REPORT #675

TAX SECTION

New York State Bar Association

Report on Proposed Treasury Regulations Under Sections 269 and 382

December 17, 1990

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New York State Bar Association

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December 19,1990

The Honorable Fred T. Goldberg, Jr.
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington", D.C. 20024

Re: Proposed Regulation (CO-77-89)

Dear Commissioner Goldberg

I enclose our Report on the Proposed Treasury Regulations Under Sections 269 and 382. The principal authors of the Report are Steven C. Todrys and Stuart J. Goldring, Co-Chairmen of our Committee of Net Operating Losses.

We strongly urge that the proposed regulations be withdrawn and substantially modified before reissuance. In particular, we oppose the adoption of the presumption in the regulations of tax avoidance purpose where the loss corporation does not carry on more than an insignificant amount of an active trade or business. It is unclear to us whether regulations under section 269 are necessary, but if they are to be promulgated, we suggest that they contain a non-exhaustive list of factors to be considered in applying section 269. Our Report suggests some factors to be included.

The Report also comments on the impact of determinations under section 1129 (d) of the Bankruptcy Code on the issue of tax avoidance purpose under section 269. It also suggests changes in the option attribution rules proposed under section 382(1)(5).

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We hope that this report will be useful to you in preparing final regulations on the subject.

Very truly yours,

Arthur Feder
Chair

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NEW YORK STATE BAR ASSOCIATION

TAX SECTION

COMMITTEE ON NET OPERATING LOSSES
COMMITTEE ON BANKRUPTCY

Report on Proposed Treasury Regulations Under Sections 269 and 382

December 17, 1990

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON PROPOSED TREASURY REGULATIONS UNDER SECTIONS 269 AND 382

COMMITTEE-ON NET OPERATING LOSSES*
COMMITTEE ON BANKRUPTCY

December 17, 1990

On August 13, 1990, the Department of the Treasury ("Treasury") issued proposed regulations (CO-77-89) concerning the relationship between sections 269 and 382 of the Internal Revenue Code,[1/] in particular the application of section 269 to ownership changes governed by section 382(1)(5). On September 5, 1990, Treasury issued proposed regulations (CO-69-89)-providing additional guidance under section 382(1)(5).

I. Overview

Section 382 provides, in general, that when there has been an ownership change of a loss corporation, the use of the corporation's losses is limited on an annual basis to the equity value of the loss corporation immediately before the ownership change multiplied by the long-term tax exempt rate. All losses, however, are disallowed if the loss corporation does not continue the business

* This report was prepared by Steven C. Todrys and Stuart J. Goldring, Co-Chairmen of the Committee on Net Operating Losses, and Stephen R. Field, Co-chairman of the Committee on Bankruptcy. Helpful comments were received from Peter C. Canellos, Peter L. Faber, Arthur A. Feder and Gordon D. Henderson.

1/ All section references are to the Internal Revenue Code of 1986, as amended, unless otherwise stated.

enterprise conducted prior to the ownership change at all times during the two-year period beginning on the date of the ownership change.

Section 382(1)(5) provides that the basic limitation of section 382 is inapplicable to an ownership change if (i) the loss corporation is under the jurisdiction of a court in a title 11 or similar case and (ii) the shareholders and creditors (immediately before the ownership change) own (after the ownership change and as a result of being shareholders or creditors before the change) at least 50 percent of the total voting power and value of the stock of the loss corporation. Only creditors who have held their claims for at least 18 months before the filing of the case, or whose claims arose in the ordinary course of the debtor's business, qualify for this test. Section 382(1)(5)(E). If section 382(1)(5) applies, the loss corporation's tax attributes are reduced for certain interest deducted on debt exchanged for stock and for amounts not treated as discharge of indebtedness income by reason of the-stock-for-debt exception. Sections 382(1)(5)(B) and (C). In addition, if a second ownership change occurs within two years, section 382(a) is applied retroactively and the section 382 limitation with respect to the second ownership change is zero. Section 382(1)(5)(D).

II. The Proposed Regulations

The first set of proposed regulations (August 13, 1990) contains the following basic rules:

1. Section 269 may be applied to disallow a deduction, credit, or other allowance notwithstanding that the utilization of that deduction, credit or allowance is limited by section 382 or 383. However, the limitation is relevant in .determining whether the principal purpose of the acquisition of control is the evasion or avoidance of Federal income tax. Prop. Reg. § 1.269-7. The preamble to the proposed regulations cites as their source the statement in the Conference Report to the Tax Reform Act of 1986 (the "1986 Act") that the legislation adopting sections 382 and 383 "does not alter the continuing application of section 269, relating to acquisitions made to evade or avoid taxes, as under present law."[2/]

2. The proposed regulations confirm that the continuity of business enterprise requirement of section 382(c) is inapplicable to an ownership change governed by section 382(1)(5). Prop. Reg. § 1.382-3(b).

3. However, the proposed regulations also provide that, "[a]bsent strong evidence to the contrary, a requisite acquisition of control or property in connection with an .ownership change to which section 382(1)(5) applies is considered to be made for the principal purpose of evasion or avoidance of Federal

[2/] H.R. Conf. Rep. No. 99-841, 99th Cong., 2nd Sess. 11-194 (1986) (the "Conference Report").

income tax unless the corporation carries on more than an insignificant amount of an active trade or business during and subsequent to the title 11 or similar case." Prop. Reg. § 1.269- 3(d). This modified continuity of business enterprise requirement is based on all facts and circumstances including the amount of business assets that continue to be used and the number of employees who continue in the work force. The requirement may be satisfied even though all trade or business activities of the corporation temporarily cease. Id.

4. Section 1129(d) of the Bankruptcy Code provides that "on request of a party in interest that is a governmental unit, the court may not confirm a plan if the principal purpose of the plan is the avoidance of taxes. . . In any hearing under this subsection, the governmental unit has the burden of proof on the issue of avoidance." Prop. Reg. § 1.269-3(e) states that the fact that a governmental unit did not seek a determination under section 1129(d) of the Bankruptcy Code is not controlling for purposes of section 269, nor is an actual-determination by the court. The rationale of the proposed regulation is that the burden of proof under the Bankruptcy Code is on the governmental unit whereas the burden of proof under section 269 is on the taxpayer.

5. Finally, Prop. Reg. § 1.269-5(b) states that the acquisition of control of a corporation by creditors of a bankrupt corporation does not occur earlier than the confirmation of the plan of reorganization by the bankruptcy court, even though "the interests of the creditors predominate as a practical matter" before that date. Thus, the proposed regulations reject an extended application of the doctrine of Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179 (1942), which treated creditors as having a proprietary interest in the corporation for purposes of the continuity of interest test under the predecessor to section 368.

The second set of proposed regulations (September 5, 1990) provides the following additional rules:

1. The Internal Revenue Service (the "Service") has issued several private rulings holding that the confirmation of a plan of reorganization is an interest similar to an option under Temp. Reg. § 1.382-2T(h)(4)(v)[3/] and that, therefore, the confirmation date is the testing date for an ownership change, unless the plan is effective within 120 days and the loss corporation elects to apply the later date. Temp. Reg. § 1.382- 2T(h)(4)(x)(J) excludes the confirmation of a plan from the option attribution rules until the effective date.

2. In general, options are treated as exercised under section 382(1)(3)(A)(iv) if the exercise results in an

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[3/] See e.g. PLR 8902047 (October 28, 1988).

ownership change. Because section 382(1)(5) presupposes an ownership change, the preamble to the proposed regulations states that the option attribution rules did not apply to determine whether the shareholders and qualified creditors obtained the requisite stock ownership of the loss corporation.[4/] Prop. Reg. § 1.382-3(c)(1) provides that the option attribution rules apply to section 382(1) (5) if their application would cause the pre-change shareholders and qualified creditors to fail to satisfy the stock ownership requirement of section 382(1)(5)(A)(ii). Options held as a result of being pre-change shareholders or qualified creditors are not treated as exercised. If there is a lapse or forfeiture of an option that caused section 382(1)(5) to not apply, the loss corporation may file amended returns (within the statute of limitations) to claim the benefits of section 382(1)(5).

III. Summary of Major Recommendations

1. We urge Treasury to quickly modify the proposed regulations because of their in terrorem effect on pending reorganizations.

2. We believe that section 269 should apply to transactions subject to section 382 only when the statutory purposes of section 382 are circumvented. Failure of the loss corporation to carry on more than an insignificant amount of an active trade or business

[4/] Some practitioners had suggested that, because section 382(1)(5)(A)(ii) refers to section 1504(a)(2), the option

should be one of the factors enumerated, but such failure should not create a presumption that section 269 applies. Since section 269 applies a subjective standard, it is not clear to us that detailed regulations in the area are necessarily desirable. If there are to be regulations, however, we believe they should include a non-exhaustive list of factors to be considered in applying section 269.

3. We recommend that the regulations abstain from comment as to the controlling effect of a determination under section 1129(d) of the Bankruptcy Code. However, a determination by the bankruptcy court that the principal purpose of a plan of reorganization is not tax avoidance should be included as a factor indicating that section 269 does not apply.

4. We support the rejection by the regulations of an extended application of the Alabama Asphaltic doctrine. However, we recommend that the regulations add a statement that ordinarily the acquisition of control by creditors of a bankrupt corporation shall not occur until the effective date of the bankruptcy plan of reorganization, at which time the debt is actually exchanged for stock of the bankrupt corporation.

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attribution rules under section 1504 -- which have yet to be released in regulations -- would apply.

5. We support the exclusion of the confirmation of a plan of reorganization from the option attribution rules until the effective date of the plan, and recommend that corporations be allowed to elect the exclusion retroactively.

6. We support the application of a set of option attribution rules to the determination of stock ownership under section 382(1)(5)(A)(ii). However, we propose a modification that would treat as exercised, for purposes of satisfying the stock ownership requirement, certain options held as a result of being pre-change shareholders or qualified creditors. We also suggest certain technical changes in the proposed rules.

IV. Discussion

A. Relationship Between Section 269 and Section 382

The only reference to the relationship between section 269 and section 382 in the 1986 Act is the statement in the Conference Report that the legislation "does not alter the continuing application of section 269".

Prior to the 1986 Act, section 269 played a limited role in acquisitions otherwise governed by section 382. The report of the Senate Finance Committee on the 1976 amendments to section 382 stated:

"The committee believes, however, that section 269 should not be applied to disallow net operating loss

carryovers in situations where part or all of a loss carryover is permitted under the specific rules in section 382, unless a device or scheme to circumvent the purpose of the carryover restriction appears to be present."[5]

Although that legislative history is not controlling, we believe that it reflects a proper balancing of the relative roles of section 382 and 269. This also accords with our understanding of Congress' intent in providing for the continued application of section 269 in the Conference Report to the 1986 Act. Accordingly, as discussed below, we believe that where section 382 applies, the role of section 269 — and, thus, the focus of the regulations — should be limited to those situations which circumvent the purposes of section 382.

Section 382(a) contains comprehensive limits to assure that after an ownership change losses can only be used against income generated by the historic capital of the loss corporation. The possibility of effecting the kind of transaction that was the real focus of section 269 (the infusion of a profitable business into a loss corporation) is severely limited because: (i) the section 382 limitation is based upon pre-ownership change values, (ii) section 382(1)(1) excludes pre-change capital contributions from the computation of value, (iii) section 382(1) (4) reduces value in the case of substantial non-business assets and (iv) section 382(c) imposes a continuity of business enterprise requirement.

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[5] S. Rep. No. 94-938, 94th Cong., 2d Sess. 206 (1976).

Prop. Reg. § 1.269-7 recognizes that the limitations of section 382(a) and 383 are "relevant" in determining tax avoidance purposes. We believe that if those limitations are applicable, they should ordinarily make section 269 inapplicable. At very least, the regulations should point out that time-value factors greatly reduce the economic value of NOLs (and credits) if sections 382 and 383 apply.

For different reasons, we also believe section 269 should play a limited role in ownership changes subject to section 382(1)(5). There, Congress expressed a policy of fostering the rehabilitation of bankrupt corporations in the hands of shareholders and qualified creditors by excluding acquisition of control by these persons from the general limitations of section 382. A different set of detailed requirements applies under section 382(1)(5), including the limiting definition of qualified creditors, the regulatory application of the option attribution rules, the reductions in tax attributes and the elimination of losses if a subsequent ownership change takes place within two years.

The proposed regulations fail to apply section 269 consistently with the statutory scheme of section 382. First, even though the continuity of business enterprise test is specifically inapplicable to section 382(1)(5)[6], the proposed regulations adopt a modified (and ill-defined) version of that test to create a presumption of tax avoidance purpose. In drafting section 382, Congress carefully considered and explicitly addressed the continuity of business rule, significantly altering the role served by the rule (as well as the rule itself).[7] It is therefore noteworthy that in doing so Congress did not impose a continuity of business test in section 382(1)(5). This being the case, Treasury should not now resurrect a change in business test under the guise of a regulatory presumption under section 269.

Second, the proposed regulations ignore the historic relationship, recognized by the report of the Senate Finance Committee on the 1986 Act (the "Senate Report"), of the creditors in funding the losses of the corporation.

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[6] See Prop. Reg. § 1.382-3(b).

[7] Under prior law, in the context of "purchase" transactions, section 382 did not apply unless the corporation failed to continue substantially the same trade or business. In contrast, current section 382 applies regardless of change in business but, under the general limitations, provides that the annual limitation shall be zero if the continuity of business test is not satisfied.

> "[In the case of an insolvent corporation], the loss corporation's creditors are the true owners of the corporation, although it may be impossible to identify the point in time when ownership shifted from the corporation's shareholders. The committee concluded that relief from a strict application of the general rule should be provided, as the creditors of an insolvent corporation frequently have borne the losses reflected in an NOL carryforward."[8]

The committee's concern "about the potential for abusive transactions" was satisfied by "appropriate safeguards intended to limit tax-motivated acquisitions of debt issued by loss corporations." Senate Report at 236. Finally, the proposed regulations do not even deal with the key inquiry under section 269 — whether there is a plan to infuse capital or a profit-making business into the loss corporation.

We propose that Prop. Reg. § 1.269-3(d) and § 1.269- 5(b) be deleted. Where section 382 applies, section 269 appropriately serves as a back-stop for those situations which circumvent the purposes of section 382 but could not be foreseen at the time of section 382's enactment. Because section 269 is a subjective test based upon the facts and circumstances of the particular case, it is not clear to us that detailed regulations in the area are necessarily desirable. If there are to be regulations, however, we believe they should include a non-exhaustive list of factors to be considered in applying section 269. We believe that those factors should include the following:

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[8] S. Rep. No. 99-313, 99th Cong., 2d Sess. 236 (1986). Cf. GCM 34185 (August 22, 1969) recognizing the interrelationship between losses and borrowed funds, and the continued availability of losses when creditors acquire stock of the loss corporation. See also In re Prudential Lines Inc.. Dkt. No. 90 Civ. 1262 (S.D.N.Y. October 3, 1990) in which the court prevented a parent corporation from claiming a worthless stock deduction which would eliminate the loss carryforwards of a subsidiary under section 382(g)(4)(D) and stated "[w]hen creditors go unpaid due to the very losses giving rise to the NOL, they ought to be able to realize the value of a NOL carryover as property of the bankruptcy estate upon reorganization".

1. Business continuity. Whether the loss corporation is carrying on any business activity is a relevant factor, as is the amount of the NOLs relative to the quantum of business activity. However, the regulations should recognize that the pruning of a troubled company's business, as well as a temporary cessation of business activity, is a natural part of the rehabilitative process. See New York State Bar Association Tax Section, Committee on Bankruptcy, Report on Reorganizations Under Section 368(a) (1) (G); Recommendations for Proposed Regulations. October 25, 1985, at pp. 14-25.

2. Relationship of creditors to the losses. Consistent with the Senate Report, a relevant factor is the relationship between the amount of losses funded by the creditors who acquire stock and the amount of losses incurred by the corporation prior to the issuance of indebtedness to those creditors. We believe this inquiry could reveal tax avoidance purpose when, for example, the corporation's losses were funded with equity and, at the time that the creditors acquired their debt, it was foreseeable that the corporation would become bankrupt or insolvent and that the creditors would become the stockholders. We do not believe, however, that where section 382(1)(5) could apply (whether or not the corporation elects out of such section), the acquisition of debt in the market for less than face amount should indicate tax avoidance purpose given that the 18-month holding period requirement for qualified creditors in section 382(1)(5)(E) reflects the Congressional policy judgment that such holding period was sufficient to protect against trafficking in losses through acquisition of indebtedness.

3. Shift in ownership. The acquisition by a new investor of more than 50% of the stock of the loss corporation through a combination of pre-change ownership of stock or qualified debt

and a substantial new investment may evidence tax 13 avoidance purpose. In this case, control could have been acquired by a person who does not have a significant pre-change interest in the loss corporation.[9/]

4. Cutbacks. We believe that the reduction in tax attributes under section 382(1)(5)(B) and (C) should be a factor contra-indicating tax avoidance purpose, as are the limitations under sections 382(a) and 383 where section 382(1) (5) does not apply. Prop. Reg. § 1.269-7.[10]

5. Other business purposes. As in any other section 269 analysis, the presence of other business purposes for not liquidating, and for acquiring stock in, the reorganized corporation should be taken into account. In addition, a determination by the bankruptcy court under section 1129(d) of the Bankruptcy Code that the principal purpose of the plan of reorganization is not tax avoidance should be included as a factor indicating that section 269 does not apply.

B. Section 1129(d) of the Bankruptcy Code

We agree that the failure of a court to make a determination concerning tax avoidance purpose under section 1129(d) of the Bankruptcy Code should have no relevance under section 269. On the other hand, there is some question whether an actual determination of the tax avoidance issue in the bankruptcy

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[9/] On the other hand, the infusion of capital by the reorganized corporation's shareholders who were historic shareholders or qualified creditors after a change in ownership under section 382(1)(5) should not indicate tax avoidance purpose.

[10] The Service might consider adopting a safe harbor that section 269 is inapplicable when the reduction in favorable tax attributes exceeds a specified percentage.

proceeding should be res judicata between the Service and the loss corporation in a subsequent dispute concerning section 269.

We have found only one recent case dealing with section 1129(d) of the Bankruptcy Code, In re Rath Packing Co.. 55 B.R. 528 (1985)[11/].u In Rath, the loss corporation sold all of its assets and was left with a $35 million net operating loss carryforward. The corporation was publicly traded and its stock was widely distributed. An investor group proposed a modification to the plan of reorganization under which the old shareholders would retain 52% of the corporation's stock, the old creditors would obtain 17% in exchange for their debt and the new investors would purchase 31% for cash. Rath would then form a subsidiary in which it would initially own 80% of the stock and the new investors would own 20%. The investors would have options to acquire up to 80% of the stock of the subsidiary and would agree to lend the subsidiary up to $10 million to acquire new businesses.

The bankruptcy court in Rath raised section 1129(d) of the Bankruptcy Code without a formal request from the Service. As a result, the Service argued that the issue of tax avoidance purpose was not properly before the court for determination. The court rejected the Service's position and held that Rath's publicly-held status was as important a factor in the plan of reorganization as the tax losses. Therefore, it concluded that the principal purpose of the plan was not tax avoidance. The court must have believed that its determination was res judicata on the issue of tax avoidance purpose because, in ruling that it

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[11/] See also In re Maxim Industries Inc.. 22 B.R. 611 (1982), in which the court denied confirmation of a plan under section 1129(a)(3) of the Bankruptcy Code on the ground that it was not proposed in "good faith," where a shell corporation's losses were to be used to shelter the income of an unrelated profit corporation.

could make a determination under section 1129(d) of the Bankruptcy Code without a formal request, it stated that it was "not going to allow the IRS to ... bring an action in tax court seven years from now." Id. at 536.

Nevertheless, a determination as to tax avoidance purpose in the bankruptcy proceeding under section 1129(d) of the Bankruptcy Code may not be res judicata in a subsequent dispute under section 269 because, in part, of the differing burden of proof.[12/] We doubt, however, that the ultimate resolution of this issue is within the Service's regulatory power. Accordingly, we recommend that final regulations abstain from any comment (pro or con) as to the controlling effect of a determination under section 1129(d) of the Bankruptcy Code.

C. Alabama Asphaltic Doctrine

We support the proposed regulation's conclusion that the acquisition of control by creditors of a bankrupt corporation does not occur earlier than the confirmation of the plan of reorganization by the bankruptcy court and, thus, the implicit rejection of an extended application of the Alabama Asphaltic doctrine.

This conclusion, however, begs the question whether the creditors should be treated as stockholders as of the confirmation of the plan of reorganization or, alternatively, only at the time the debt is actually exchanged for stock of the bankrupt corporation (generally the effective date of the plan). Although this distinction may have little relevance to the application of section 269 due to the factual nature of the determination, it has potential substantive implications in other

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12/ See Restatement of Judgments 2d § 2S(4) (1982).

areas of the tax law. For example, it may affect the date on which a debt-for-stock exchange occurs for purposes of determining gain or loss. Accordingly, we recommend that the regulations add the statement that ordinarily the acquisition of stock by creditors of a bankrupt corporation shall not occur until the effective date of the bankruptcy plan of reorganization, at which time the debt is actually exchanged for stock of the reorganized corporation.

D. Option Attribution Rules

We support the proposed regulation excluding the confirmation of a plan of reorganization from the option attribution rules until the effective date of the plan, and recommend that the regulation allow an election to apply this rule retroactively. Since it is not uncommon for the effective date to occur more than 120 days after confirmation, the proposed regulation will tend to prevent a change date from occurring before the corporation actually emerges from bankruptcy and the debt is discharged under the plan.

We also believe that the application of the option attribution rules is appropriate in determining whether the stock ownership requirements of section 382(1)(5) are satisfied. We question, however, whether a blanket rule disregarding options held by pre-change shareholders and qualified creditors is consistent with the purpose of the statute. In our view, such a rule disregards the acknowledged policy objective of fostering the rehabilitation of bankrupt corporations and, thus, is inconsistent with the Congressional policy supporting a bankruptcy exception to the general limitations of section 382. Rather, the section 382(1)(5) option attribution rules should be tailored to the perceived abuse — namely, the issuance of options

with no significant likelihood of exercise (determined at the time of issuance) to pre-change shareholders and qualified creditors so that the actual or constructive ownership of a new investor is reduced to a point where section 382(1)(5) is applicable.[13/] Thus, although inconsistent with the general option attribution rules, we believe that the option attribution rules under section 382(1)(5) should treat as exercised all options (including those held as a result of being pre-change shareholders and qualified creditors), other than in the above described abusive case. Cf. Temp. Reg. § 1.382-2T(m)(8)(iii). Any stock deemed held under the option attribution rules as a result of being a pre-change shareholder or qualified creditor would count towards satisfying the ownership requirement of section 382(1)(5)(A)(ii).

If, however, the proposed option attribution rules are retained, the proposed regulation should include the following two additional examples on the treatment of options held by pre-change shareholders and qualified creditors.

> Example 1: Pursuant to a confirmed bankruptcy plan of reorganization, pre-change shareholders and qualified creditors of Corporation L acquire all 100 shares of common stock, and options to acquire an additional 50 shares of common stock, in exchange for their stock and debt. Corporation L issues options to acquire 110 shares of common stock to a new investor.

Under the proposed regulation, the options issued to pre-change shareholders and qualified creditors are not treated as exercised. Therefore, section 382(1)(5) will be inapplicable because the new investor owns, by attribution, more than 50% of the stock of Corporation L.

[13/] Admittedly, determining whether options fall into this class may raise factual issues.

Example 2; Pursuant to a confirmed bankruptcy plan of reorganization, pre-change shareholders and qualified creditors acquire all 100 shares of common stock of Corporation L in exchange for their stock and debt. They had previously purchased options to acquire 50 shares of common stock of Corporation L. A new investor acquires an option to purchase 90 shares of common stock of Corporation L.

Assume that the 50 options were not acquired as a result of being pre-change shareholders and qualified creditors, they are treated as exercised for purposes of the stock ownership test of section 382(1)(5). As a result, that test will not be satisfied because only 100/240 shares (41.7%) were acquired as a result of being pre-change shareholders and qualified creditors.[14/]

The proposed regulations do not provide guidance on J whether an option is held as a result of being a pre-change shareholder or qualified creditor. We believe that options held as a result of being pre-change shareholders or qualified creditors should include any options issued in connection with the original issuance of the instruments, or any modification or refinancing of the instruments, including options received in the reorganization. In addition, options previously issued as distributions on stock or in payment of interest on indebtedness should qualify as options acquired as a result of being a pre-change shareholder or qualified creditor.

We also believe the regulations should permit loss corporations to satisfy retroactively the stock ownership test of section 382(1)(5). if, taking into account options held by pre-change shareholders and qualified creditors, the test would have been satisfied, and such options are in fact exercised before (or at the same time as) the options held by the nonqualifying

[14/] Taken to extreme, section 382(1)(5) would not apply if pre-change shareholders and qualified creditors held options on 110 shares not acquired as a result of being pre-change shareholders and creditors, even without a new investor.

investor,[15/] In this case, as in the case of the lapse or forfeiture of options held by the nonqualifying investor, the loss corporation should be permitted to file an amended return (if the statute of limitations has not expired) claiming the benefits of section 382(1)(5).

As a final point, we recommend that the regulations make it clear that a loss corporation may make a protective election under section 382(1)(5)(H). Since a loss corporation can elect out of section 382(1)(5), it should not be forced, retroactively, into section 382(1)(5) by reason of a lapse, forfeiture or exercise of an option as described in the preceding paragraph. Otherwise, the loss corporation may lose the benefit, for example, of section 382(1)(6).

In conclusion, we urge Treasury to quickly modify the proposed regulations because their in terrorem effect impairs the ability of corporations to complete their reorganizations.

[15/] Similarly, see New York State Bar Association Tax Section, Committee on Net Operating Losses, Supplemental Report on Section 382. February 22, 1988, at pp. 37, 82-83, recommending a similar approach under the existing option attribution rules.