will also be adjusted downward if one-third or more of the value of all the corporation's assets immediately following the ownership change are assets held for investment.<sup>156</sup> The amount of the reduction will be equal to the excess of the fair market value of the corporation's investment assets over the investment debt, i.e., the portion of the corporation's debt which bears the same proportion to total debt as the fair market value of investment assets bears to all assets.<sup>157</sup> The Conference Report indicates that cash will be considered an investment asset for this purpose.<sup>158</sup> Also, there is a special "look through" rule with respect to stock in a subsidiary, i.e., a corporation in which the loss corporation owns 50% or more of all classes of voting stock and 50% or more of the total value of all classes of stock.<sup>159</sup> In such a case, the stock of the subsidiary is disregarded as an investment asset and the parent corporation is deemed to own its proportionate share of the subsidiary's assets.<sup>160</sup> The purpose of this rule is to prevent a corporation from liquidating a large part of its operating assets and investing in passive assets, the income on which would be offset by the NOL carryover.<sup>161</sup>

**BANKRUPTCY PROCEEDINGS.** Under prior law, in cases other than a reorganization defined in section 368(a)(1)(G), stock issued by an insolvent corporation to the corporation's unsecured creditors in return for discharge of the corporation's debt was, as a general rule, treated as a taxable purchase which could be subject to the limitations of old section 382.<sup>162</sup> Subject to certain specific limitations, the new section 382 includes provisions which provide relief when the loss corporation is under the jurisdiction of the court in a federal bankruptcy or other similar proceeding and the historic shareholders and creditors of the loss cor-

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154. *Id.*

155. *Id.*

156. I.R.C. § 382(l)(4) (West Supp. 1988).

157. *Id.* An exemption from the investment asset rule is made for regulated investment companies, real estate investment trusts, and real estate mortgage investment conduits. *Id.* § 382(l)(4)(B)(ii) (West Supp. 1988).

158. CONFERENCE REPORT, *supra* note 45, at II-190.

159. I.R.C. § 382(l)(4)(E) (West Supp. 1988).

160. *Id.*

161. SENATE REPORT, *supra* note 4, at 233. It is expected that additional anti-abuse rules will be promulgated in regulations under I.R.C. § 382(m)(3) to limit the use of NOL carryovers to offset allocations of partnership income to a loss corporation partner. See CONFERENCE REPORT, *supra* note 45, at II-194.

162. I.R.C. § 382(a)(l), (4) (1982); Rev. Rul. 77-81, 1977-1 C.B. 97.

poration (determined immediately before such ownership change) own at least 50% of the value and voting power of the corporation's stock immediately after the ownership change.<sup>163</sup>

The stock held by a creditor will be considered in this regard only if the debt was held by the creditor for at least eighteen months before the commencement of the bankruptcy proceeding or if it arose in the ordinary course of the trade or business of the corporation and is held by the person who at all times holds the beneficial interest in such indebtedness.<sup>164</sup> Additionally, the Technical Corrections Act would clarify that stock held by a prior stockholder is taken into account only to the extent that such stock was received in exchange for stock held immediately before the ownership change.<sup>165</sup>

The Code provides several limitations to these rules. The NOL carryover deduction must be reduced for certain interest paid to creditors whose debt has been converted to stock in the proceeding. The NOL carryover must be reduced by the amount of interest paid to such creditors during the period of the taxable year in which the ownership change occurs on or before the change date, or during any of the three preceding taxable years.<sup>166</sup> The purpose for this reduction is to reflect that the creditor's interest before the ownership change was an equity interest, with interest payments to the holder treated as non-deductible amounts.<sup>167</sup>

A second adjustment is a reduction of the carryover by an amount equal to 50% of any income excluded by the operation of section 108(e)(10)(B).<sup>168</sup> In a bankruptcy case or to the extent a debtor corporation is insolvent, section 108(e)(10)(B) provides that discharge of indebtedness income does not include the amount by which the discharged debt exceeds stock given in exchange for such debt. The result under new section 382 is that the NOL carryover is reduced by 50% of the amount by which the discharge of indebtedness exceeds the fair market value of the loss corporation's stock. Example: Pursuant to a plan approved by the court in a bankruptcy proceeding, the stock of Loss Corporation is issued to creditor Z to discharge a debt in the amount of \$100,000. The value of the Loss Corporation stock issued to creditor Z is \$50,000. Section 108(e)(10)(B) allows Loss Corporation to exclude from income the discharge of indebtedness income which would otherwise be included in the amount of \$50,000. Therefore, under section 382 the NOL carryover would be reduced by \$25,000 (50% × \$50,000).

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163. I.R.C. § 382(I)(5)(A) (West Supp. 1988). The stock-for-debt exchange must be ordered by the court or be pursuant to a plan approved by the court. CONFERENCE REPORT, *supra* note 45, at II-192.

164. I.R.C. § 382(I)(5)(E) (West Supp. 1988).

165. Tech. Corr. Act, *supra* note 68, at § 106(d)(7).

166. I.R.C. § 382(I)(5)(B) (West Supp. 1988).

167. REVISION REPORT, *supra* note 24, at 249-50. Presumably, the NOL carryover reduction must only be made for interest deducted, and no reduction need be made for accrued interest which has not resulted in a deduction.

168. I.R.C. § 382(I)(5)(C) (West Supp. 1988).

Lastly, if there is a second ownership change within two years of the change of ownership in the bankruptcy proceeding, the NOL carryovers are eliminated completely.<sup>169</sup> According to the Senate Report, this limitation stems from a view that the corporation had no value as of the ownership change and that any value it has within the following two years is a result of capital contributions or debt discharge.<sup>170</sup> Accordingly, a purchase made prior to the two-year period should not obtain the benefit of the bankruptcy proceeding rules.<sup>171</sup>

### C. Identification and Information Reporting Requirements.

As a means of policing the imposition of the section 382 limitations, the Temporary Treasury Regulations require a loss corporation to report on its income tax return information relevant to a determination of whether an ownership change has occurred.<sup>172</sup> The statement filed with the return must include: (i) a statement as to whether any testing dates occurred during the year and identification of each testing date, (ii) identification of the date, if any, on which an ownership change occurred, (iii) a list of each 5-percent shareholder on the testing dates, the respective percentage ownership interests of each 5-percent shareholder as of the testing dates, and the increase, if any, of ownership interests during the testing period, and (iv) a statement as to the extent to which the corporation relied on Securities and Exchange Commission filings<sup>173</sup> or a signed statement of a representative of entity owners to determine ownership interest in the loss corporation.<sup>174</sup> Additionally, the Temporary Regulations require a loss corporation to keep records necessary to determine (i) the identity of 5-percent shareholders, (ii) their ownership interest in the corporation, and (iii) whether the section 382 limitation is applicable.<sup>175</sup> An affirmative duty is imposed on the loss corporation to determine the stock ownership on each testing date of any individual with a direct ownership interest of 5% or more in the loss corporation, any first tier entity, any higher tier entity with an indirect ownership interest of 5% or more in the loss corporation's stock, and any individual who indirectly owns 5% or more of the stock of the loss corporation through ownership interests in a first tier or higher tier entity.<sup>176</sup>

For purposes of making these determinations, a corporation whose stock is subject to the rules of section 13(d) of the Securities Exchange Act of 1934 may, subject to the Actual Knowledge Rules and Avoidance Rules, rely on the existence and absence of the filings of relevant sched-

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169. *Id.* § 382(l)(5)(D) (West Supp. 1988).

170. SENATE REPORT, *supra* note 4, at 246.

171. *Id.* See I.R.C. § 382(1)(5)(F) (West Supp. 1988) for special rules relating to ownership changes of financial institutions involved in certain reorganizations.

172. Temp. Treas. Reg. § 1.382-2T(a)(2)(ii) (1987).

173. See text accompanying note 178.

174. Temp. Treas. Reg. §§ 1.382-1T(a)(2)(ii), 1.382-2T(k)(1) (1987).

175. Temp. Treas. Reg. § 1.382-2T(a)(2)(iii) (1987).

176. *Id.* § 1.382-2T(k)(3) (1987).

ules to identify the individuals and first tier entities who have a direct ownership interest of 5% or more in the corporation's stock.<sup>177</sup> Additionally, similar filings with respect to the registered stock of any first tier entity or higher tier entity may be relied on to identify the individuals who indirectly, through such entity, are 5-percent shareholders of the loss corporation.<sup>178</sup>

The loss corporation may also make the necessary identification in reliance on a statement, signed under penalties of perjury, by a representative of a first tier entity or higher tier entity as to the changes in ownership interest of any individual who owns 5% or more of the the entity's stock. The loss corporation, however, may not rely on such a statement if the loss corporation knows the statement is false or if the statement is made by an entity that owns 50% or more of the loss corporation's stock.<sup>179</sup>

#### D. *Effective Dates.*

Section 382 generally applies to ownership changes occurring after December 31, 1986.<sup>180</sup> In the case of an equity structure shift resulting in an ownership change after December 31, 1986, the new rules will not apply if the plan of reorganization was adopted before January 1, 1987, and, either alone or in combination with other events prior to January 1, 1987, results in an ownership change. A plan of reorganization is considered to have been adopted on the earlier of (i) the first date the boards of directors of all parties to the reorganization have adopted the plan or have recommended adoption to their shareholders, or (ii) the date the shareholders approve the plan.<sup>181</sup> In any case, the testing period can begin no earlier than May 6, 1986. Owner shifts prior to that date are disregarded.<sup>182</sup> Old section 382 continues to apply to any increase in ownership to which the new rules do not apply because of the transitional rules.<sup>183</sup> Example: Z and Y each own 50% of the stock of Loss Corporation. Z transfers 40% of Loss Corporation stock to X on January 1, 1986, and Y transfers 20% of Loss Corporation's stock to W on January 1, 1987. New section 382 does not apply to render these transactions an ownership change because the transfer from Z to X is prior to the earliest testing date of May 6, 1986. Therefore, old section 382 would apply. Likewise, if both transfers of Loss Corporation stock were between May 6, 1986 and December 31, 1986, old section 382 would apply (and the NOL carryover deduction would be limited, unless the con-

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177. *Id.* § 1.382-2T(k)(1)(i) (1987).

178. *Id.*

179. *Id.* § 1.382-2T(k)(1)(ii) (1987).

180. TRA '86, *supra* note 16, at § 621(b)(f); Temp. Treas. Reg. § 1.382-2T(m)(1) (1987).

181. Temp. Treas. Reg. § 1.382-2T(m)(2) (1987).

182. *Id.* § 1.382-2T(m)(3) (1987).

183. See GENERAL EXPLANATION *supra* note 137, at 327. A clarifying amendment is included in section 106(d)(10) of the Tech. Corr. Act, *supra* note 68, with respect to the continued application of § 382.

tinuity of business requirements were satisfied). In the event an ownership change does occur after May 5, 1986 and on or before December 31, 1986, a new testing period will begin after the ownership change even though the new section 382 limitation will not apply.<sup>184</sup>

Special transitional rules apply to aggregation and segregation of public groups. As to testing dates prior to September 4, 1987, the public groups of a first tier entity or higher tier entity will not include stock acquired by such entities on or before May 5, 1986.<sup>185</sup> The rules requiring segregation of a loss corporation's direct public group as a result of transactions by the loss corporation shall only apply to tax-free reorganizations in which more than one corporation is a party to the reorganization.<sup>186</sup> Furthermore, transfers of stock of the loss corporation, a first tier entity or higher tier entity by an individual, first tier entity or higher tier entity acquired on or before May 5, 1986 will not be subject to the segregation rules.<sup>187</sup> The loss corporation, however, is permitted to apply public group rules without the special transitional rules.<sup>188</sup>

Equity structure shifts in which a first tier entity or higher tier entity is involved where more than one corporation is a party to the reorganization will be considered even though the testing date is prior to September 4, 1987.<sup>189</sup>

The information reporting requirements do not apply to any taxable year for which the due date, including extensions, of the income tax return is on or before October 5, 1987.<sup>190</sup>

Special effective date rules also apply to option transactions. For purposes of a deemed exercise, options issued prior to May 6, 1986 are considered only if transferred by, or to, a 5-percent shareholder or a person who would be a 5-percent shareholder if this option were treated as exercised. Where the options are not transferred by or to such a shareholder or person, the options are not taken into account until exercised.<sup>191</sup>

The new rules relating to bankruptcy proceedings apply to ownership changes after December 31, 1986 in cases filed with the relevant court on or after August 15, 1986.<sup>192</sup>

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184. See CONFERENCE REPORT, *supra* note 45, at II-196.

185. The September 4, 1987 effective date is one month after publication of the Temporary Treasury Regulations. See Temp. Treas. Reg. § 1.382-2T(m)(4)(i).

186. Temp. Treas. Reg. § 1.382-2T(m)(4)(i)(B).

187. Temp. Treas. Reg. § 1.382-2T(m)(4)(A) (1987).

188. *Id.* § 1.382-2T(m)(4) (1987).

189. *Id.*

190. *Id.* § 1.382-2T(m)(4)(v) (1987).

191. *Id.* § 1.382-2T(m)(8)(i) (1987). For special transitional rules relating to options issued on or after September 18, 1986 and before January 1, 1987. See *id.* § 1.382-2T(m)(8) (1987).

192. *Id.* § 1.382-2T(m)(5) (1987).



#### IV. CONCLUSION

Section 382, as rewritten by TRA '86, is undoubtedly Congress' most conceptually refined approach to the limitation of trafficking in NOL carryovers. Whereas the prior law adopted an all or nothing approach, which depended on the subjective intent of the acquiring party in the case of section 269 (which remains in effect) and continuation of the loss corporation's business in the case of old section 382(a), TRA '86, with one exception, abandons the all or nothing approach and attempts to fashion an approach which is in accord with sound tax policy and the economic realities of a transaction. To the extent the combination of old assets and old capital from which the NOLs were derived could have produced income, the new corporation can use the NOLs to offset future income. No longer will the recouping of corporate losses fall on the government as a result of merely continuing the same business or, in the case of a tax-free reorganization, as a result of a limited continued interest in the surviving corporation. The one exception where the all or nothing approach has survived is with respect to the continuity of business requirement which requires continued operation of the business for two years after the ownership change in order to avail of any NOL carryover deduction. An additional conceptual refinement is the uniformity of treatment of ownership changes resulting from taxable and tax-free transactions. No longer does it matter how the ownership change was effected; it only matters that it was effected.

Even if the conceptual underpinnings of the TRA '86 are accepted, the application of the new rules in certain circumstances is flawed. The continuity of business requirement, though less stringent than under prior law, may still result in the continuation of an uneconomical business. Also, the existence of such a requirement when, after an ownership change, the NOL carryover deductions are limited to the earnings of the loss corporation's assets does not materially further the new law's purpose of restoring the income averaging function of the NOL carryover rules. There also remains the possibility after an ownership change for an inequitable result as to continuing shareholders who may be effectively deprived of their use of the NOLs in the event and to the extent the business turns around without the infusion of capital or income producing activities and assets by the new shareholders.

This latest development in the evolution of tax policy as it relates to NOL carryovers, though more refined and arguably more rational than prior laws, generally will be unwelcome by loss corporations and their shareholders. The new rules are far more complicated to analyze and to apply than prior law and will require more record keeping, compliance measures and appraisals than prior law. The detailed analysis and identification to be made with respect to 5-percent shareholders, including public groups, the inclusion of option transactions in the ownership change analysis, the built-in gain or loss rules, and the potential need for appraisals on a testing date make the rules burdensome even to those loss

corporations who do not experience an ownership change. The most significant impact, however, is the difficulty of using the NOL carryover after an ownership change. The limitation of NOL carryover deductions on an annual basis to a relatively small percentage of the value of the corporation at the time of the ownership change will take the NOL carryovers from the position of being a valuable asset and meaningful factor in the acquisition of a corporation's business and relegate the NOL carryovers to playing a minor, possibly very minor, role in future acquisitions, as Congress intended.