REPORT #526

New York State Bar Association

TAX SECTION

REPORT ON NET OPERATING LOSS PROVISIONS OF H. 3838

May 12, 1986

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TAX SECTION

New York State Bar Association

Attached letter dated 5/13/86 enclosing report on pending legislative proposals for the treatment of net operating loss carryovers sent to the following:

The Honorable Dan Rostenkowski
cc: The Hon. John J. Duncan
Robert J. Leonard, Esq.

The Honorable Bob Packwood
Chairman
Senate Finance Committee
cc: The Hon. Russell B. Long
John Colvin, Esq.

The Honorable David H. Brockway
Chief of Staff
Joint Committee on Taxation

J. Roger Mentz, Esq.
Assistant Secretary (Tax Policy)
United States Treasury

REPORT # 526

TAX SECTION

New York State Bar Association

May 13, 1986

The Honorable Dan Rostenkowski
2232 Rayburn Building
Washington, DC 20515

Dear Representative Rostenkowski:

Enclosed is a report of the New York State Bar Association Tax Section on pending legislative proposals for the treatment of net operating loss carryovers.

The report makes three principal recommendations:

1. If proposed section 382 is enacted, Section 269 (insofar as it relates to the tax attributes that may be affected by proposed sections 382 and 383) should be repealed and so should the consolidated return SRLY and CRCO limitations.

2. Given the existence of a continuity of business enterprise requirement, the provisions limiting the use of NOL carryovers where the loss corporation owns nonbusiness assets should apply, if at all, only to the extent that nonbusiness assets do not exceed the net amount of recent contributions to capital. Capital contributions invested in business assets should not reduce the trigger value.

3. The use of a long-term federal bond rate adjusted for the difference between taxable and tax-exempt rates to calculate the trigger value produces an unrealistically low ceiling on the use of NOL carryovers; at certain interest rate levels the result may be the economic equivalent of a flat disallowance of a substantial percentage of the loss corporation’s carryovers. We could not support enactment of proposed section 382 if the trigger amount were calculated based on a tax-exempt bond rate.

In addition, the report contains technical comments that discuss (1) the trigger that must occur to invoke the limitations of section 382, (2) calculation of the trigger amount, (3) the continuity of business enterprise requirement, (4) rules for built-in gains and losses, (5) rules for nonbusiness assets, (6) special rules for bankrupt or insolvent corporations, (7) the effect of proposed section 382 on gain recognized by a target as a result of a deemed sale of assets under section 338, (8) previously acquired shares, (9) effective dates and, finally, (10) organization and drafting style.

I hope the report proves useful to you in considering the net operating loss carryover proposals.

Sincerely,

Richard G. Cohen
Chairman

Enclosure

cc: The Hon. John J. Duncan) w/ enclosure
Robert J. Leonard, Esq.) w/ enclosure

REPORT #526

NEW YORK STATE BAR ASSOCIATION, TAX SECTION

REPORT ON NET OPERATING LOSS PROVISIONS OF H.R. 3838

May 12, 1986

New York State Bar Association, Tax Section

Report on Net Operating Loss Provisions of H.R. 3838[1]

I. Introduction.

A. Background.

Section 321 of H.R. 3838, as passed by the House of Representatives on December 17, 1985 ("H.R. 3838" or the "House Bill"), provides for a sweeping revision of sections 382 and 383.[2] These sections restrict the use of net operating loss ("NOL") and other carryovers of a corporation following certain acquisitions of the corporation's stock or assets. This report comments on the proposed amendments to sections 382 and 383 contained in the House Bill. The need for changes in sections 382 and 383 has been recognized for some time. These sections were substantially amended by the Tax Reform Act of 1976, but the effective dates of those amendments have been repeatedly

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[1] This report was prepared by James M. Peaslee and Matthew A. Rosen, Co-chairmen of the Committee on Net Operating Losses, Robert P. Rothman, David Z. Nirenberg, Morris Kramer, Herbert Camp and Matthew Brady. Helpful comments were received from Peter C. Canellos, Richard G. Cohen, Arthur A. Feder, Kenneth H. Heitner, Robert A. Jacobs and Michael L. Schler.

[2] Except where otherwise noted, all references herein to sections and chapters are to sections and chapters of the Internal Revenue Code of 1954, as amended (the "Code").

postponed on the ground that the amendments were seriously flawed.[3] Over the past few years, a consensus has developed that an alternative approach to the 1976 amendments, based on the so-called “neutrality principle”, should be adopted. This principle provides the conceptual foundation for the limitations on NOL and other carryovers included in the House Bill.

The neutrality principle has been the touchstone of a number of reform proposals beginning with the American Law Institute’s 1982 study on subchapter C (the “ALI Proposal”).[4] The most recent proposals are those adopted by the tax section of the American Bar Association in February of 1985 (the “ABA Proposal”)[5] and those included in the May 1985 final report of the staff of the Senate Finance Committee on subchapter C reforms (the “SFC Proposal”).[6] Appendix A to this report compares the ABA Proposal and the SFC Proposal with proposed section 382.

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3 The 1976 amendments have been in effect since January 1, 1986 as a result of a failure of Congress to enact a further extension of the effective dates. However, it is anticipated that any revision of sections 382 and 383 that emerges from the current tax reform effort would be effective on January 1, 1986, or, alternatively, if such revision becomes effective on a later date, the pre-1976 version of sections 382 and 383 would be further extended until that later effective date. Thus, in either case, in practical terms, the 1976 amendments would be repealed.

4 American Law Institute, Federal Income Tax Project -- Subchapter C: Proposals on Corporate Acquisitions and Dispositions (1982).

5 Report on American Bar Association Legislative Recommendation No. 1985-1, February 6, 1985 (“ABA Report”).

6 The Subchapter C Revision Act of 1985 -- A Final Report Prepared by the Staff, S. Prt. 47, 99th Cong., 1st Sess. (“Senate Finance Subchapter C Report”).

Under the neutrality principle, NOLs would generally be available to the buyer of a corporation to the extent, but only to the extent, that they would have been available to the seller had the acquisition not taken place. To achieve this result, the House Bill, in a manner similar to the ABA Proposal and the SFC Proposal, would limit the use of pre-acquisition losses to the amount of income that would have been generated by the loss corporation, calculated by applying a hypothetical rate of return to the value of the loss corporation's equity at the time of the acquisition.

In testimony before the Senate Finance Committee on September 30, 1985, the Tax Section supported the neutrality principle and, with some reservations, the overall approach of the SFC Proposal relating to carryovers.[7] H.R.3838 incorporates most of the features

[7] In particular, the Tax Section took the position that the applicable Federal long-term rate was too low as an assumed earn-out rate, there should be no special rule for investment companies (although an investment company might be required to use a lower earn-out rate reflecting the lower level of risk associated with its assets), section 269 should not disallow any loss or credit to which section 382 or 383, as amended, applied, and, upon adoption of the proposed new version of sections 382 and 383, the separate return limitation year and consolidated return change of ownership rules found in the consolidated return regulations should be repealed.

of the SFC Proposal, but differs from the SFC Proposal in some significant respects as described in Appendix A.

The Senate Finance Committee has approved an amended version of H.R. 3838. As far as can be determined from the information currently available to the public, the Senate Finance Committee bill generally follows the provisions of the House Bill relating to sections 382 and 383, but makes a number of technical changes. Not surprisingly, many of those changes would eliminate or reduce differences between the House Bill and the SFC Proposal. Given that the text of the Senate Finance Committee bill is not available, we have not commented specifically on that bill (to the extent it differs from the SFC Proposal) in this report.

A note on terminology may be helpful. In this report, the term “proposed section” will refer to sections of the Code as amended by the House Bill and “SFC section” and “ABA section” will refer to sections of the Code as amended by the SFC Proposal and the ABA Proposal, respectively. Section 382 as in effect prior to January 1, 1986 will be cited as “old section 382”. An acquired loss corporation will sometimes be referred to as “L” and an acquiring corporation as “P”. The report of the House Ways and Means Committee accompanying H.R. 3838 (H. Rep. No. 99-426, 99th Cong. 1st Sess.) will be cited as the “House Report”.

The balance of this report consists of a summary of proposed section 382, followed by general and technical comments on the House Bill.

B. Summary of Proposed Section 382.

The principal features of proposed section 382 are as follows:

General Rule. Under proposed section 382(a), if a “trigger” (as defined below) occurs with respect to L, the amount of income of L in any post-acquisition year that may be offset by its pre-acquisition NOL carryovers[8] is limited to the “trigger amount”, defined in proposed section 382(b)(1) as the product of the “trigger value” and the long-term tax-exempt bond rate. If that amount exceeds the actual income for a year, there is an increase in the next year’s trigger amount, thus providing a carry forward of the excess until it is absorbed.

Continuity. Under proposed section 382(c), the trigger amount is zero, and thus no carryover of NOLs is allowed, “if the continuity of business enterprise requirements applicable under section 368 are not met with respect to [L] during the 2-year period beginning on the date of the trigger”.

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8 References herein to limitations on NOL carryovers should generally be understood to include references to other tax attributes that are subject to a parallel set of limitations under proposed section 383.

Trigger Value. Under proposed section 382(e), the trigger value of L is generally the value of its equity (including stock, warrants, options and the conversion features of debt) immediately before the trigger. Proposed section 382(e)(3) provides that if the last component event of a trigger is a redemption, the trigger value is determined immediately thereafter, i.e., after subtracting the value of the redeemed stock. Under proposed section 382(e)(4), in the case of a “G” reorganization or an exchange of stock for debt in a bankruptcy case, the trigger value is the equity value after the trigger.

Rate. The long-term tax-exempt bond rate is the section 1274(d) Federal long-term rate, adjusted under regulations to reflect the difference between taxable and tax exempt rates. Proposed section 382(f).

Trigger. A trigger is a more than 50-percent owner shift or a more than 50-percent equity structure change. Proposed section 382(g)(1). The former occurs if the total value of the stock (defined below) of L held at the end of the testing period (defined below) by 5-percent shareholders (including for this purpose all shareholders holding individually less than 5 percent taken as a group) has increased by more than 50 percentage points compared to their holdings at the beginning of the testing period. Proposed sections 382(g)(2) and (i)(2). Under proposed section 382(i)(1), a 5-percent shareholder is any person holding 5-percent or more in value of the stock of L at any time during the testing period.

A more than 50-percent equity structure change occurs if, as a result of a reorganization (other than a divisive reorganization), the continuing interest of the shareholders of L in the corporation that survives the reorganization is less than 50%. Proposed sections 382(g)(3) and (5). If there has been an increase in the holdings of 5-percent shareholders during the testing period ending immediately prior to the reorganization, then the continuing interest is reduced under proposed section 382(j)(2).[9] Under proposed section 382(k), the testing period is, generally, the 3-year period ending with an owner shift or equity structure change.

Built-In Gains and Losses. Under proposed section 382(h)(1), net unrealized built-in gains, when recognized in the 10-year period after the trigger, increase the trigger amount, and net unrealized built-in losses, when recognized in that 10-year period, are limited as if they were pre-trigger losses. A net unrealized built-in gain (or loss) is the excess (or shortfall) of value over adjusted basis of all assets of L on the trigger day, except that there is no such gain or loss unless it exceeds 15% of the value of such assets (exclusive of cash, cash items and marketable securities not having substantial appreciation or depreciation). Proposed section 382(h)(3).

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9 For example, if a 10% stockholder increases his ownership of L stock to 30% as a result of a cash purchase, and within the next 3 years (the testing period) L is acquired in a reorganization in which its stockholders receive 60% of the stock of the acquiring corporation, the continuing interest percentage (60%) would be reduced by 20%, to 48%, on account of the 20 percentage point increase in the 10% stockholder's stock holdings prior to the reorganization.

Stock. Under proposed section 382(m)(6), “stock” excludes nonparticipating, nonvoting preferred stock des-scribed in section 1504(a)(4), and under proposed section 382(o), regulations are authorized treating warrants, convertible obligations and other similar interests as stock and treating options as having been exercised.

Capital Contributions. Under proposed section 382(n)(1), the trigger value is reduced by capital contributions during the testing period.

Nonbusiness Assets. Under proposed section 382(n)(8), the trigger value is reduced if at least 1/3 of the value of the assets of L consists of (1) cash, (2) marketable stocks or securities, (3) assets not held for active use in a trade or business or (4) assets disposed of outside the ordinary course of business pursuant to a plan or arrangement in existence before the trigger day. The reduction is the excess of the value of such assets over a ratable part of L’s indebtedness. For purposes of the 1/3 rule, a parent corporation owning 50% or more (by vote or value) of the stock of another corporation is deemed to own its ratable share of the subsidiary’s assets.

SRLY; CRCO; Libson Shops; Section 269. The legislative history indicates that following the adoption of proposed section 382, the separate return limitation year (“SRLY”) and consolidated return change of ownership (“CRCO”) rules currently applicable under the consolidated return regulations[10] and section 269 will continue to apply, but the rule of Libson Shops v. Koehler, 353 U.S. 382 (1957) (business continuity test applied under the 1939 Internal Revenue Code in determining the availability of NOL carryovers following a merger), will cease to have any effect. House Report at 272. Section 269 generally applies to disallow NOL carryovers or other tax benefits where control of a corporation is acquired, or assets of a corporation are acquired in a carryover basis transaction from unrelated persons, and the principal purpose for the acquisition is tax avoidance. Thus, section 269 presumably can eliminate NOL carryovers when control of L is acquired even though the carryovers are not limited under proposed section 382.

[10] Under the SRLY rules (Treasury Requlations sections 1.1502-l(f),-15 and -21(c)), an NOL carryover from a SRLY can be applied in a consolidated return only against income of the loss member. Taxable years before a corporation became a member of a group are considered SRLYs. In addition, built-in losses in excess of a de minimis amount are treated, when realized within a ten-year period, as if they were SRLY losses. If the persons described in old section 382(a) increase their percentage ownership of the common parent of an affiliated group within two taxable years by more than 50 percentage points by purchase or redemption, a CRCO occurs. Thereafter, losses of the old members of the group can be used to offset only income of the old members of the group. Treasury Regulations sections 1.1502-(1)(g) and -21(d).

C. Summary of Comments.

Our general comments on proposed section 382 may be summarized as follows:

1. Section 269 (insofar as it relates to the tax attributes that may be affected by proposed sections 382 and 383) and the SRLY and CRCO limitations should be repealed if proposed section 382 is enacted.

2. Given the existence of a continuity of business enterprise requirement, the provisions limiting the use of NOL carryovers where L owns nonbusiness assets should apply, if at all, only to the extent that nonbusiness assets do not exceed the net amount of recent contributions to capital. Capital contributions should not reduce the trigger value to the extent they are invested in business assets.

3. The use of a long-term federal bond rate adjusted for the difference between taxable and tax-exempt rates to calculate the trigger value produces an unrealistically low ceiling on the use of NOL carryovers; at certain interest rate levels the result may be the economic equivalent of a flat disallowance of a substantial percentage of L’s carryovers. Such a rate of return is likely to be meaningfully lower been earned by than the return on equity that could have the pre-trigger owners of L -- a clear contradiction of the neutrality principle. We could not support enactment of proposed

section 382 if the trigger amount were calculated based on a tax-exempt bond rate.

On a more technical level, our major recommendations include the following:

1. The two proposed definitions of trigger, for tax-free reorganizations and owner shifts, should be replaced with a single unified definition of trigger.

2. The rules governing transfers of stock between related parties, and transfers of assets between corporations with common shareholders, should be clarified and revised so that a trigger does not result in situations where the interests of beneficial owners do not change by more than 50 percentage points.

3. The definition of “stock”, for purposes of determining when a trigger has occurred, should be amended so as more closely to reflect those equity investments with an economic stake in NOL carryovers.

4. The “anti-stuffing” rules regarding capital contributions are substantially broader than is necessary to accomplish their purpose, and may produce unfair and (we expect) unintended results in many common situations. We believe that recent capital contributions should reduce L’s trigger value only to the extent L holds nonbusiness assets. Also, the amount of capital contributions should be calculated net of any distributions on stock.

5. The effect of proposed section 382 on conversions of mutual thrift institutions to stock form should be clarified. In general, a conversion should receive the same treatment as a new stock offering by a corporation already having capital stock.

6. The basic rules governing the treatment of contingent price acquisitions should be set forth in whatever legislation is enacted (or at least in the accompanying committee reports), so that taxpayers will have the benefit of some guidance in this important area before regulations are issued.

7. The rules governing built-in gains and losses should be amended to eliminate several mechanical problems in their operation.

8. In its treatment of insolvent or bankrupt corporations whose creditors receive stock in exchange for all or a portion of their claims, the proposed legislation is conceptually inconsistent and unnecessarily harsh. Creditors' claims that are exchanged for stock should be treated as stock before the exchange, with the result that (i) the exchange would not itself be treated as a change in stock ownership which counts towards a trigger, (ii) pre-exchange changes in the ownership of those claims would (with certain exceptions) be taken into account in determining whether a trigger occurs, and (iii) NOL carryovers would be recomputed by disallowing deductions for interest on such claims.

Similiar rules should apply to bankruptcies and to workouts outside of bankruptcy.

9. NOL carryovers should be permitted to offset gain recognized upon a deemed sale of assets under section 338.

II. General Comments.

We have two general comments on proposed section 382. These relate to (i) the desirability of continuing an array of different limitations on carryovers of NOLs in addition to a limitation based on a rate of return on equity value, and (ii) the calculation of that rate of return.

Other Limitations. The House Bill would preserve section 269 and the SRLY and CRCO rules, and impose limitations on investment companies that would not apply to purely operating companies.

We believe that the purposes of section 269 and of the SRLY and CRCO rules would be adequately served by proposed section 382 standing alone. In addition, those rules are either difficult to administer (in the case of section 269), or significantly flawed in their operation (in the case of the SRLY and CRCO rules). Accordingly, we recommend that the enactment of proposed section 382 be coupled with the repeal of section 269 (insofar as it relates to the tax attributes that may be affected by proposed sections 382 and 383) and especially of the SRLY and CRCO rules.

The practical difficulties in applying the subjective tax avoidance test of section 269 are well known. The section introduces a speculative factor into the pricing of business acquisitions, resulting in windfalls or losses depending on unpredictable audit and litigation results. For that reason, we believe that it should be repealed following the enactment of proposed section 382. The only counterarguments we see are that (i) section 269 could be used to restrict tax attributes if there were technical defects in proposed section 382 and (ii) the use of tax attributes of an acquired corporation should be denied if the principal purpose of the acquisition is to use those attributes, without regard to any other factors.

Given the level of study of this subject over the past decade, we do not think that the existence of possible defects in proposed section 382 is an adequate justification for retaining section 269. Moreover, if a technical defect did exist in the proposed exploited in transactions section, it would presumably be that were not primarily tax motivated as well as in those that were. Thus, section 269 would not represent an evenhanded solution to the problem.

As to the second possible argument, whether or not the presence of a tax avoidance motive is an adequate ground for denying tax benefits, we doubt that an acquisition of a loss corporation that results in the imposition of limitations on the use of NOL carryovers and built-in losses of the type found in proposed section 382, and in which the loss corporation passes a continuity of business enterprise test, would in fact be undertaken for the principal purpose of making use of those tax attributes. Even if there were a few cases where tax avoidance was the motivating factor, the advantage of eliminating tax attributes altogether (rather than subjecting them to the limitations of proposed section 382) in the even fewer number of cases where section 269 would be successfully applied after an audit and possibly litigation would not in our judgment come close to outweighing the undesirable effects on non-tax-motivated transactions of retaining section 269.

Turning to other limitations that would be preserved in addition to proposed section 382 under the House Bill, the SRLY rules have a number of defects:

(1) Where an acquiring corporation purchases, for cash, stock of a parent of a group of affiliated corporations filing consolidated returns, even though prior to the acquisition the losses of one member of the acquired group could be used freely to offset the income of any member of the group, following the acquisition, the SRLY rules would apply to prevent the use of NOL carryovers of one member of the acquired group to offset income of another acquired group member. This is inconsistent with the neutrality principle.

(2) The SRLY rules allow NOL carryovers of a corporation to be used to offset the separate taxable

income of that corporation, but that separate taxable income is calculated without any general allocation of expenses incurred elsewhere in the group that are attributable economically to the loss corporation.[11] For example, if a parent corporation borrows to acquire stock of a loss corporation, there is no requirement that the deductions for interest on that debt reduce the separate taxable income of the subsidiary.

(3) Since the SRLY limitations apply on a corporation-by-corporation basis, they can often be avoided by physically blending acquired loss corporations into profitable corporations through reorganizations or section 332 liquidations.[12] The ability of taxpayers to avoid the SRLY limitations through these means will often depend on factors unrelated to taxation (e.g., the need to maintain separate subsidiaries to shield against liabilities or to preserve a nontransferable asset). Thus, the practical effect of the SRLY rules may vary arbitrarily from one taxpayer to another based on non-tax factors.

The CRCO rules prevent losses of an acquired group of corporations from being used to reduce income earned on capital contributed by new owners. These rules

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[11] Where there are intercompany transactions, section 482 could be relied upon to allocate expenses. Proposed section 382 adopts an arbitrary formula for determining the future earnings to be derived from the assets of a loss corporation against which NOL carryovers may be offset. This reflects the view that a precise calculation of those earnings on an manipulation, particularly, it may be assumed, where the loss corporation is acquired by a group of affiliated corporations engaged in other activities.

are not necessary if the limitations of proposed section 382 apply since the use of NOLs would then be restricted in any event to income generated by reference to capital on hand when ownership changes (subject to some adjustments). The CRCO rules are also defective in that they apply based on the identification of corporations as old or new members of the group. Thus, they can be manipulated by moving income into old members, unless, again, this is prevented by non-tax considerations.

In addition to generally restricting the use of NOL carryovers based on expected earnings on L's capital, the House Bill would disallow all NOL carryovers unless L met a continuity of business enterprise requirement for two years. It would also reduce the trigger value by the amount of nonbusiness assets in excess of a *de minimis* amount. The rule for the carryover of NOLs following a change in ownership generally should be the same for an investment company and a company engaged in an active business. Since the former owners of an investment company could use its NOLs to offset income from the corporation's assets, under the neutrality principle NOLs should be useable to the same extent by the investment company's new owners.

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[12] In the case of a liquidation, the tax avoidance test of section 269 would be applied separately to the liquidation under section 269(b).

We recognize, however, two possible limitations on this analysis. The first is that if investment companies with NOL carryovers could be freely sold as tax shelters, the perception of tax abuse on the part of those uninitiated in the workings of the neutrality principle could have an adverse effect on the self-assessment system. Second, the asset base of an investment company can, perhaps, be inflated above historic levels in anticipation of a sale with greater ease (or at least with less risk that newly contributed assets will attract attention) than would be true of an operating company.

If the first of these concerns is valid, we believe that the continuity of business enterprise requirement found in proposed section 382(c) would be an adequate response. The second concern should be addressed by a rule which reduces the trigger value by the lesser of (i) the net amount of nonbusiness assets of a loss corporation (without a de minimis exception) and (ii) the net amount of capital contributed to the loss corporation during the testing period.

Thus, if the continuity of business enterprise test were met and the loss corporation had not received eleventh hour capital contributions, the NOL carryovers of the loss corporation would not be reduced even if it held substantial nonbusiness assets. In our view, the trigger value should not be reduced because of capital contributions made during the trigger period except to the extent that the loss corporation holds nonbusiness assets. The “antistuffing” rule under proposed section 382(n)(1) is discussed is more detail in III.B.5. below.

Rate of Return. In testimony before the Senate Finance Committee on September 30, 1985, the Tax Section took the position that the rate contained in the SFC Proposal (the applicable Federal long-term rate) was too low and that it should be replaced with a rate that conforms more closely to an expected rate of return on an equity investment. Proposed section 382 deviates even further from the proper course by adjusting the applicable Federal long-term rate for the difference between taxable and tax-exempt rates.

This lower rate is justified in the House Report on the ground that, because of the existence of tax attributes, the earnings of an acquired loss corporation would be effectively tax-free. Accordingly, the price paid to acquire the corporation, including its tax attributes, would equal the “true value” of its equity divided by one minus the applicable tax rate and it is therefore necessary to reduce the trigger amount by one minus the applicable tax rate in order to correct for the inflated price.

We believe the pricing assumptions in the House Report to be unrealistic in most cases, particularly given the reduction in the value of tax attributes that would result from proposed section 382 if the annual limit on the use of NOL carryovers were computed based on any kind of bond rate of return, and the further reduction that could result from section 269 if it is retained.[13] Moreover, we continue to believe that using a Treasury bond rate as a starting point is wrong, particularly in view of the significant drop in bond yields that has recently occurred (resulting in a Federal long-term rate for May of 1986 of less than 8%).

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[13] The House Report at 258 includes the following example illustrating the effect of tax attributes on market value :

> Example. -- L corporation has assets with a value of $540 and an NOL carryforward of $2,000. L's assets generate a pre-tax return of 20-percent a year, or $108. Assume all of L's stock is sold for $1,000, which amount is assumed to be equal to the value of L's equity. If a pre-tax rate of return were used, NOL deductions of $200 per year would be allowed -- more than L could have used had no change in ownership occurred or capital been infused. If an after-tax rate of return is used (assuming a 46-percent tax rate), NOL deductions of $108 (10.8 percent of $1,000) would be allowed in each post-acquisition year -- exactly what L could have used under the stated assumptions.

This example makes a number of assumptions (stated or implied) that we think are unrealistic for the broad range of transactions to which proposed section 382 would apply. First, it assumes that market value would be determined solely by capitalizing after-tax earnings. Second, it assumes that the amount of available NOLs would allow the loss corporation to avoid taxes forever (so that earnings for all future periods would be capitalized based on an after-tax rate). Third, while the example assumes a realistic pre-tax rate of return of 20% which translates into an after-tax return of 10.8%, proposed section 382 would not allow any significant portion of that return to be offset by NOL carryovers. For example, the applicable Federal long-term rate for May of 1986 is 7.81%. Accordingly, the rate of return that would be used to calculate the trigger amount under proposed section 382 for an acquisition in that month would (apparently) be only 4.22% (54% of 7.81%). Thus, if the purchaser of L expected to derive an after-tax return of 10.8% as the example assumes, the most he would pay to purchase L (given the other assumptions of the example) is not $1,000 but rather $658.33, which is the amount that solves the equation: purchase price = (100% of the portion of the $108 of annual earnings that will be tax free, or 4.22% of the purchase price, plus 54% (one minus the tax rate) of the remaining amount of those earnings) divided by. 108.

The choice of a rate is at the heart of proposed section 382, and we could not support enactment of proposed section 382 if the trigger amount were calculated based on a tax-exempt bond rate. At some point, the trigger amount becomes so unrealistically low that in practical effect proposed section 382 would not differ significantly from the much discredited version of section 382 enacted in 1976.

III. Technical Comments.

Our technical comments discuss (1) the trigger that must occur to invoke the limitations of section 382, (2) calculation of the trigger amount, (3) the continuity of business enterprise requirement, (4) rules for built-in gains and losses, (5) rules for nonbusiness assets, (6) special rules for bankrupt or insolvent corporations, (7) the effect of proposed section 382 on gain recognized by a target as a result of a deemed sale of assets under section 338, (8) previously acquired shares, (9) effective dates and, finally, (10) organization and drafting style.

A. Definition of Trigger.

1. Relationship Between Owner Shifts and Equity Structure Changes. Although the House Bill attaches less importance than did old law to the distinction between taxable purchases and tax-free reorganizations, it preserves “more than 50-percent owner shifts” and “more than 50-percent equity structure changes” as two separate types of triggers. The two are similar in that each involves a greater than 50% change in ownership of stock of the loss corporation. The only practical difference

between the two types of triggers that we can see is that, in the case of an owner shift, the group of shareholders holding individually less than 5% of the stock (“less than 5-percent shareholders”) are in all events treated as a single 5-percent shareholder, whereas in the case of an equity structure change the less than 5-percent shareholders of L and P (before the equity structure change) are treated as two separate 5-percent shareholders. This difference is illustrated below.

We believe it preferable to have a single definition of trigger and, if it is thought necessary, a special definition of 5-percent shareholder to take account of all changes in the ownership of stock that result from an acquisitive reorganization (and certain other similar transactions). The two parallel definitions of trigger create uncertainty and inconsistency in applying the trigger definition to a case where ownership of a loss corporation changes as a result of a combination of one or more tax-free reorganizations and one or more other transactions.

Proposed section 382(j)(2) attempts to deal with one aspect of the problem by providing that, where an equity structure change follows other changes in holdings of 5-percent shareholders during the testing period, the “continuing interest” for purposes of determining whether a more than 50-percent equity structure change has occurred is adjusted to reflect the prior changes. However, the mechanism for making this adjustment does not appear to function properly.

For example, assume that L has three shareholders: a corporation, P, which owns 45%, A, who owns 40%, and B, who owns 15%. Neither A nor B owns any stock of P. Assume that B sells his 15% interest for cash to C, and that one month later P acquires A's 40% interest in exchange for P stock representing a negligible percentage of the outstanding P stock in a transaction that qualifies as a reorganization under section 36B(a)(1)(B).[14] Overall, 55% of the stock of L has changed hands, and, accordingly, it should be concluded that a trigger has taken place. Under the proposed statute, however, the "continuing interest" is equal to the basic continuing interest determined under proposed section 382(j)(1), or slightly more than 60% (45% plus 15% plus a small amount attributable to A's indirect interest in L through P), multiplied by the adjustment under proposed section 382(j)(2), which is equal to 100 minus 15, or 85%.

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[14] Because P will be in "control" of L immediately after the acquisition, the acquisition can qualify as a "B" reorganization provided only P voting stock is given to A and P'S 45% holding is "old and cold".

This results in a continuing interest of slightly more than 51%, which leads to the conclusion that a more than 50-percent equity structure change has not occurred.

Proposed section 382(j)(2) does not work properly because it assumes that all stock of L is treated the same in the equity structure change. This, however, may not be the case, either because some stock is not exchanged at all (as in the example above) or because the terms of the reorganization permit stock of P, and cash or other consideration paid by P, to be allocated non-pro rata among L stockholders (as is often done to avoid dividend treatment for those receiving cash).

As discussed below, it may be possible to achieve the proper result on the facts of the example above by concluding that, even if there has not been a more than 50-percent equity structure change, there has been a more than 50-percent owner shift. Still, the adjustment mechanism of proposed section 382(j)(2) will not have worked properly.

Another aspect of the overlap between equity structure changes and owner shifts is dealt with in proposed section 382(g)(4)(B), which states that "[a]n equity structure change shall not be treated as an owner shift". On a literal reading of the statute, it is difficult to see what this provision accomplishes, since the definition of "more than 50-percent owner shift" does not by its terms require that there have been an "owner shift". Literally, therefore, a reorganization (i.e., an equity structure change) may constitute a more than 50-percent owner shift, even though it cannot be an owner shift.

One problem with this literal interpretation of the statute is that, under such interpretation, proposed section 382(g)(4)(B) appears to have no operative effect whatsoever. The only time the phrase “owner shift” appears in the House Bill, other than as part of the phrase “more than 50-percent owner shift”, is in the definition of “testing period” in proposed section 382(k)(1), and it is irrelevant for this purpose whether a transaction that is an equity structure change also constitutes an owner shift. Moreover, the House Report, although it does not explicitly address the issue, seems to suggest that the Committee intended proposed section 382(g)(4)(B) to mean that ownership changes resulting from a reorganization would not be taken into account in determining whether a more than 50-percent owner shift has occurred. House Report at 264.

On the other hand, a literal reading of the proposed legislation, which would count ownership changes in reorganizations in determining whether there has been a more than 50-percent owner shift, and which would treat proposed section 382(g)(4)(B) as having little, if any, operative effect, would provide more sensible results in a number of instances. Consider the example, discussed above, of a sale of a 15% block of stock followed by a reorganization acquisition of a second 40% block. As discussed above, even though 55% of L has changed hands, the transactions do not constitute a more than 50-percent equity structure change. However, if the acquisition of the 40% block of stock can be counted in determining whether a more than 50-percent owner shift has occurred (i.e., proposed section 382(g)(4)(B) is not interpreted to preclude consideration of the change in ownership attributable to the reorganization in determining whether a more than 50-percent owner shift has occurred), then there has in fact been a more than 50-percent owner shift, and hence a trigger.

As another example, consider a sale to a new stockholder of an outstanding 30% block of stock in L, followed by a reorganization in which all of the L stock is exchanged for P stock and the continuing interest (before adjustment for the sale of the 30% block) is 60%. Under proposed section 382(j)(2), the continuing interest would be reduced to 42% because of the prior sale, and hence a more than 50-percent equity structure change would occur. If, however, the order of the steps were reversed, so that the reorganization preceded a sale of the 18% block of P stock received in exchange for the 30% block of L stock, no trigger would occur unless the ownership change in the reorganization (40%) can be added to the sale of the 18% block in determining whether there has been a more than 50-percent owner shift.

It would appear, therefore, that more sensible results would be achieved within the framework of the proposed statute if ownership changes pursuant to reorganization transactions were counted, like other ownership changes, in determining whether a more than 50-percent owner shift has occurred.

Proper implementation of this approach may require some clarification of the effect of a reorganization on the holdings of 5-percent shareholders. To illustrate the problem, it will be helpful to consider an expanded version of the example discussed in the second preceding paragraph. Assume that L has outstanding 600 shares of which 180 (or 30%) are owned by a single shareholder, A, and the remaining 420 (or 70%) are widely held (i.e., there are no 5-percent shareholders among the holders of the 420 shares). Assume further that P has outstanding 400 shares of stock and that P acquires L in a straight “A” merger in which each L share is exchanged for one newly issued P share (so that P has 1,000 shares outstanding after the merger). P has no 5-percent shareholders prior to the merger. The two transactions to consider are (i) a sale by A to B (who has no prior interest in P or L) of A’s 180 L shares, followed by the merger, and (ii) the merger, followed by a sale by A to B of A’s 180 P shares. Assuming that changes in stock ownership in a reorganization can be counted in determining whether a more than 50-percent owner shift has occurred, would these two transactions constitute a more than 50-percent owner shift? Clearly, the answer should be the same for both.

To answer this question, it is necessary to examine the holdings of 5-percent shareholders of the loss corporation. A 5-percent shareholder is generally defined in proposed section 382(i)(1) as “any person holding 5-percent or more in value of the stock of the corporation at any time during the testing period”.[15] In addition, proposed section 382(i)(2) states that if the percentage of the total value of the stock of the corporation held by persons who are not 5-percent shareholders exceeds the percentage of the total value of the stock of the corporation held at the beginning of the testing period by persons who would not have been 5-percent shareholders if the determination had been made at that time,[16] then the percentage points representing such increase shall be taken into account as if the increase were an increase in the percentage holdings of a 5-percent shareholder. Applying these definitions, the two shareholders (or groups of shareholders) who will increase their interests in the loss corporation and who will be treated as 5-percent shareholders are B and the pre-merger shareholders of P.

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[15] If the definition of owner shift were expanded to include reorganizations, the word “corporation” in the definition should probably be replaced with “old loss corporation or new loss corporation” (which under proposed section 382(m)(3) may be the same corporation).

[16] Because the definition of 5-percent shareholder is any person who owns 5% or more of the stock of the corporation <u>at any time during the testing period</u>, rather than at any one time, it is not clear how to determine “the percentage of the total value of the stock of the corporation held at the beginning of the testing period by persons who would not have been 5-percent shareholders if the determination had been made at that time”. Why would it not be enough to substitute for the language beginning with persons “persons who are not 5-percent shareholders”?

Two problems arise in determining the increase in the interests of 5-percent shareholders in the loss corporation. First, if B purchased A's 180 shares after the merger, that purchase would clearly be counted as only an 18 percentage point increase in the ownership of the loss corporation by B. On the other hand, if the purchase preceded the merger, the 180 shares would represent 30% of L at the time of the purchase (although that interest would be diluted to 18% in the merger). To ensure parallel treatment of the 180 shares regardless of when the purchase occurs, in the case where B purchases L stock prior to the merger, B's percentage interest in the loss corporation should be measured immediately after the merger (_i.e._ the increase in B's interest should be only 18 percentage points). This result is also appropriate in light of the fact that the merger, although it decreases B's percentage interest in the loss corporation, will increase the percentage interest in the loss corporation of the pre-merger stockholders of P and that increase will be counted toward the 50% threshold (as discussed below).

A second problem concerns the less than 5-percent shareholders of P and L. Less than 5-percent shareholders own 70% of L prior to the merger and 82% of P after the merger (consisting of 42% attributable to the former less than 5-percent shareholders of L and 40% attributable to the pre-merger shareholders of P). Thus, if the less than 5-percent shareholders of P and L were treated as a single 5-percent shareholder, the merger would increase that 5-percent shareholder's interest in the loss corporation by only 12 percentage points (the difference between 82 and 70). In measuring the continuing interest of shareholders of the loss corporation following a reorganization under proposed section 382(j)(1), account is taken only of the continuing interest of the shareholders of the loss corporation; in effect, the shareholders of the loss corporation (including small shareholders) are not combined to any extent with the shareholders of other parties to the reorganization. In order to achieve a similar result in applying the definition of a more than 50-percent owner shift to the P-L merger, the less than 5-percent shareholders of P should be segregated from the less than 5-percent shareholders of L. Furthermore, for reasons discussed above, the increase in the percentage ownership of the loss corporation on the part of the pre-merger P shareholders should be measured in terms of their percentage interest in P after the merger. Accordingly, since the pre-merger P shareholders owned no interest in L prior to the merger and own 40% of P thereafter, the increase in their interest in the loss corporation resulting from the merger is 40 percentage points. This figure is not affected by whether the purchase of 180 shares by B occurs before or after the merger. When the 40 percentage point increase is added to the 18 percentage point increase attributable to that purchase, there is a more than 50-percent owner shift.

To clarify the measurement of the increase in the interests of 5-percent shareholders, we recommend that the following new paragraph (4) be added to proposed section 382(i):

(4) SPECIAL RULES FOR EQUITY STRUCTURE CHANGES. -If an equity structure change occurs during the testing period then--

(A) the increases in the holdings of stock by persons who are not 5-percent shareholders shall be measured separately under paragraph (2) with respect to the shareholders, immediately prior to the equity structure change, of each corporation which is a party to the reorganization comprising the equity structure change, and

(B) in determining whether a more than 50-percent owner shift occurs at the time of the equity structure change or at any time thereafter (until a subsequent equity structure change subject to this subparagraph (B)), the percentage interest in the loss corporation represented by any stock shall be determined based on the stock outstanding immediately following the equity structure change.

The effect of suggested section 382(i)(4)(A) is to treat the less than 5-percent shareholders of each party to a reorganization as separate 5-percent shareholders. Should a similar approach ever apply to old and new shareholders of a single corporation? To make the question more concrete, suppose that instead of participating in the P-L merger described above, L sells for cash 400 newly issued L shares in a public offering. Assume further that those shares are purchased by less than 5-percent shareholders having no prior interest in L. The relative economic interests of the old L shareholders and the new L shareholders in the old L business would be the same as the interests in that business of the old L shareholders and the old P shareholders following the P-L merger. Nonetheless, under proposed section 382, the stock sale would not be a trigger because there is no apparent basis for treating separately the interests of the old and new L shareholders; they are all part of the group of less than 5-percent shareholders. Treating them as a single group, the less than 5-percent shareholders of L own 82% of the stock of L immediately after the contribution and owned 70% before. When this 12 percentage point increase is added to the increase of 18 percentage points in the stock owned by B, the 50 percent threshold is not met.

A difference in results between an equity structure change and a stock issuance for cash by a single corporation might be justified on two grounds. First, where capital is raised from a diverse group of new shareholders, each shareholder is acting on his own in deciding whether to invest. By contrast, the less than 5-percent shareholders of P are acting as one through P. Second, a cash contribution to L might represent a less significant event in the life of L, depending on how the cash was used and the amount, than a merger with another corporation conducting an ongoing business.[17]

Whether these factual differences do in fact justify a difference in results depends in part on the reasons for creating the concept of a 5-percent shareholder. If the primary reason is that changes in the ownership of stock by small shareholders are not sufficiently akin to the corporate acquisition transactions that have traditionally raised the specter of “trafficking” in tax attributes, then the distinction between equity structure changes and cash purchases of newly issued stock should be preserved. On the other hand, if the reason for the concept is only that it is

[17] Applying these factors to other nonreorganization transactions involving combinations of operating businesses, such as a cash merger, or a section 351 contribution of assets of an operating business by a corporation that is widely held, would suggest that they should be treated in the same manner as a reorganization and not in the same manner as a public offering of stock for cash. See III.A.5 below for a discussion of the exclusion of recapitalizations from the definition of equity structure change (and hence from the operation of our suggested section 382(i)(4)(A)).

administratively unworkable to monitor changes in the ownership of stock by small shareholders, then that problem would be less severe where a change in ownership results from a stock offering than where outstanding stock changes hands; hence, the distinction might be eliminated.

If the distinction is preserved, then suggested section 382(i)(4)(A) (as set forth above) should not be applied to divide old and new less than 5-percent shareholders into separate groups following a stock offering by a single ongoing corporation merely because the stock offering is combined with an “F” reorganization of the corporation. This question would arise most often in the context of conversions of mutual thrift institutions to stock form. See III.A.8.

A final point to consider in applying definition of trigger is the handling of common single ownership of L and P. The treatment of common ownership under proposed section 382 in its present form is discussed below at III.A.2.

To illustrate the problem, return to the facts of the P-L merger described above. Suppose that, in addition to A, there is another 5-percent shareholder, C, who has owned for many years 150 shares of L and 100 shares of P. If L is merged into P and A sells his 180 shares to B as described above, would a trigger occur?

The 18 percentage point increase in the ownership of P stock by B would be the same as before. However, the increase in the ownership of loss corporation stock by the less than 5-percent shareholders of P would amount to only 200 shares (the 570 P shares owned by those shareholders immediately following the merger less the 370 P shares that were exchanged for L shares owned by the less than 5-percent shareholders of L), or 20 percentage points. Finally, C is a 5-percent shareholder, so that account must be taken of any increase in C's interest in the loss corporation. However, that increase is zero because C owns 25% of P following the merger and owned 25% of L prior to the merger.[18] The increase in the percentage ownership of the loss corporation is therefore only 38 percentage points (18 plus 20) and there is no trigger.

To generalize, under a unified definition of trigger, there should be no increase in the percentage ownership of a loss corporation by a 5-percent shareholder because of a reorganization to which L and P are parties if that shareholder owned before the reorganization the same percentage of the stock of each corporation, or a greater percentage of L’s stock than of P's stock. Common, ownership of P and L by a 5-percent shareholder would make it less likely that the

[18] In effect, the increase in the percentage interest in the loss corporation that occurs with respect to the 100 shares of P owned prior to the merger by C is entirely offset by the decrease resulting from the dilution in the interest in the loss corporation represented by C's 150 shares of L.

reorganization would result in a trigger because of the increase in the percentage interest in the loss corporation on the part of the P shareholders that owned no stock of L. A 50% or greater common interest in each of P and L would always prevent the reorganization from qualifying as a trigger (assuming no other ownership changes). The size of a common interest sufficient to block a trigger would be less than 50% if before the reorganization the value of all outstanding stock of P was greater than the value of all outstanding stock of L. These results are demonstrated algebraically in Appendix B to this report.

In summary, we recommend that the concept of an equity structure change as a separate trigger be dropped and that proposed section 382(i) be amended as described above.

2. Reorganizations of Commonly Owned Corporations. Under proposed section 382(j)(1), the continuing interest of the shareholders of the old loss corporation as the result of an equity structure change is "the percentage of the value of the stock of the new loss corporation owned (immediately after the change) by the shareholders (immediately before the change) of the loss corporation, as the result of owninq stock of the loss corporation [emphasis added]". The underscored language may have the effect of characterizing as a more than 50-percent equity structure change reorganizations that involve no change in the beneficial ownership of the loss corporation.

To illustrate, suppose that P owns all of the outstanding stock of two subsidiaries, S1 and S2. S1 has NOL carryovers and is worth 1/3 as much as S2. To save administrative costs, S1 is merged into S2. In the merger, P exchanges its S1 stock (actually or constructively) for 25% of the stock of S2 outstanding immediately after the merger. The merger is a more than 50-percent equity structure change as defined in the House Bill. It is clearly an equity structure change and the continuing interest of the S1 shareholder is only 25% (the percentage of the stock of S2 which S1 owns as a result of its ownership of S1 stock). Needless to say, restricting NOLs as a result of this transaction makes no sense.

If the transaction were analyzed under the rules governing owner shifts described above in III.A.1., there would not be a more than 50-percent owner shift because P. would own 100% of S2 immediately after the merger and 100% of S1 immediately before. Indeed, as explained above and in Appendix B, a merger of two corporations would never be a trigger (assuming no other ownership changes) if the common ownership of those corporations by persons who were more than 5-percent shareholders of both corporations was at least 50%.

A merger between two commonly owned corporations failed to meet the 20% continuity requirement of old section 382(b)(1) if before the merger the value of the loss corporation was less than 25% of the value of the other corporation; as under proposed section 382(j)(1), the only stock of the surviving corporation that was counted toward the 20% thresh hold was stock resulting from the ownership of stock of the loss corporation. However, old section 382(b)(3) provided an escape from the limitations of old section 382(b)(1) where “the transferor corporation and the acquiring corporation are owned substantially by the same persons in the same proportion”. In our view, adding a comparable exception to proposed section 382, while better than nothing, would not be enough. If a trigger is supposed to occur only where there is a more than 50-percent shift in the ownership of tax attributes, then 50-percent common ownership (rather than substantially the same ownership) of the parties to a reorganization should prevent the transaction from constituting a trigger.

Proposed section 382(o)(4)(c) authorizes the Secretary of the Treasury to adopt regulations adjusting the application of proposed section 382 “where the same persons own stock in 2 corporations”. In light of the frequency of reorganizations of commonly owned corporations, leaving the problem to be resolved in regulations is not an adequate solution.

3. Transfers of Stock in Carryover Basis Transactions and Between Related Persons. An owner shift is not limited to changes in stock ownership attributable to a “purchase” or redemption as was the case for old section 382(a). Under old section 382(a)(4), the term “purchase” meant an acquisition of shares the basis of which is determined solely by reference to its cost to the holder thereof, from a person or persons other than the person or persons the ownership of whose shares would be attributed to the holder under section 318 (as modified by section 382 (a)(3)). Thus, for example, if a parent corporation P contributed L stock to P's wholly-owned subsidiary S, the contribution was not a purchase, both because S did not take a new basis and because P's ownership of L stock was attributed to S.

Does the elimination of the purchase requirement mean that a carryover basis transfer of stock of L or a transfer of such stock from a person whose shares would be attributed to the transferee under section 318 would constitute changes in the ownership of stock contributing to a possible more than 50-percent owner shift? To address this question, one must review the definition of a more than 50-percent owner shift and the ownership attribution rules of proposed section 382(n)(3).

Proposed section 382(g)(2) states that there is a more than 50-percent owner shift if “the total value of the stock of the corporation <u>held</u> at the close of the testing period by 5-percent shareholders has increased by more than 50 percentage points over such <u>holdings</u> by such shareholders at the beginning of the testing period” (emphasis added).[19] Section 1223 provides tacked holding periods “[f]or purposes of this subtitle” (which would include proposed section 382) in a number of circumstances including a case where a transferee of property takes a carryover basis in the property

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[19] Similarly, the definition of 5-percent shareholder in proposed section 382(i) refers to a person “holding” at least 5 percent of the stock of the corporation.

(see section 1223(2)). Arguably, then, in the case of the transfer described above from P to S, S would be treated as having “held” the L shares for the same period as they were held by P (provided one can make the leap that stock which S is considered to have held at the beginning of the testing period are its “holdings” of the stock at the time).

While we believe that it might conceivably be possible to take advantage of tacked periods under section 1223 in applying the proposed definition of a more than 50-percent owner shift as now written, we suspect that this result was not intended by the drafters and that the references to “held” and “holdings” were intended to mean “owned” and “stock owned”. The House Report does not refer to the possible application of section 1223, and the result would be inconsistent with the stated intent of including within the scope of proposed section 382 a number of carryover basis transactions (such as a contribution of stock to a corporation under section 351 or to a partnership under 721). See House Report at 251.[20]

Proposed section 382(n)(3) provides that the section 318 attribution rules, with certain modifications, apply in determining stock ownership.

[20] Proposed section 382(n)(6) specifically provides, in effect, a tacked holding period for property acquired by reason of death. An argument might be made that, had similar treatment been intended for transactions having tacked holding periods under section 1223, language analogous to proposed section 382(n)(6) would have been included in the House Bill.

In addition, proposed section 382(n)(5)(B) provides that, in applying such rules, that person whose ownership of the loss corporation's stock would result in the greatest change in its stock ownership is treated as the owner of its stock.

One effect of these rules is to prevent avoidance of the proposed section 382 limitations by acquiring stock of a loss corporation indirectly. In addition, however, the rules were apparently intended to avoid those limitations where there is a change in stock ownership but the beneficial ownership of the loss corporation remains the same.[21] See House Report at 266. It appears, however, that the statute as drafted does not properly achieve the latter result.

For example, assume that L has a single shareholder, A, who contributes all the L stock to a newly-formed holding company, HC, in exchange for

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[21] The House Report sets forth a single not particularly helpful example of how these rules operate. The example involves an all-cash merger of the loss corporation into another corporation with 80% common beneficial ownership. See House Report at 266, Example 8. The example analyzes the continuing stock ownership of the former loss corporation shareholders in the corporation which survives the merger. However, it is not clear why this is relevant, since the merger would, presumably, be treated as a liquidation of the loss corporation into its parent under section 332, which would have the effect of transferring the NOL carryover not to the survivor, but to the loss corporation's parent, under section 381

all of the HC stock. As there has been no real change in the beneficial ownership of the loss corporation, the proposed section 382 limitations should not apply. However, there is no rule treating HC as the owner of the L stock for the period during which that stock was held by A before HC came into existence. Accordingly, HC's increase in ownership since the beginning of the testing period would be l00%, and the contribution would be a trigger. Even though, under the rules of section 318, A would be deemed to continue to own the L stock, treating HC as a new owner would result in a higher percentage change of ownership, and accordingly would be required under proposed section 382(n)(5)(B).

This problem could be addressed in two ways. First, a rule could be adopted providing that transfers of outstanding L stock will not count toward a more than 50-percent owner shift if the transferee is considered to own stock held by the transferor under the section 318 attribution rules.[22] Alternatively, effect could be given

[22] The rule would protect against application of proposed section 382 only to the extent that the transferee -- and all other persons who are considered to own stock owned by the transferee -- are considered to own stock owned by the transferor. Thus, if A transfers L stock to a partnership AB in which A and B are equal partners, and A and B are not otherwise related, the trans than 50-percent owner shift because of the receipt of the stock by AB since under section 318(a)(3)(A) AB would be considered to own all of the stock owned by A, but the increase in B's ownership of the transferred stock under section 318 would be counted to the same extent as if B had acquired 50% of the transferred stock directly from A.

to the transfer, but the transferee would be considered to own the transferred stock for the period it was owned by its related transferor (cf. proposed section 382(n)(6) which provides a tacked holding period for certain transfers arising because of death). While these alternative formulations would provide similar results in most cases, the second rule may not produce the proper result where the transferor and transferee do not have the same status as 5-percent shareholders.

To illustrate, suppose that L, a public company with no 5-percent shareholders, wishes to place a holding company on top of itself. This is accomplished by organizing a new corporation, again HC, which creates a transitory subsidiary that is merged into L. In the merger, each share of L common stock is exchanged for an equivalent HC share. Suppose that the exchange qualifies under section 351 but is not a reorganization (for example, because L has a class of preferred stock that is not affected by the transaction and which prevents HC from having control of L within the meaning of section 368(c)).

It was assumed that there were no 5-percent shareholders of L prior to the transaction. However, immediately following the transaction, HC will own 100% of the stock of L and will, therefore, be a 5-percent shareholder. Accordingly, in the absence of a special rule, there would be a more than 50-percent owner shift because HC, a 5-percent shareholder, would increase its ownership of the stock of L by more than 50 percentage points, a clearly wrong result because there has been no change in L’s beneficial ownership.

Were HC considered to own the L stock received from the former L stockholders for the period during which they held the stock (the second of the two solutions considered above), HC would still be a 5-percent shareholder and whether a trigger has occurred would depend on the periods during which the L shareholders had held their stock. It is not clear that HC could obtain accurate information as to the holding periods of the L shareholders, particularly since they would not hold substantial blocks of stock (and would not be required to file reports of their holdings with the Securities and Exchange Commission as would be the case for 5-percent shareholders). Perhaps HC could ask for holding period information as a condition to exchanging L stock for HC stock, although in that event it would not be known in advance whether creation of the holding company would constitute a trigger and, obviously, the answer to that question could be a major factor in deciding whether to initiate the transaction. More fundamentally, it is inconsistent with the policy underlying the 5-percent ownership threshold to require HC to take account of changes in the ownership of L stock that occur solely within the group of less than 5-percent shareholders (at least to the extent that policy rests on administrative convenience).

The alternative approach described above of exempting transfers of stock from persons whose ownership of stock would be attributed to the transferee would provide the proper result in the example--were it not for proposed section 382(n)(3)(C)(ii). This section provides that a corporation will be considered to own stock held by a shareholder only in that proportion which the value of the stock owned by the shareholder bears to the value of all stock of the corporation. Under this rule, HC would be considered to own only 1% of the L stock which it receives from a 1% shareholder of L under section 318, with the result that it might not be entitled to an exemption with respect to the remaining 99%.

We recommend that proposed section 382 include an exemption for transfers of stock of a loss corporation to the extent the stock would be attributed from the transferor to the transferee under section 318 as modified by proposed section 382(n)(3) (other than proposed section 382(n)(3)(C)(ii).[23]

Proposed section 382(n)(3)(A) says that family status at the end of the testing period will be the same as family status at the beginning of the testing period. Read literally, this would seem to mean that a spouse (or an adopted child) of a shareholder who was not a spouse (or an adopted child) at the beginning of the testing period would not be considered to have owned the shares that the shareholder owned at the beginning of the testing period. Is that the intended result?

4. Measurement of Ownership Changes. Under section 382(g)(2), there is a more than 50-percent owner shift "if the total value of the stock of the corporation

[23] For purposes of determining whether stock of the transferor would be attributed to the transferee under section 318, the relationship between the two should be tested immediately after the transfer. Thus, in the example in the text above, it should make no difference whether L shareholders are considered to own any of the HC stock prior to their transfer of the L stock to HC. If an exception for related party transfers were adopted, an anti-abuse rule modelled after Treasury Regulation section 1.382(a)-1(e)(2) (acquisition of stock or an interest in a partnership, trust or estate with a view to invoking the constructive ownership rules so that a later acquisition would not be a "purchase") might be continued in regulations under proposed section 382.

held at the close of the testing period by 5-percent shareholders has increased by more than 50 percentage points over such holdings by such shareholders at the beginning of the testing period." To illustrate a possible problem with the language, suppose that L is owned 100% by shareholder A. A sells 100% of the L stock for cash to a new unrelated investor B. While B would be a 5-percent shareholder at the end of the testing period, A would be as well, since a 5-percent shareholder (as defined in proposed section 382(i)(1)) is any person holding 5 percent or more in value of the stock of the corporation at any time during the testing period. Thus, the "total value" of the L stock held at the close of the testing period by 5-percent shareholders (l00%, held by B) is not greater than the holdings of 5-percent shareholders at the beginning the testing period (l00%, held A).[24] Whether or not this is a correct literal reading of the statute as now written, it is clear that

[24] This assumes that the reference in proposed section 382(g)(2) to "such shareholders" means any 5-percent shareholders, and not simply those 5-percent shareholders owning stock at the end of the testing period. However, even if the reference was so limited, a trigger would still not occur if A sold only 95% of the L stock to B, so that A continued to own stock at the end of the trigger period.

the test should look at the sum of the increases in stock ownership by each 5-percent shareholder.

5. Definition of Equity Structure Change. If the concept of an equity structure change is continued, then we suggest some changes in the definition.

An "equity structure change" is defined in proposed section 382(g)(5) as any reorganization within the meaning of section 368, other than a divisive reorganization. Apparently, any change in stock ownership resulting from a recapitalization would be an equity structure change. This represents an unwelcome change from the SFC Proposal, which defined an equity structure change as one resulting from certain acquisitions of the assets of a corporation.[25] As discussed above, the principal difference between the rules relating to owner shifts and equity structure changes is that less than 5-percent shareholders are treated collectively as one shareholder in determining whether there is a more than 50-percent owner shift, but not in determining whether there is a more than 50-percent equity structure change. This distinction would make sense if equity structure changes were limited to corporate transactions in which businesses are combined and shareholders are affected as a group, but a recapitalization does not by itself change a corporation's business and can result from actions taken by individual shareholders (e.g., the exercise of conversion rights). We question whether recapitalizations

[25] SFC section 382A(c).

should be included in the definition of equity structure change.[26]

If recapitalizations continue to be excluded from the definition of owner shifts, then a change in the measurement of the continuing interest may be necessary to prevent a dissimilarity in the treatment of economically similar redemptions and recapitalizations. For example, if L has two shareholders, A who owns 10% of the stock and B who owns 90%, and L redeems most of B'S stock with cash, there would apparently be a more than 50-percent owner shift attributable to the increase in the proportionate ownership of L stock by A,[27] However, if P was recapitalized and B

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[26] AS noted above (see III.A.1.), if the purpose of having separate rules for equity structure changes is that such transactions are somehow more significant from a corporate perspective and present greater potential for abuse in terms of “trafficking” in tax attributes, the same rules should apply to taxable mergers in which L survives and should not necessarily apply to recapitalizations. To define an equity structure change in terms of the tax-free character of the transaction makes little sense.

[27] The definition of more than 50-percent owner shift refers to an increase, by more than 50 percentage points, in the “total value” of the stock of the corporation during the testing period. While this language could be improved, presumably the test is applied by looking at changes in proportionate stock ownership.

received long-term debt in exchange for most of his stock, the shareholders of P before the recapitalization would own as a group 100% of P after the recapitalization. Furthermore, because the recapitalization is an equity structure change it is not an owner shift. Thus, if an owner shift is required to have a more than 50-percent owner shift, it is possible that the relative change in holdings between A and B would not constitute a trigger.

The definition of equity structure change refers to any reorganization without requiring that L be a party to the reorganization. Thus, for example, if P owned 60% of the stock of L and the assets of P were acquired by an unrelated corporation in a “C” reorganization, there would conceivably be an equity structure change with respect to L though even L did not in any way participate in the transaction. It would seem to make more sense to analyze such a transaction under the rules applicable to owner shifts. Thus, the definition of equity structure change should be limited to reorganizations to which L is a party.

6. Definition of Stock. The definitions of more than 50-percent owner shift and more than 50-percent equity structure change refer to changes in the ownership of “stock”. Proposed section 382(m)(6)(A) excludes from the definition of “stock” any stock described in section

1504(a)(4), i.e., stock which is (i) nonvoting, (ii) limited and preferred as to dividends and nonparticipating in the corporation's growth, (iii) not entitled to redemption and liquidation rights which exceed the issue price, except for a reasonable redemption premium,[28] and (iv) not convertible into another class of stock. Because a more than 50-percent equity structure change or a more than 50-percent owner shift can only occur as a result of changes in the ownership of “stock”, as defined, changes in the ownership of excluded types of stock will not result in a trigger, and the retention of such stock by historic shareholders will not prevent a trigger.

Apparently, the purpose of excluding stock described in section 1504(a)(4) from the definition of “stock” is to limit triggers to those owner shifts and equity structure changes in which there has been a substantial shift in the ownership of those classes of stock which are entitled to “the beneficial ownership of a NOL carryforward”. See House Report at 260. Ideally, this purpose would be served by determining in each case whether, based on the relative rights of a corporation's various classes of stock and the corporation's

[28] See sections 1504(e)(1) and (6) of H.R. 3838 which substitute “issue price” for “paid-in capital or par value” in section 1504(a)(4)(C).

projected cash flows, the availability of an NOL carryforward would affect what the holders of a particular class could reasonably expect to receive. For example, if the anticipated cash flows were such that preferred dividends on a particular class of stock could be paid only if the corporation were able to utilize its NOL carryovers, that class of preferred stock, even if it is otherwise nonparticipating, would have a meaningful interest in the losses.[29] Such a case-by-case determination would, of course, be virtually impossible to administer, and, accordingly, the statutory definition seems to be a rule of convenience.

Based on this formulation of the purpose for the definition of “stock”, it is difficult to understand the relevance of voting power which, by itself, is in no way related to whether a class of stock has a beneficial interest in losses. Further, the inclusion of voting preferred stock in the definition of “stock” presents the potential for manipulation. For example, a transaction could be structured whereby all of the common stock of L is acquired,

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[29] An argument could be made that even debt should be considered “stock” for this purpose if the availability of the losses were essential to the corporation being able to service the debt.

after recapitalizing L to create a new class of nonparticipating, redeemable voting preferred stock that represents more than 51% of the aggregate value of the common and preferred stock after the recapitalization. If the common stock appreciates over the three-year period beginning on the date of the acquisition, so that it becomes more valuable than the preferred stock, the preferred stock could be redeemed three years and one day after the acquisition, without ever having a trigger.[30] The definition of "stock", in effect, provides a mechanism whereby seller financing (in the form of redeemable preferred stock) can avoid a trigger when the common equity is sold and, if the common stock appreciates, also when the preferred stock is redeemed.[31]

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[30] Proposed section 382(n)(7) states that under regulations, any change in proportionate ownership which is attributable solely to fluctuations in the relative fair market values of different classes or amounts of stock shall not be taken into account. Presumably, this would not prevent account from being taken of the relative values of the preferred and common stock at the time of redemption of the preferred stock since the change in ownership of stock at that time would not be attributable solely to a change in relative fair market values.

[31] This technique, of course, requires that the preferred stock be respected as equity and not be recharacterized as debt. Relying on the possibility of recharacterizing an equity instrument as debt, however, is a poor way to deal with a potentially abusive transaction that otherwise complies with the terms of proposed section 382.

One could attack such a transaction by arguing that, if the issuing corporation has the right to redeem the preferred stock, it should be treated as, in effect, having an option to acquire the stock with the result that, pursuant to proposed section 382(n)(3) and section 318(a)(4) (but subject to regulations adopted under proposed section 382(n)(3)(D)), the voting preferred stock should be treated as already having been redeemed. However, the House Bill specifically provides that stock which is treated as owned by the issuer by reason of section 318(a)(2) should not be treated a s outstanding; the absence of a reference to section 318(a)(4) in this context suggests that redeemable voting preferred should be treated as outstanding for this purpose.

An additional, apparently unintended, result of excluding nonvoting, nonparticipating preferred stock from the definition of “stock” is that a trigger may result if the preferred stock becomes entitled to vote as a result of preferred dividends being in arrears. It is difficult to see why such an event, occurring pursuant to the terms of the stock itself, should result in limitations on the use of the issuer's losses.

7. Successive Triggers. Proposed section 382(k)(2) states that if there has been a trigger “affecting any carryforward of a loss or of an excess

credit, the testing period for determining whether a 2d trigger has occurred with respect to such carryforward shall not begin before the trigger day of such earlier trigger”. This provision should be modified. In particular, if there has been a trigger, the testing period should not be considered to begin before the trigger day of the earlier trigger, not only for determining whether a second trigger has occurred with respect to carryforwards affected by the earlier trigger but for all purposes.

To illustrate the problem with the existing language, suppose that 99% of the L stock is acquired in a single transaction constituting a trigger a t a time when L has no NOL carryovers, L incurs losses (which it cannot carry back) in the first year after the trigger day, and at the beginning of the second year after the trigger day, the 99% shareholder acquires the remaining 1% of L’s stock. The NOL arising after the first trigger should not be limited because of the acquisition of the additional 1% of stock, and yet that result may not be prevented by proposed section 382(k)(2) because the NOL arising after the first trigger would not have been affected (at least directly) by the first trigger. It is also not clear what the word “affecting” means as it applies to losses or credits existing as of the date of a trigger. For example, suppose that there is a trigger with respect to a corporation having NOLs arising in prior years and the trigger amount is less than the full amount of NOLs potentially subject to limitation under proposed section 382 in post-trigger years but greater than the taxable income of the corporation in those years (before taking account of NOL carryovers). Are those NOLs considered to be “affected” by the trigger? The answer should be “yes”.

The proper result could be achieved in both of the situations discussed above if proposed section 382(k)(2) were revised to read as follows: “If there has been a trigger, the testing period for determining whether a subsequent trigger has occurred shall not begin before the trigger day of such earlier trigger.”

8. Thrift Conversions.

Background. A mutual thrift institution has no authorized capital stock but instead is owned by its depositors. However, the depositors' rights as owners are quite limited. The depositors receive interest on their deposits at rates comparable to those offered by stock thrifts. Additional earnings are not distributed currently but are retained and become available for distribution to depositors only in the event of a liquidation, which is highly un likely.

The depositors have voting rights, but those rights are also granted to borrowers from the thrift, and in any event actual voting control is held by the board of directors through voting proxies. All interests of a depositor in the thrift cease when the depositor closes his account. For a further description of mutual thrift institutions, see Paulsen v. Commissioner, ___ U.S. ___ (1985-1 USTC 79116) and Revenue Ruling 80-105, 1980-1 C.B. 78.

In a thrift conversion, a mutual thrift converts to stock form and issues capital stock to investors for cash. In many conversions, depositors, borrowers, directors, officers and employees of the thrift are given a first opportunity to subscribe for such stock, but the offering price is the same in the subscription offering and in the offering to the public of unsubscribed shares (if any). Following the conversion, all voting rights not attributable to the capital stock cease. A liquidation account is established in an amount equal to the net worth of the thrift at the time of the conversion. In liquidation, each eligible depositor at the time of the conversion has a right to receive his portion of the liquidation account balance before any distribution can be made with respect to the capital stock. An eligible depositor's interest in the liquidation account will never increase after the conversion but will decrease to reflect subsequent withdrawals by the depositor. Except for the change in capital structure and the infusion of cash, the conversion does not generally alter the business of the thrift. In transactions subject to Federal Home Loan Bank Board rules, no one shareholder can acquire a greater than 10% interest in the newly issued stock of a converting thrift (except that this percentage may be increased to 100% in the case of a supervisory acquisition of a failing thrift).

Revenue Ruling 80-105, supra, concludes that a thrift conversion is a reorganization under section 368(a)(1)(F). At first blush, this conclusion is surprising in that an “F” reorganization requires substantial identity of equity owners before and after the reorganization, and in a thrift conversion equity ownership is dramatically changed.[32] This hurdle is overcome by analyzing the transaction as if it consisted of two independent steps: (1) the “conversion” in which the mutual thrift is reorganized to authorize the issuance of capital stock, followed by (2) the sale of capital stock for cash. The initial step involves no change in equity ownership -- the depositors' equity interest

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[32] Cf. Revenue Ruling 66-284, 1966-2 C.B. 115 (cashing out of dissenting shareholders owning less than one percent of shares was de minimis).

is preserved in the liquidation account and the issuance of capital stock is a future event that is not integrated with the conversion -- and may therefore qualify as an "F" reorganization.[33]

Following the two-step approach, it was generally concluded (and private letter rulings have repeatedly held) that a thrift conversion of the type described above did not result in the loss or restriction on use of NOL carryovers of the converted thrift under old section 382.[34] The first step conversion was a reorganization governed by old section 382(b), but the limitations of that section did not apply because the thrift was considered to be owned before and

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33 The two step approach is not obvious on the face of Revenue Ruling 80-105. Rather the ruling, after reciting that the business of the thrift will not change as a result of the conversion, states the following: "Since the equity interest of a depositor in a mutual savings and loan association is more nominal than real, unlike that of a shareholder in a corporation, the conversion into a state stock savings and loan association is a mere change in identity, form, or place of organization within the meaning of section 368(a)(1)(F)". Several private letter rulings and technical advice memoranda, however, focus on the liquidation account as a separate class of capital stock outstanding after the conversion (rather than as a nominal interest which is disregarded), which is consistent with the two-step approach. See e.g., PLRs 8604054, 8542098 and 8509098.

34 See, e.g., PLRs 8542018 and 8527056. A different result may be obtained if the conversion is coupled with a merger. See PLR 8552068.

after the conversion substantially by the same persons in the same proportion within the meaning of old section 382(b)(3).[35] The second step (the issuance of stock for cash) was treated as a purchase of stock governed by old section 382(a), but no limitations on NOL carryovers were imposed because the thrift continued its old business and the ten largest shareholders usually did not own as much as 50% of the stock of the thrift.

Proposed section 382. Whether a conversion would constitute a trigger under proposed section 382 depends on whether the depositors' equity interests are recognized to be “stock” and whether the existence of a trigger is tested by comparing (i) the interests of the purchasers of capital stock with those purchasers' interests in the thrift before the conversion, (ii) the interests of the purchasers of capital stock and of the depositors after the conversion with the interests of the depositors before the conversion, or (iii) (a) the interests of the purchasers of capital stock and the depositors with the interests of the depositors after the conversion but before the purchase of capital

[35] Old section 382(b)(3) did not require that “stock” be owned by substantially the same persons in the same proportion. By contrast, the common ownership exception in section 382(b)(6) does refer to the ownership of “stock” .

stock and (b) the interests of the depositors before and after the conversion. The choice among these competing standards will depend on whether the conversion transaction is analyzed as an integrated or two-step transaction and whether a distinction is drawn between old and new less than 5-percent shareholders following an issuance of stock by an ongoing corporation (a question discussed above in III.A.1.). For simplicity, and because it is generally true in thrift conversions, it will be assumed that there are no 5-percent shareholders.

The House Report does not address these questions directly. Following a discussion of financially troubled thrifts, the House Report states (at 262) that the committee determined that no special rules should apply to acquisitions of thrift institutions. This sheds little light on how the general rules of proposed section 382 are to apply to conversions of solvent thrifts where capital stock is acquired by a diverse group of stockholders. Second, the House Report at 264 lists as an example of “transactions that effect owner shifts” the conversion of a mutual savings and loan association to a stock savings and loan association. This could mean that a thrift conversion was intended to be analyzed exclusively under the rules governing owner shifts, or, more likely, that a conversion would effect an owner shift (namely, the sale of stock) but could also include an equity structure change as an initial step.

If the depositors' equity interests in a converting thrift are not recognized to be stock, then regardless of how the transaction is analyzed, the ownership of stock by less than 5-percent shareholders as a group would increase from zero before the conversion when no capital stock was outstanding to 100% thereafter. Thus, a trigger would always occur unless the rule in proposed section 382 that treats the increase in stock ownership by less than 5-percent shareholders as a group as if it were an increase in the ownership of stock by a 5-percent shareholder was abandoned.

If depositors' interests in a thrift <u>are</u> recognized to be stock, then both the depositors and the purchasers of capital stock would be less than 5-percent shareholders, and less than 5-percent shareholders would own 100% of the stock of the thrift before and after the transaction. Accordingly, there would be a trigger only if the purchasers of capital stock are isolated from the depositors so that the increase in stock ownership by those purchasers alone is counted against the 50% threshold. This would happen under proposed section 382 in its present form only if the transaction were analyzed as a one-step transaction (<u>i.e.</u>, the initial conversion-reorganization was integrated with the purchase of capital stock) and, as such, was tested under the rules governing equity structure changes. In that event, the continuing interest of the depositors would be very small since a comparison would be made between their stock interest before the conversion and their (much diluted) stock interest after giving effect to the purchase of capital stock (but disregarding stock which the depositors might have purchased in the stock offering).

On the other hand, if the transaction were analyzed as a two-step transaction, the continuing interest of the depositors would be determined by comparing their pre-conversion interest with their interest after the conversion-reorganization but before giving effect to the purchase of capital stock. The sale of the converted institution's capital stock in the severable second step also would not produce a trigger since all less than 5-percent shareholders would be treated as only one 5-percent shareholder in determining whether there was a more than 50-percent owner shift. We see nothing in the principles underlying proposed section 382 or in the House Report that would support abandonment of the two-step approach

If a conversion transaction were tested under a unified trigger definition, then the transaction would not constitute a trigger unless either (i) the amendment to proposed section 382(i) suggested above in III.A.1 is extended to stock issuances by ongoing corporations or (ii) proposed section 382 is adopted without that extension and the two-step analysis is abandoned with the result that the stock issuance is integrated with the “F” reorganization (without such integration resulting in the conversion being treated as a purchase of assets following a taxable liquidation of the mutual institution).

As the discussion above indicates, it will be important, in applying proposed section 382 to a thrift conversion, to determine whether a depositor's interest will be recognized to be “stock”. It is not clear whether a deposit would be recognized to be stock in the context of a conversion in the absense of a special statutory rule. In Paulsen, supra, the Supreme Court held that deposits would not be treated the equivalent of stock for purposes of applying the continuity of interest requirement to the merger of a stock thrift into a mutual thrift on the ground that, when compared with the rights of a true stockholder, the equity rights of a depositor in a mutual thrift were insubstantial. The Court recognized that depositors' interests would be recognized as equity interests in the case of a mutual into mutual or mutual into stock merger, because in those transactions the depositors' equity interests would remain the same or would be upgraded; in a stock into mutual merger, by contrast, the former stockholders who received deposits were effectively “cashed out”.

It is not entirely clear what the effect of Paulsen would be on a conversion. An argument could be made that the depositors' pre-conversion interests in the thrift should be compared with the interests of the holders of capital stock after the conversion, and when viewed in that light, only the latter should be recognized to be “stock”. On the other hand, Paulsen could be distinguished on the ground that the Court recognized that depositors' interests are to be treated as equivalent to stock where those interests remain unchanged and are not “cashed out”, or on the ground that the cash equivalent nature of a deposit has less significance under proposed section 382 than in applying the continuity of interest test. It must also be recognized, however, that the term “stock” in proposed section 382 is likely to be less embracing than the concept of equity that counts in applying the continuity of interest tests.[36]

[36] It is possible that a depositor's equity interest, if otherwise “stock”, would be excluded from the definition on the ground that it is preferred stock within section 1504(a)(4). It should be noted that old section 382(b)(7)(B)(ii) was added to the Code in 1981 to allow deposits of insolvent thrifts to be treated as stock for purposes of section 382(b).

In our view, a thrift conversion should be treated as a trigger only if, under the general provisions of proposed section 382, a primary stock offering to a diverse group of shareholders would be treated as a trigger. While we express no view as to whether there should be a more favorable rule for thrifts than for companies in other industries, we do believe that mutual thrift institutions should not be disadvantaged in raising capital as compared with stock institutions because of uncertainties arising from their peculiar capital structure.

B. Determination of Trigger Amount.

1. Definition of Tax-Exempt Rate. The trigger amount is generally defined in section 382(b)(1) as the product of the trigger value of the old loss corporation and the "long-term tax-exempt rate". The long-term tax-exempt rate is defined in proposed section 382(f) as the "Federal long-term rate (determined under section 1274 as of the trigger) properly adjusted, under regulations prescribed by the Secretary, for differences between rates on taxable and tax-exempt obligations" (emphasis added).[37]

It is not entirely clear from this language how the adjustment is to be made. For example, yields on

[37] Cf. section 1288(b)(1).

long-term tax-exempt bonds historically have been considerably in excess of the yields on taxable bonds of comparable maturity and quality multiplied by one minus the maximum marginal rate of tax. Is the adjustment in fact to be made by comparing actual market rates on taxable and tax-exempt obligations, as the language of proposed section 382(f) states, or is it instead to be made by multiplying the Federal long-term rate by one minus the tax rate (however that tax rate may itself be determined)?

The rate to be applied to the trigger value should be reduced (or some other adjustment made) for taxable years of less than 12 months.

2. Definition of Equity. The trigger value of the loss corporation is generally defined in proposed section 382(e)(1) as the value of the equity of such corporation. Equity, in turn, means “stock,... warrants or other options (issued by the corporation) to acquire an interest in the equity of the corporation,... the conversion feature of convertible debt interests, and ... any other interest in the equity of the corporation.”

As discussed above, the term “stock” excludes certain preferred stock described in section 1504(a)(4). While such stock should fall into the category of “any other interest in the equity of the corporation”, it would be preferable if it were separately listed.

Also, the reference to “convertible debt interests” would be more clear if it read “debt obligations of the corporation convertible into an interest in the equity of the corporation”.

3. Control Premiums. As noted above, the trigger value is defined as the equity value of the old loss corporation. Under proposed section 382(m), value means fair market value. The House Report at page 268 states that the price at which the old loss corporation's stock changes hands is evidence of the value of the equity, but in the event an acquiror purchases the stock of the loss corporation in several separate transactions and in one of those transactions the acquiror pays a control premium, it is “inappropriate to include the premium paid... in the measure of the corporation's equity value”. In the example given in the House Report, the acquiring corporation purchases 40% of the target over a twelve month period and thereafter acquires another 20% of the old loss corporation's stock at a price reflecting a control premium. While we believe it inappropriate to compute the value of all of the stock of the old loss corporation by grossing-up the price paid for the controlling block of stock (even though it is the most recent block purchased), we also believe it inappropriate to ignore the premium paid altogether. To the extent the acquiror actually pays a premium, the trigger value should reflect it.

We suggest the appropriate mechanism would follow the approach of Treasury Regulations section

1.338-4(h)(T)(3) in computing the aggregate deemed sales price (or “ADSP”) of the assets deemed sold in a section 338 transaction. The ADSP, which is also intended as a measure of fair market value, is computed under a formula that includes the grossed-up basis of the acquiror's recently purchased target stock. It is computed based on the average price paid by the acquiror for target shares, including shares purchased at a premium or discount, if any. We suggest that the same approach be followed under proposed section 382.

4. Redemptions. Proposed section 382(e)(3) states that if the last component event of the trigger is a redemption, the trigger value shall be determined immediately after the trigger (i.e., giving effect to the reduction in assets attributable to the redemption). The theory underlying this rule is, presumably, that if the loss corporation were not acquired and its asset base were reduced through a redemption of stock, the income that would be generated by its assets, and hence the rate of absorption of its NOLs, would also be reduced. Thus, to maintain neutrality between the case where the loss corporation is acquired and the case where it is not, the trigger value should be reduced by the amount of assets distributed in the redemption. This result would occur automatically in the case of redemptions that predate the trigger, because the trigger value on the trigger day would reflect the reduced net worth of the loss corporation. The effect of proposed section 382(e)(3) is to ensure that where the event causing a trigger is a redemption, that redemption is, in effect, treated as

having occurred before the time when the trigger value is to be determined.

We are concerned that this rule will result in distinctions being drawn between transactions that are economically equivalent. For example, suppose P is organized with an equity contribution of $30 million. P borrows $70 million and purchases all the L stock for $100 million. Immediately following the purchase, L and P are combined through merger, perhaps because the lenders insist that the debt end up as a liability of a corporation that holds the L assets. If the merger is downstream, then under recent private letter rulings, the transaction would be treated as a redemption by L of the $70 million of its stock that was purchased with the proceeds of P's borrowing.[38] Thus, the trigger value would be $30 million. But if the merger is upstream, the transaction apparently would not be treated as a redemption by L.[39] Thus, the trigger value would be $100 million. It would be unfortunate to distinguish between these two transactions; yet that is the apparent effect of proposed section 382(e)(3).

The redemption rule applies only when the redemption is the last component event of the trigger. This suggests that slight changes in the steps taken to effect an acquisition will be critical in determining whether the rule applies. For example, suppose P wishes to acquire 100% of L. If P acquires 49% of L’s stock from

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[38] PLRs 8546110, 8542020 and 8539056.

existing stockholders and the remaining 51% of L's stock is redeemed by L, then the assets used to effect that redemption would reduce the trigger amount. On the other hand, if P first acquired 51% of L's stock, that change in ownership would be a trigger. A subsequent redemption by L of the remaining 49% of its stock would not cause a trigger (because the testing period for purposes of determining whether the redemption is a trigger would commence immediately following the prior trigger). Again, a premium is placed on legerdemain.

Another area of concern is the relationship between the rules for redemptions and the rules for capital contributions. Because capital contributions during the testing period are generally disregarded while redemptions are given effect, transactions involving the issuance and redemption of a security that have no ultimate effect on the net worth of a corporation can nonetheless result in a reduction in the trigger value. These issues are discussed in III.B.5, below.

Given that any rule that seeks to measure the equity value of a corporation at one moment in time will involve some degree of arbitrariness and that a redemption that occurs prior to a trigger will reduce the trigger value, we have no strong objection to proposed section 382(e)(3). On the other hand, it is important that proposed section 382(e)(3) not be understood as a license to invoke step transaction principles to give

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[39] An upstream merger would, of course, be subject to a separate tax avoidance test under section 269(b).

effect to post-trigger redemptions and reallocations of the assets of the target.

The principal reason for adopting an arbitrary rule for calculating earnings that are expected to be derived from assets of the loss corporation is that it is not possible to trace over time the earnings from those assets. Particularly in transactions in which the loss corporation becomes a member of an affiliated group of corporations, it would be unfortunate if the redemption rule were construed to cast a shadow over post-acquisition transfers of assets of the loss corporation to other group members if the transfers made business sense. When the loss corporation does not become a member of a group, redemptions following a trigger will always reduce the rate of absorption of NOLs by reducing the future earnings against which they may be offset. Thus, redemptions will limit the acquiror’s ability to benefit from the loss corporation's NOLs, even if they do not reduce the trigger value.[40]

5. Capital Contributions. Proposed section 382(n)(1) reduces the trigger value by an amount equal to the aggregate capital contributions (including all amounts exchanged for stock) that are made during the testing period. The purpose of this rule is to prevent tax avoidance in the form of eleventh hour capital

[40] In the example above in the text when L is acquired with $30 million of equity and $70 million of debt, and the debt is combined with the assets of L, the future income of L against which the NOLs of L may be offset will be reduced by the interest paid on the debt. Thus, to that extent, utilization of the NOLs is already restricted even if the trigger value is determined to be $100 million.

contributions that are intended to inflate artificially the value of the equity of the loss corporation. An objective test has been chosen, apparently out of concern that a rule based on tax avoidance motives would be difficult to administer.

We believe that the rule in its proposed form is far too sweeping and probably unnecessary in light of the nonbusiness assets rules found in proposed section 382(n)(8).

The rule is objectionable because it fails to distinguish between capital contributions made for business reasons and those made for tax avoidance reasons. For example, under the House Bill, if a start-up company receives capital from its shareholders, incurs start-up losses and then is sold, all within a three year period, the trigger value of the company would be zero. This makes no sense. Further, the rule would also deduct all capital contributions made to a bankrupt company during the three years prior to a trigger, even though the likelihood that shareholders would inject additional capital into a failing company (which presumably has untold numbers of creditors) for tax avoidance reasons is remote.

Further still, what if a business is conducted as a division of a corporation and the assets of that division (consisting entirely of operating assets) are transferred to a subsidiary and the stock of that subsidiary is sold within three years? The trigger value of the corporation, apparently, would be zero as well. Similarly, if a business conducted as a partnership were incorporated within three years prior to a sale of the new corporation's stock, the trigger value of the corporation would be zero even though no new assets were added to the business upon its incorporation. As an even more extreme example, suppose that during the testing period, L participates in a reorganization involving a transfer of its assets to a new corporation and no significant change in equity ownership. Would the reorganization be a capital contribution?

In addition, proposed section 382(n)(1) fails to distinguish between capital contributions made by shareholders of closely held corporations and capital raised in public securities offerings; yet, the potential for abuse would seem to be much greater in the former case. It also does not distinguish between pro rata contributions and non-pro rata contributions in exchange for stock. Since the latter would affect relative stock holdings, they would be less likely to be undertaken for tax avoidance reasons.

If the primary purpose of the capital contribution rule is to prevent artificial increases in the net value of the equity of a loss corporation and a subjective tax avoidance purpose test is thought to be too difficult to administer, then why not place reliance on a test that looks to the composition of the assets of the loss company at the time of the trigger? If contributed capital is in fact not being used in a business, then it would be eliminated from the trigger value; otherwise, it would count. Proposed section 382(n)(8) (discussed further below) is, of course, just such a rule. One objection to relying solely on proposed section 382(n)(8) to prevent tax motivated capital contributions is that it does not apply unless at least 1/3 of the assets of the loss corporation are nonbusiness assets. If this is a problem, then the section might be amended to require nonbusiness assets to be subtracted from the trigger value to the extent of capital contributions received during the trigger period if the value of those assets was less than 1/3.

One mechanical defect in the capital contribution rule is that it assumes that capital contributions during the three years prior to the trigger have increased the trigger value dollar-for-dollar. This, however, need not be the case because, among other reasons, the capital may have been redistributed to shareholders. To take an extreme but by no means unusual case, suppose that during the testing period the loss corporation issues common stock and uses the proceeds to retire a class of preferred stock. The transaction would have no effect on the net worth of the corporation but would reduce its trigger value by the amount of proceeds of the common stock offering. To prevent such an anomolous result, we believe that if the rule mandating the reduction of the trigger value by the aggregate amount of capital contributions is retained, the reduction should be limited to the excess of the aggregate amount of capital contributions during the trigger period over the distributions made during that period.

We believe a distribution with respect to stock should be counted for this purpose, without regard to whether the distributee is treated as receiving a dividend, a return of capital of a gain. While at first it might appear appropriate to limit the relief provided to the excess of the amount of the distribution over the previously undistributed earnings for the period between the date of the capital contribution and the date of the distribution (to that extent the distribution is not a return of capital),[41] such a limitation would be inconsistent with the basic approach of the House Bill which is to subtract one dollar from the trigger value for each dollar of contributed capital without an adjustment for earnings or losses attributable to that dollar. Thus, even though one dollar of contributed capital would increase the trigger value by $1.20 if the dollar earned $.20 from the date of the contribution to the trigger day, or by only $.80 if a loss of $.20 were experienced, under proposed section 382(n)(1), the trigger value would be reduced by one dollar. It would be only reasonable to apply the same approach to distributions.

[41] Such a rule might be similar to Treasury Regulations section 1.334-1(c)(4) (in the case of a liquidation of certain subsidiaries, the basis of property to the transferee is reduced by the amount of all distributions received by the parent from the subsidiary during the period between the purchase of controlling stock and the adoption of a plan of liquidation but shall not be reduced to the extent such distributions are out of earnings and profits beginning on the date of purchase and ending on the date of the last distribution in liquidation).

In summary, we recommend that the capital contribution rule be dropped, possibly accompanied by a rule that would allow the trigger value to be reduced (without regard to the 1/3 threshold) by the amount of nonbusiness assets held on the trigger day to the extent of capital contributions (net of distributions) made during the testing period. Even then, an effort should be made to exclude from the definition of a capital contribution “F” reorganizations and other transactions that involve a repackaging of the assets of a business without the addition of new capital.

6. Contingencies. We believe that the text of any new version of section 382 (or at least the accompanying committee reports) should provide rules governing the treatment of contingent price acquisitions (either of L or by L). The area is too important to leave taxpayers completely in the dark until regulations are issued.

The treatment of contingent consideration may be relevant in determining whether a trigger has occurred and, if it has, the trigger value. To illustrate possible issues, suppose that L, which has outstanding 1,000 shares of stock, acquires all of the stock of P from P's sole shareholder, A. In exchange, A receives 750 shares of L stock and a contingent right to receive up to an additional 500 shares of L stock, depending on P's earnings, over the next five years. If at least 250 of the contingent shares are considered to be acquired by A during the testing period, a trigger will occur.

Among the questions suggested by this simple example is whether the contingent L shares should be treated as being owned by A only when and if they are actually issued, at the time when the right to receive the shares becomes fixed, or possibly at the time of the P acquisition to the extent of (i) the maximum number of shares that can be issued, (ii) the maximum number that can be issued in three years, (iii) the number of shares that are expected to be issued based on forecasts, or (iv) a number of noncontingent L shares having a value equal to the value of the contingent right to receive L shares. If shares are counted only if issued and a trigger occurs because of the issuance of contingent shares, does the trigger occur at the time when the contingent shares are issued, or at the time of the P acquisition? Suppose that L issues additional shares to shareholders other than A during the pay-out period. Would those shares be taken into account in determining A's percentage interest in L? Should the portion of the L shares deemed to constitute interest under section 1274 or 483 be counted in determining whether a trigger has occurred? Should the results be different if stock is escrowed and subject to forfeiture instead of being contingent, and should any forfeitures be counted in determining if a second trigger has occurred? Once it has been determined whether a trigger has occurred, how is the trigger value to be computed? Are rights to contingent stock or contingent payments included in equity value?

In general, it would seem appropriate to take contingent stock or contingent payments into account only when the stock is issued or the payments are actually made (or perhaps when the rights thereto become fixed) without any retroactive effect. This approach is consistent with the concept of annual accounting and also provides a desirable degree of certainty. It also tends to reduce the need to value contingent stock or payments which is very desirable.

C. Continuity of Business Enterprise Requirement.

Proposed section 382(c) fixes the trigger amount at zero if the continuity of business enterprise requirements applicable under section 368 are not met with respect to the new loss corporation during the two-year period beginning on the trigger date. This test is intended to be more lenient than the change of business test under old section 382(a). See House Report at 267. However, the apparent leniency of relying on the section 368 standard for measuring the required continuity of L’s business activities is largely fictitious because of the inclusion in the definition of “nonbusiness assets” in proposed section 382(n)(8)(C)(iii)(II) (discussed below) of any asset which is “disposed of (other than in the ordinary course of the old loss corporation's trade or business) pursuant to a plan or arrangement in existence before the trigger day”. Barring extraordinary circumstances, it would be difficult to establish that there was not a plan or arrangement in existence if significant business assets are sold within a short period after the trigger day. Thus, if at least 1/3 of L's assets are disposed of outside of the ordinary course, the trigger value would be reduced by the net value of the assets disposed of. Moreover, unlike the trade or business test under old section 382(a), which required a business to be continued for at most two taxable years, under proposed section 382(n)(8) there is no firm date after which sizable businesses can be disposed of with impunity.

Proposed section 382(c) reduces the trigger value to zero if the continuity of business enterprise test is not met. Proposed section 382(h) increases the trigger amount by the amount of built-in gains. It is unclear what is the respective order of application of these two subsections and, thus, whether NOL carryovers that could otherwise be used to offset built-in gains can be so used if the continuity of business enterprise requirement is not met.

D. <u>Rules for Built-In Gains or Losses.</u>

1. A recognized built-in loss is defined as follows in proposed section 382(h)(2)(B):

> (B) Recognized Built-In Loss.--The term "recognized built-in loss" means--
>
> (i) any loss recognized in the recognition period on the disposition of any asset to the extent such loss does not exceed the excess of--

(I) the adjusted basis of such asset as of the trigger day, over

(II) its fair market value as of such day, and

(ii) any amount allowable for depreciation, amortization, or depletion for the taxable year attributable to the excess described in clause(i)

This definition should be amended to take account of the overlap between clauses (i) and (ii).

To illustrate, suppose that as of the trigger day an asset has a basis of 100 and a fair market value of 50. The asset is sold for 35 after 10 of the 100 of basis has been recovered through depreciation resulting in a loss of 55 (90 minus 35). Under clause (ii) 5 of the depreciation deduction of 10 would be treated as a recognized built-in loss. The portion of the loss of 55 realized upon sale of the asset that is treated as a recognized built-in loss under clause (i) should be only 45 (the 50 excess of basis over fair market value on the trigger day minus the 5 of depreciation attributable to that difference that has already been treated as a recognized built-in loss under (ii)). By contrast, the definition would appear to treat as the recognized built-in loss the full 50 (the excess of the basis of the asset over its fair market value on the trigger day).[42]

2. Proposed section 382(h)(5) states that if 80% or more in value of the stock of a corporation is acquired during a twelve-month period, for purposes of determining the net unrealized loss, the fair market value of the assets of the corporation shall not exceed the grossed-up amount paid for such stock properly adjusted for indebtedness of the corporation and other relevant items. This provision should be rewritten to conform to the formula under section 338(h)(11) for determining the fair market value of assets of an acquired corporation.

In particular, it makes no sense to determine fair market value by reference to the basis of stock unless the stock has been acquired through purchase; otherwise, the basis would not necessarily have any connection to fair market value at the time it is acquired. Further, the cost of stock purchased more than 12 months in the past should not be counted in determining the grossed-up basis because it may not reflect current values.

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[42] Under proposed section 382(h)(1)(B)(ii)(II), recognized built-in losses for any year cannot exceed the net unrealized built-in loss reduced by the recognized built-in losses for prior taxable years ending in the recognition period. While this rule would eventually prevent the overstatement of recognized built-in losses for all assets of the loss corporation as a group, the change suggested in the text is necessary to prevent the recognized built-in loss from being calculated improperly for individual assets year-by-year.

3. Under proposed section 382(n)(1)(A)(ii), if identifiable as of the trigger, capital contributions are not taken into account for the purposes of applying section 382(h) (special rules for built-in gains and losses). The purpose of this provision must be to keep shareholders from contributing built-in gain property to the loss corporation. However, the meaning of “identifiable” is unclear. Obviously, if just prior to a trigger a stockholder contributes an item of built-in gain property to a corporation in return for stock, that item would be identifiable. However, it is not clear whether a capital contribution would be considered identifiable if, for example, two years prior to a trigger a shareholder contributed cash for stock and the corporation went out and bought property at its fair market value which then, over time, increased.

4. The proration rules of proposed section 382(b)(3) do not appear to operate properly in conjunction with the built-in gain rules of proposed section 382(h). The difficulty flows from the fact that under the proration rules, the portion of the income (including gain on sales of property) subject to limitation under proposed section 382 does not depend on when during the year a sale actually takes place, but for purposes of applying the built-in gain rules, it is critical whether a sale takes place before or after the trigger day.

For example, assume that L is a calendar year corporation. A trigger occurs on July 1 that does not result in the termination of L's taxable year. Assume further that L has an asset, with a basis of zero and a value of $100, that it disposes of in connection with the acquisition transaction, and that it has no other built-in gains or losses. If the asset is disposed of on July 2 (the day after the trigger day), approximately $50 of gain will, under proposed section 382(b)(3), be subject to offset by pre-trigger year losses without limitation, and $50 of gain will be subject to the limitation of proposed section 382. Because on the trigger day there was a net unrealized built in gain of $100, the trigger amount for the year of sale would be increased under proposed section 382(h) by the full $100. In effect, there is an element of double counting, in that the $50 of gain allocable to the period before the trigger is not subject to limitation under proposed section 382, but results in an upward adjustment to the trigger amount.

Alternatively, assume the same facts as above except that the sale of the asset takes place on June 30 (i.e., one day before the trigger day). As in the previous example, approximately $50 of gain would be subject to offset without regard to the proposed section 382 limitations, and $50 of gain would be subject to such limitations. However, in this example, because the property is disposed of prior to the trigger day, there would be no unrealized built-in gain on such day and as a result no upward adjustment to the trigger amount under proposed section 382(h).

To achieve consistent results between the two situations and to avoid certain possibilities for manipulation, the statute should provide that where, as a result of the proration rules, a portion of gain recognized in the year of the trigger is subject to the proposed section 382 limitations, only that portion of such gain should be treated as a built-in gain. Under this rule, in both of the above examples there would be an upward adjustment to the trigger amount of $50 under proposed section 382(h), which is precisely the amount required to offset the $50 of gain subject to limitation under the proration rules of proposed section 382.

As another example, assume a trigger occurs on July 1 with respect to L, a calendar year corporation, and that the trigger does not terminate L's taxable year. Assume further that L owns Asset A, which has a built-in gain of $100, and Asset B, which has a $100 built-in loss. L desires to dispose of Asset A currently, but to hold Asset B for an indefinite period.

If Asset A is sold on June 30, approximately $50 of the gain would be subject to offset without limitation, and $50 of gain would be subject to limitation under proposed section 382. Because there is no net unrealized built-in gain on the trigger date, there will not be an upward adjustment to the trigger amount. Moreover, because there will be a net unrealized built-in loss of $100 on the trigger day, if Asset B is sold within ten years, the loss (to the extent it does not exceed $100) will be subject to proposed section 382 limitations as though it were a pre-trigger loss.

If, on the other hand, Asset A were sold on July 2, $50 of the gain would be subject to offset without limitation and $50 of the gain would be subject to limitation under proposed section 382, the same result that follows from a sale on June 30. However, because there would be no net unrealized built-in gain or loss on the trigger day, a loss recognized on the sale of Assets B in a later year could offset future income without limitation.

The rule suggested above would avoid these inconsistent results flowing from a two-day difference in when the sale takes place (and alter the result in each case) by providing that, in both situations, there would be a net unrealized built-in loss of $50 as of the trigger day.

5. Under proposed section 382(h)(3)(C), the Treasury may by regulation treat amounts which accrue before the trigger day but which are allowable as a deduction on or after such day as unrealized built-in losses. The proposed legislation should similarly authorize the Treasury to write regulations that treat accrued income items as unrealized built-in gains. Otherwise, taxpayers anticipating a trigger will be forced to enter into transactions just prior thereto merely to recognize gain.

E. Nonbusiness Assets.

Under proposed section 382(n)(8), if immediately after a trigger one-third or more of the total assets of the old loss corporation are “nonbusiness assets”, the trigger value is reduced by the excess, if any, of the value of L’s nonbusiness assets over the portion of L’s indebtedness attributable to those nonbusiness assets. Nonbusiness assets are defined as cash, marketable stocks or securities, and any other assets either (i) not held for active use in a trade or business or (ii) disposed of (other than the ordinary course of the old loss corporation's trade or business) pursuant to a plan or arrangement in existence before the trigger day. The amount of indebtedness attributable to nonbusiness assets is those nonbusiness assets' ratable share of the corporation's indebtedness. We have the following technical comments on this rule.

If the threshhold is met, L’s trigger value is reduced by the amount of nonbusiness assets less allocated liabilities. Because debt is allocated ratably between business assets and nonbusiness assets, to the extent that a nonbusiness asset is more highly leveraged than the average of all of the corporation's assets, some of the debt to which that nonbusiness asset is subject will be allocated to the business assets, and L’s trigger value will be reduced by a greater amount on account of nonbusiness assets than it would be if indebtedness was allocated to the particular assets to which it is attributable.

We believe that an across the board assumption that debt supports all assets equally does not adequately comport with business reality, particularly when a comparison is made between financial assets which are most vulnerable to characterization as nonbusiness assets (and most likely to be highly leveraged) and operating assets of a business. It would be appropriate, therefore, to allow taxpayers to demonstrate to which assets indebtedness is attributable.

Under proposed section 382(n)(8)(C), nonbusiness assets include cash and marketable stocks and securities. The rule, however, does not have an exception for working capital or for financial institutions for which marketable stocks and securities are business assets.[43]

F. Special Rules for Bankrupt or Insolvent Corporations.
Background.

Current tax law relating to bankruptcy reflects a longstanding federal policy of attempting to facilitate the rehabilitation of corporations in bankruptcy or similar proceedings. This policy can be seen in the retention of the stock-for-debt exception to the realization of cancellation of indebtedness income, in

[43] The SFC Proposal specifically excepted from its definition of an investment company, regulated investment companies and real estate investment trusts. SFC section 382(f)(3)(B). A broader exception than this is necessary to deal with securities dealers, banks, insurance companies, consumer loan companies and other financial institutions that are operating businesses. Possible analogies for making such a determination include the regulations governing the allocation of interest deductions for source purposes (Treasury Regulation section

1980, in the Bankruptcy Tax Act. The Senate Finance Committee report accompanying the Bankruptcy Tax Act states, in part:

> It is anticipated that by providing for favorable tax treatment if stock is issued to creditors in discharge of debt, the committee bill will encourage reorganization, rather than liquidation, of financially distressed companies that have a potential for surviving as operating concerns.[44]

Regarding limitations on carryovers, the Bankruptcy Tax Act added old section 382(b)(7) to treat as stockholders creditors who receive stock in title 11 or similar cases. The effect of old section 382(b)(7) was to avoid limitations on NOL carryovers that otherwise might arise under old section 382(b) when creditor claims were converted into stock in the context of bankruptcy-related tax-free reorganizations.[45] The federal policy favoring bankruptcy restructuring was also expressed in the 1984 amendment to section 108 which, in bankruptcy cases, retained the stock-for-debt exception without limitation.[46]

1.861-8(e)(2)), the definition of acquisition indebtedness under section 514, and the rules of section 265.

44 S. Rep. No. 1035, 96th Cong., 2d Sess. 3 (1980) ("Senate Bankruptcy Report").

45 There was no similar rule under old section 382(a).

46 The Deficit Reduction Act of 1984 also added section 108(e)(l0)(C) to the Code, effective as if it had been included in the amendments made to section 382 by the Tax Reform Act of 1976. Section 108(e)(l0)(C) expands coverage of the stock-for-debt exception to transfers of stock in "qualified workouts" outside the context of bankruptcy or insolvency proceedings. Section 321(d)(1) of H.R. 3838 would repeal portions of the Tax Reform Act of 1976, one of the ancillary effects of which would be to prevent section 108(e)(l0)(C) from ever becoming effective. This result

The same exception was retained for other insolvent debtors, to the extent of the debtor's insolvency.[47]

These legislative developments (avoiding cancellation of indebtedness income and preserving NOL carryovers in bankruptcy) reflect a strong and longstanding federal policy of providing special tax treatment for bankrupt corporations, thereby providing them with greater flexibility in restructuring their debt and rehabilitating their businesses.

Similarly, the SFC Proposal and the ABA Proposal exempted bankruptcy restructurings from the general limitations on the use of NOLs. (A broad stock-for-debt exception

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(Footnote continued)

appears to have been unintended. According to the conference report to the Deficit Reduction Act of 1984, the effective date of section 108(e)(l0)(C) was delayed to allow Congress to reconsider the matter in connection with its reexamination of the general treatment of NOLs. The report also stated that it anticipated that certain technical issues which remained would also be resolved before the section became effective. (These issues parallel many of the issues discussed herein.) See H.R. Rep. No. 861, 98th Cong., 2d Sess. 830-831 (1984). We believe section 108(e)(10)(C) reflects a sensible approach to the problems facing insolvent companies and that, subject to resolution of the remaining technical issues, section 108(e)(10)(C) should be allowed to become effective in connection with the revision of section 382.

47 In other contexts, the 1984 legislation restricted application of the stock-for-debt exception. See Section 108(e)(10).

was also recommended for inclusion in proposed NOL carryover rules published by the American Law Institute in 1982.)[48]

General Comments.

Given this background, we turn to the special rules for bankrupt and insolvent corporations found in proposed section 382. Apart from a transitional rule, the only relief granted those corporations is found in proposed section 382(e)(4), which provides that in the case of a reorganization under section 368(a)(1)(G) or an exchange of debt for stock in a title 11 or similar proceeding, the trigger value of the corporation is to be determined immediately after the trigger rather than immediately before the trigger.

In a typical bankruptcy reorganization, creditors of an insolvent corporation exchange at least a portion of their claims for stock of the debtor corporation, rendering the corporation solvent to some extent. Presumably, it is this value that proposed section 382(e)(4) intends to establish as the trigger value of a corporation emerging from bankruptcy.

A good starting point for the discussion of the purpose of proposed section 382(e)(4) is the discussion of insolvent companies found in the House Report at 261-262:

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48 ALI Proposal at 263-264.

Finally, the committee reviewed the treatment of ownership changes of insolvent corporations. Under the general rule of the committee's bill, no carryforwards would survive the acquisition of an insolvent corporation because the corporation's equity value immediately before the acquisition would be zero. In such a case, 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 shareholder.[[49]] While the committee concluded that relief from a strict application of the general rule should be provided, as the creditors of an insolvent corporation frequently bear the losses reflected in a NOL carryforward, the committee discerned no tax policy reason that would justify a blanket exception from the special limitations. The former creditors of an insolvent loss corporation are as likely as any other new owners to attempt to accelerate the use of pre-acquisition NOLs. The committee was also concerned about the potential for abusive transactions if an exception was made. For example, if there were a general stock-for debt exception, an acquiring corporation could purchase a loss corporation's debt immediately before or during a bankruptcy proceeding, exchange the debt for stock without triggering the special limitations, and then use the loss corporation's NOL carryforwards immediately and without limitation. The committee also believes that allowing favorable tax treatment for creditors of insolvent corporations could divert lending away from solvent corporations, including start-up corporations, that may contribute more to the productivity of the economy.

[49] Cf. Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179 (1942) ("When the equity owners are excluded and the old creditors become the stockholders..., it conforms to reality to date [the creditors'] equity ownership from the time when they invoked the processes of the law to enforce their rights of full priority").

> For these reasons, the committee's bill provides that the annual limitation after a G reorganization or stock-for-debt exchange that occurs as part of a title 11 or similar proceeding is computed by reference to the value of the loss corporation's equity immediately <u>after</u> the end of a bankruptcy proceeding (when ownership is formally shifted) (similar to the treatment of redemptions under the bill). In this manner, the use of NOL carryforwards after a G reorganization or qualified stock-for-debt exchange will be limited to the equity value that remains after the discharge of a loss corporation's debts, subject to the bilL's anti-abuse rules relating to passive assets and capital contributions.

Two basic principles emerge from this discussion:(1) under the general rules of proposed section 382, an insolvent corporation would have an equity value of zero, and an exception from the strict application of this rule should be provided to acknowledge that creditors that exchange debt for stock in a title 11 case have been the true equity owners for some time, although this should not be a complete exemption from proposed section 382, and (2) new investors should not be allowed to avoid the limitations of proposed section 382 by buying the debt of a loss corporation and exchanging the debt for stock, or otherwise avoid the limitations that would apply under proposed section 382 had the creditors been stockholders from the start of the testing period.

In applying these principles, we think it important to distinguish three possible general approaches to fashioning a rule for insolvent companies: (1) the rule could ignore changes in holdings of debt altogether in determining whether a trigger has occurred and thus exclude from the definition of trigger exchanges of debt for stock; (2) the rule could treat exchanges of debt for stock as a change in the ownership of stock that may give rise to a trigger, but then treat the debt as if it had been stock for purposes of determining the trigger value, or (3) the rule could treat debt exchanged for stock as if it were already stock, with the result that (a) changes in the ownership of such debt prior to the exchange would count in determining whether a trigger has occurred, (b) the exchange would be treated as an exchange of stock for stock and therefore would not of itself count as a change in the ownership of stock for purposes of determining whether a trigger had occurred, and (c) deductions for interest accrued on such debt during the period it is treated as stock would be excluded from NOLs.

The first of these rules would represent a blanket exemption of the type rejected in the House Report. We agree that such an exemption is not appropriate.

The rule found in proposed section 382(e)(4) appears to be an attempt at adopting the second approach, although for reasons described below the attempt is unsuccessful. Furthermore, it would make no sense to acknowledge that debt of a bankrupt company has in reality been stock since the beginning of the testing period but then ignore that fact in determining whether a trigger has occurred.

The preferred approach, we submit, is the third one. It applies consistently the logic of treating debt as if it had been stock, and avoids the potential abuses in determining whether a trigger has occurred referred to in the House Report by counting changes in the ownership of debt as if they were changes in the ownership of stock. Accordingly, subject to the modifications discussed below, we recommend that the third approach be adopted. We also strongly recommend that the proposed exception be extended to workouts outside of bankruptcy (cf. section 108(e)(10)(C)). Otherwise, proposed section 382 would drive into bankruptcy companies that might otherwise be able to resolve their financial difficulties without court supervision.

A strict application of the third approach would count all changes during the testing period in the ownership of debt which is exchanged for equity as though they were changes in equity ownership. However, we recommend two modifications to this approach. First, adoption of the strict approach might tend to discourage the making of new loans to troubled companies, because, if the borrower went into bankruptcy within three years and the lender received stock, the loan itself would count in determining whether there has been a trigger. Moreover, the abuses referred to in the House Report (i.e., the purchase of debt claims for the purpose of acquiring the stock for which such claims will be exchanged in bankruptcy) are not generally present in the case of new borrowings. Accordingly, we recommend that only changes in the ownership of existing debt (and not new advances) be counted as changes in stock ownership in this context. Similarly, new loans made during the testing period and converted into stock in bankruptcy should not be excluded from the trigger value under proposed section 382(n)(1). Contributions of funds to a failing company are most unlikely to be undertaken for tax avoidance purposes.

The testing period that would apply under the strict approach should also be modified. Unlike purchasers of stock who are aware that changes in ownership may result in a trigger, a purchaser of debt three years before a bankruptcy proceeding may have no reason to anticipate that his purchase may cause a trigger as a result of a subsequent bankruptcy. On the other hand, as discussed in the House Report, changes shortly before a bankruptcy should be taken into account in order to prevent abuse. We believe that these interests are best balanced by not taking into account any changes in the ownership of debt that occur more than one year prior to the filing of a bankruptcy petition. In the case of a workout outside of bankruptcy, the date of the first report to shareholders that a qualified workout is being undertaken (see section 108(e)(10)(C)(ii)(II)) could be substituted for the date of filing of a bankruptcy petition.

Technical Comments.

1. The House Report, as quoted above, states that NOL carryovers would not survive the acquisition of an insolvent corporation because the corporation's equity value would be zero. It goes on, however, to acknowledge that the creditors may in that event be the true equity owners and cites Alabama Asphaltic which holds that creditors may be treated as equity holders for purposes of the continuity of interest test in reorganizations.

It is reasonably clear that under proposed section 382 debt would not be treated as “stock” for purposes of measuring changes in the ownership of stock to determine whether a trigger has occurred[50]. However, as described above, the trigger value is not limited to the

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[50] Cf. Helvering v. Southwest Consolidated Corp., 315 U.S. 194, 201-202 (1942), which held that creditors were not “stockholders” within the meaning of a predecessor of section 368(a)(1)(D), although they might be considered to have a proprietary interest under Alabama Asphaltic.

value of “stock” but is rather the value of all “equity” of the old loss corporation, including such non-stock equity interests as options and the right to convert debt into stock. Given Alabama Asphaltic, a strong argument could be made that in some circumstances debt would be an “interest in the equity of the corporation” under proposed section 382(e)(2)(D). In view of the apparent conflict between the statute and the House Report, some clarification of the point would be welcome.

2. As described above, proposed section 382(e)(4) generally would require the trigger value of a bankrupt company to be determined after an exchange of debt for stock so that the net value would, presumbly, include the equity created by such exchange. However, this result would effectively be denied by the capital contribution-offset rule of proposed section 382(n)(1). As discussed above, under proposed section 382(n)(1), the trigger value of an old loss corporation is reduced by an amount equal to the aggregate capital contributions received by the corporation during the testing period (which is generally the three-year period ending on and presumably including the trigger day). Proposed section 382(n)(1)(B)(i)(I) defines a capital contribution to include “any amount received by the corporation... for stock in the corporation”. Assuming, as seems likely, that any amount of debt surrendered to the issuer in

exchange for stock is an “amount received by the corporation... for stock”, the trigger value, having been increased by the fair market value of the stock issued to creditors under proposed section 382(e)(4), is reduced under proposed section 382(n)(1) either by the same amount, or perhaps by the presumably greater face amount of the debt exchanged. As a result, the bankrupt company will have no equity value (or a negative equity value) after the adjustment under proposed section 382(n)(1) is made. Moreover, infusions of cash made by shareholders during the testing period would also reduce the trigger value of the corporation as determined immediately after the trigger, eventhough those cash contributions were critical to the needs of the business. See III.B.5, above.

3. The NOLs of bankrupt companies may also be peculiarly vulnerable under the substantial nonbusiness asset rule of proposed section 382(n)(8). As described above, nonbusiness assets include cash, marketable securities and assets disposed of (other than in the ordinary course of the old loss corporation's trade or business) pursuant to a plan or arrangement in existence before the trigger day. Under proposed section 382(n)(8), it appears that if a bankrupt corporation sells one of its businesses while under the jurisdiction of the

bankruptcy court (or pursuant to a plan formulated during such period) to generate cash to finance its continuing operations, or to repay creditors or other security holders, and the sale generates proceeds constituting more than 1/3 of the total value of all the assets of the corporation, the trigger value will be reduced by the amount of those proceeds (reduced by a pro rata portion of the corporation's liabilities). This offset rule may create more problems for bankrupt corporations than for others because they are more likely than healthy corporations to have plans to dispose of unwanted assets or businesses, either in the bankruptcy proceedings or shortly thereafter.

The desirability of special rules to take account of the need of bankrupt companies to dispose of assets was recognized in the Bankruptcy Tax Act. The Senate Finance Committee report acknowledged that bankrupt companies might have difficulty complying with the “substantially all of the assets” test which was to apply to reorganizations under new section 368(a)(1)(G) if account was not taken of their special circumstances and states that the test should be applied to carry out, the intent of the new “G” rules to facilitate reorganizations of bankrupt companies.[51] The report continues:

[51] Senate Bankruptcy Report at 35.

> Accordingly, it is intended that facts and circumstances relevant to this intent, such as the insolvent corporation's need to pay off creditors or to sell assets or divisions to raise cash, are to be taken into account in determining whether a transaction qualifies as a “G” reorganization. For example, a transaction is not precluded from satisfying the “substantially all” test for purposes of the new “G” category merely because, prior to a transfer to the acquiring corporation, payments to creditors and asset sales were made in order to leave the debtor with more manageable operating assets to continue in business.[52]

The liquidation or other disposition of marginal businesses is inherent in the reorganization process and does not demonstrate the presence of a tax avoidance motive. That such dispositions occur should not result in the disallowance of NOLs.

4. Proposed section 382(e)(4) applies to “any exchange of debt for stock in a title 11 or similar proceeding”. The terms “title 11 or similar proceeding” should be defined, presumably in a manner conforming to the definition in section 368(a)(3)(A) (which applies only to part III of subchapter C, which would not include proposed section 382). In addition, the term “exchange of debt for stock” should be clarified to assure the inclusion of an exchange of debt in one company for stock of another company, such as a newly created parent company.

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[52] Id. at 35-36.

5. A literal reading of proposed section 382(e)(4) could cause anomalous results in the case of a "G" reorganization in which the assets of the loss corporation are acquired directly (i.e., not through a subsidiary) by a large existing corporation. Because the acquiring corporation would be the "new loss corporation", the value of which immediately after the trigger is used as the measure of the trigger value, a literal reading of the statute would lead to the conclusion that the trigger value includes the equity value of the acquiring company. The statute should clarify that this is not intended.

G. Effect on Section 338 Gain.

The House Bill produces inconsistent results, depending on the particular form of the transaction, in determining the amount of gain recognized by a loss corporation on a deemed sale under section 338 that can be offset by the loss corporation's NOLs.[53]

The simplest case is a "one-step" acquisition in which P acquires, on a single day, 80% of the L stock.

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[53] Under existing law, gain is recognized only to the extent of recapture of depreciation, investment tax credits and similar items. If section 333 of H.R. 3838 is enacted, gain would be fully recognized, and the inconsistent limitations discussed in the text on the use of NOLs to offset such gain would become even more troublesome.

The "trigger day" (for purposes of proposed section 382) is the same day as the "acquisition date" (for purposes of section 338). L's taxable year will end as of the close of such day.[54] Because L's year will end on, rather than after, the trigger day, the year in which L's section 338 gain is recognized will not be a "post-trigger year", as defined in proposed section 382(d)(2), and, accordingly, the limitation of proposed section 382 should not apply to the gain recognized pursuant to the section 338 deemed sale.

An argument might be made that, because section 338 provides that the deemed sale takes place at the close of the acquisition date (which is also the trigger day), the year which includes the sale ends after the trigger day, and therefore is a post-trigger year. The statute (or the regulations under section 338) should make clear that this is not intended.

Different rules apply in a "two-step" acquisition in which P first acquires sufficient L stock

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54 It should not matter for this purpose whether the gain on the deemed sale is included in a one-day return under Treasury Regulation section 1.338-1T(f)(3) or in the target's regular return for the short taxable year of sale. These rules, in the context of an election under section 338(h)(10) and Treasury Regulation section 338(h)(10)-1T, are discussed in the text that follows.

to result in a more than 50-percent owner shift, and hence a trigger, and at a later date acquires sufficient L stock to constitute a qualified stock purchase under section 338. This would occur, for example, where a transaction is structured using the not unusual technique of a tender offer if more than 50% but less than 80% of the stock of the target is tendered, followed by a merger in which the remaining shareholders are cashed out.

If the gain recognized on the deemed sale under section 338 is included in a one-day return pursuant to Treasury Regulation section 1.338-1T(f)(3), that one-day return will constitute a short taxable year that, in the context of a two-step transaction, will be a post-trigger year, and thus subject to the rules of proposed section 382. Presumably, the gain would constitute built-in gain, and, accordingly, should increase the trigger amount for the year of recognition (i.e., the one-day taxable year) pursuant to proposed section 382(h). However, in several respects, the application of the built-in gain rules does not achieve a perfect result. First, pursuant to proposed section 382(h)(3)(B), no adjustment is permissible unless the net built-in gain exceeds 15% of the fair market value of the corporation's assets. In addition, section 382(h)(3)(C) provides regulatory authority to treat certain accrued deductions as built-in losses. The effect of such treatment would be that while gain is recognized on the section 338 deemed sale, the trigger amount f o the one-day taxable year will be less than the actual recognized gain because the built-in gain has been reduced by accrued deductions.

A final respect in which the built-in gain rules do not provide adequate protection is that they limit the potential adjustment to the net built-in gain as of the trigger day. Accordingly, in a two-step transaction, any appreciation occurring after the trigger day but before the section 338 acquisition date will not result in an adjustment to the trigger amount.

If the target, prior to the acquisition, was not a member of an affiliated group, so that there is no one-day return but rather gain on the deemed sale is included in a short-period return, the short taxable year will, in the context of a two-step transaction, be a post-trigger year subject to limitation under proposed section 382. The built-in gain rules would apply in the same manner, and subject to the same limitations, as discussed above with respect to a one-day return for a two-step transaction. In addition, if the section 338 acquisition date occurs in the same taxable year as the trigger day, the proration rule of proposed section 382(b)(3) would apply to treat a portion of the gain recognized on the deemed sale as attributable to a pre-trigger year and thus not subject to the section 382 limitation. All income for the year, including gain recognized on the deemed sale, is prorated based on the number of days in the year before and after the trigger.

Strange results flow from this statutory scheme. For example, assume a calendar year taxpayer, and assume further that the section 338 acquisition date occurs one day after the trigger day.[55] If the trigger day is December 31, the gain recognized the next day on the deemed sale will occur in a different taxable year; hence the proration rule of proposed section 382(b)(3) will not apply, with the result that all gain on the deemed sale is subject to section 382 limitations. Had the trigger day been one day earlier, on December 30, and the acquisition date been December 31, only 2/365 of the gain would be deemed attributable to a post-trigger year and subject to limitation. Alternatively, had the trigger day been two days later, on January 2, and the acquisition date been January 3, 2/3 of the gain on sale would be deemed attributable to a post-trigger year and

55 The one day interval between the trigger day and the section 338 acquisition date is for illustrative purposes only. The principle discussed in text is equally applicable where there is a longer interval.

subject to limitation (since in this case there would be a three-day taxable year). It is difficult to perceive any policy justification for such inconsistent results.

It is not clear how the rules of proposed section 382 apply if an election is made under section 338(h)(10) and Treasury Regulation section 1.338(h)(10)-1T. Such regulation provides that, if the appropriate election is made, gain or loss on sale of stock in the target is ignored. However, it does not provide that such sale itself should be ignored, and therefore it would appear that even if such election is made, in a two-step transaction a trigger can occur prior to the section 338 acquisition date, with the results described above.[56]

The purpose of section 338 is to provide generally consistent treatment of stock sales and asset sales. The conceptual basis for proposed section 382 is that a purchaser of a corporation with net operating losses should be able to use such losses to the same extent that such losses would have been available to the seller.

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56 Although a two-step acquisition of a member of an affiliated group (other than the common parent) is not likely, it is certainly possible. For example, regulatory concerns may require an acquisition to be structured in two steps, with the second step postponed until approval has been obtained.

The purpose of both of those sections would be best served by a rule whereby gain recognized upon a section 338 deemed sale may be offset against historic net operating losses of the target without limitation, as would be the case if the target actually sold assets. Such a rule would also eliminate the inconsistencies and formal distinctions described above, and establish equivalent results among such transactions.

H. Previously Acquires Shares.

Section 382(0)(4)(B) provides that the Secretary of the Treasury shall issue regulations providing for adjustments to the rules of sections 382 and 383 where one corporation owns stock in a second corporation which is extinguished by merger of the second corporation into the first corporation. Under both the old and current versions of section 382(b), the Code deals expressly with this situation. Thus, if L merges into P which owns stock of L, in determining whether L’s shareholders hold the requisite (20%) amount of P stock, under old section 382(b)(3), P, as a shareholder of L, was treated as owning a percentage of P stock (immediately after the reorganization) which bears the same ratio to the percentage of the fair market value of L’s stock owned by P (immediately before the reorganization) as the fair market value of L (immediately before the reorganization) bears to the fair market value of P (immediately after the reorganization). Thus, P was treated as if it were an ordinary L shareholder that actually received stock in P approximately equal in value to the L stock held before the reorganization.

Under the current version of section 382(b)(4)(B) a similar rule applies. L stock acquired (subject to minor exceptions, regardless of how acquired), during the 36 month period ending on the date of the reorganization, however, is not counted in determining whether the L shareholders have the requisite continuing interest in the acquiring corporation. In our example P would be treated as an ordinary L shareholder who actually receives P stock with respect to “old and cold” L stock but acquisitions of stock within 36 months would be integrated with the current reorganization to determine if the shareholders of L (immediately before the reorganization) have the requisite interest in P (immediately after the reorganization).

There is no similar rule in new section 382, nor does the House Report give any guidance on the point to the Secretary of the Treasury. Because the continuing interest of L’s shareholders is defined in section 382(j) as the percentage of the fair market value of the stock of the new loss corporation (immediately after the equity structure change) owned by the L shareholders (immediately before the equity structure change) it is not clear that, in the absence of regulations, the stock owned by the acquiror in the target prior to the equity structure change will be counted at all in determining the continuing interest. Further, under section 382(j)(2) any increase in the holdings of the acquiror in the old loss corporation during the testing period will cause the continuing interest percentage to be reduced by a corresponding percentage.

In light of the importance of the treatment of previously acquired shares and in light of the frequency with which we expect the issue to arise, we believe that directing the Secretary of the Treasury to promulgate regulations is not an adequate means of addressing this important issue. We have no strong preference regarding the method of treatment of previously acquired shares in the loss corporation (except we believe the limitation on the application of the relief rule with respect to recently. acquired stock is inappropriate in light of section 382(j)(2)); but whatever the rule, it should be expressed in the statute to avoid uncertainty while taxpayers await the promulgation of regulations.

I. Effective Dates.

Under section 321 of H.R. 3838, proposed section 382 applies to equity structure changes pursuant to plans of reorganization adopted after December 31, 1985 and to more than 50-percent owner shifts the trigger day for which is after December 31, 1985. General comments on these effective date rules are set forth in the Tax section's recent report on effective dates.[57] A few supplemental comments follow:

References in clauses (A) and (B) of section 321(e)(3) of the House Bill to "the reorganization" presumably mean "the bankruptcy reorganization" pursuant to which a "G" reorganization or an exchange of debt for stock occurs (and not a reorganization within the meaning of section 368). This should be clarified by inserting the word "bankruptcy" before "reorganization" in both clauses. Also the section should refer to a "more than 50-percent" owner shift or equity structure change.

Issues similar to those raised above, in III.F.4, concerning w e types of transactions covered by the "exchange of debt for stock" rule in proposed section 382(e)(4)

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[57] New York State Bar Association Tax Section, "Effective Dates of Tax Reform Legislation", 30 Tax Notes 863 (March 3, 1986).

also arise under the bankruptcy transitional rule and should be resolved on the same basis.

J. Organization and Style.

1. We recommend that further attention be given to the organization of proposed section 382. It might make sense to divide it into one part concerning the definition of trigger, a second part dealing with the trigger amount and a third part consisting of special rules. In its present form, the organization of the proposed section is difficult to follow.

2. In proposed section 382(d)(1), what does “such” in subparagraph (A) refer to? Subparagraph (B) in the same paragraph would read better if the words “portion of the” were inserted before “net operating loss”.

3. Proposed section 383(c) refers to “any taxable year before the first post-trigger taxable year”. Presumably, this should read “post-trigger year”.

Appendix A

Comparison of Proposal Section 382
With ABA and SFC Proposals

Initiating Event. Under the House Bill, the limitations of proposed section 382 apply following a more than 50-percent owner shift or more than 50-percent equity structure change. The SFC Proposal has a substantially similar trigger.[1] SFC sections 382A(a), (b) and (c). The ABA Proposal, on the other hand, does not draw any distinction between reorganizations and other transactions, but rather defines the initiating event as any transaction (or series of related transactions) in which, generally, the historic shareholders cease to own at least 50 percent of the participating stock of the loss corporation, without regard to any specific time period. ABA section 382(c). An exception is made, however, for transactions which, together with other integrated transactions, do not involve transfers of stock worth more than 5 percent of the participating stock or any holder of more than 5 percent of such stock. ABA section 382(c)(2)(D).

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[1] The SFC Proposal was part of a larger proposal for the revision of subchapter C, which also made significant changes in the reorganization provisions of the Code. Accordingly, the definition of “equity structure change” in the SFC Proposal reflects these changes.

Amount of Carryover. Under the House Bill, the trigger amount is calculated by multiplying the trigger value by the Federal long-term rate, reduced to reflect the difference between taxable and tax-exempt interest rates. Under the SFC Proposal, no adjustment is made to convert the Federal long-term rate to a tax-exempt rate. SFC section 382(b). Under the ABA Proposal, the use of losses is not tied to current market interest rates. Rather, losses may be used at a rate of 2 percent of the equity value of L per month for a period of 60 months. ABA section 382(b)(3). Based upon certain assumptions concerning interest rates, the ABA Proposal concludes that the present value of losses used on this basis will be equal to the present value of losses that would have been used by L over a period of 15 years. ABA Report at 4.

Value of Loss Corporation. Under the House Bill, the trigger value is the value of all equity of L (including options, warrants and conversion features). The trigger value is generally determined immediately prior to the trigger, except (i) in a bankruptcy proceeding, or (ii) where the last component event of the trigger is a redemption. Under the SFC Proposal, the equity value of L includes all stock (including nonparticipating, nonvoting stock) but does not (in the absence of regulations) include options or other rights to acquire stock, and is always determined immediately before the trigger. SFC section 382(d). The ABA Proposal uses essentially the same valuation method as the SFC Proposal. ABA section 382(d).

Capital Contributions. In order to prevent artificial inflation of L’s value, each of the three proposals provides special rules which reduce L’s value to the extent of certain contributions made shortly before the acquisition. Under the House Bill, this rule generally applies to all capital contributions during the three years prior to a trigger. Under the SFC Proposal, the rule applies to any contributions which were made as part of a plan to avoid the section 382 limitations. However, there is a presumption, which may only be rebutted to the extent provided in regulations, that all contributions within two years prior to the acquisition will be considered part of such a plan. SFC section 382(f)(2). The Senate Finance Subchapter C Report at 248 states that it is contemplated that these regulations would permit the equity value of L to include “capital contributions necessary to continue the basic operation of the corporation's business”

The ABA Proposal generally applies this rule to capital contributions within 2 years prior to an acquisition, but excepts contributions in the ordinary course of business and contributions to fund operating losses, as well as the lesser of the fair market value or face amount of debt more than 2 years old that is converted to stock. ABA section 382(d).

Built-In Gains and Losses. Each of the three proposals contains special rules that permit pre-acquisition losses to be used, without regard to the regular limitations, to offset gains recognized on a sale of assets after the acquisition to the extent of the unrealized gain in such asset at the time of the acquisition. A similar rule provides that losses recognized after the acquisition, but which reflect unrealized losses at the time of the acquisition, will be subject to the same limitations, when recognized, as NOL carryovers.

Under the House Bill, these rules apply to any gain or loss recognized during the ten-year period following the trigger. A de minimis rule provides that these special rules do not apply if the net unrealized gain or loss, as the case may be, does not exceed 15% of the value of L’s assets.

Under the SFC Proposal, only items recognized within five years following the acquisition are subject to these rules, and the de minimis threshold is twenty-five percent. SFC section 382(e). The ABA Proposal applies these rules to gain or loss recognized within five years of the acquisition, with no _de minimis_ threshold. ABA section 382(e).

Investment Assets. Under the House Bill, the trigger value of L is reduced by the net value of nonbusiness assets (with liabilities being allocated pro rata among assets) if those assets exceed 1/3 of L's assets and the trigger value is considered to be zero unless a continuity of business enterprise test is satisfied for two years following the trigger.

Under the SFC Proposal, pre-acquisition losses are disallowed entirely if at least two-thirds of L's value is represented by investment assets at the time of the trigger. SFC section 382(f)(3). The character of the assets owned by L is not relevant under the ABA Proposal.

Bankruptcy. Under the House Bill, there are no special rules for determining whether a trigger has occurred with respect to a bankrupt or insolvent corporation. However, once a trigger has occurred, the trigger value is determined after, rather than before, the trigger. In effect, this increases the trigger value by the amount of any discharged debt.

Under the SFC Proposal, the limitations do not apply at all following a bankruptcy proceeding in which pre bankruptcy creditors and shareholders as a group continue to own at least 50 percent of the voting power and value of L. SFC section 382(f)(4)(A). However, the amount of NOL carryovers is recomputed by disallowing the past three years' deductions for interest on debt which is converted to stock. SFC section 382(f)(4)(B). Moreover, if a second trigger occurs within two years of such a bankruptcy proceeding, pre-trigger losses are disallowed entirely. SFC section 382(f)(4)(C).

Under the ABA Proposal, acquisitions of stock by a creditor in exchange for debt are disregarded in determining whether a trigger has occurred of the acquisitions (i) occur in a bankruptcy or similar proceeding, (ii) involve an insolvent debtor (to the extent of the insolvency), or (iii) cause at least 50 percent of the debtor's debt to be extinguished.

Other Limitations. The House Bill contemplates that section 269 and the SRLY and CRCO rules will continue to apply. Both the SFC Proposal and the ABA Proposal provide that tax attributes subject to section 382 would not be subject to section 269; the SFC Proposal also instructs the Treasury to consider whether continued applicability of the SRLY and CRCO limitations is appropriate.

Appendix B

Reorganizations of Corporations with Common Ownership Facts

L merges into P. In the merger, each share of L is exchanged for one share of P. Prior to the merger, there were outstanding x shares of L stock and y shares of P stock. C, the only 5-percent shareholder of P or L, owned a% of the L shares and b% of the P shares. Thus, less than 5-percent shareholders owned 100-a% and 100-b% of those shares, respectively.

Effect of Merger Less than 5-percent shareholders. After the merger, less than 5-percent shareholders own the following percentage of the stock of P: ((100-a)x + (100-b)y)/(x+y). To obtain the increase in percentage ownership of the loss corporation by those shareholders, this percentage should be reduced by the percentage of P stock attributable to the shares formerly held by L's less than 5-percent shareholders, diluted to take account of the merger, or (100-a)x/(x+y). Thus, the increase in percentage ownership is (100-b)y/(x+Y).

5-percent shareholders. After the merger, C owns the following percentage of the stock of P: (ax + by)/(x+y). The increase (if any) in C's percentage ownership of the loss corporation is this amount less a. Thus, C's percentage ownership of the loss corporation would be increased by the merger only if (ax + by)/(x+y) was greater than a, or, solving the inequality, if b was greater than a. Stating this in words, a 5-percent shareholder would increase his percentage interest in the loss corporation only if his pre-merger percentage interest in P was greater than his pre-merger percentage interest in L. There would be no increase if the percentages were the same.

Total Increase

5-percent shareholder owns the same percentage of P and L or a lesser percentage of P. If a equals or exceeds b, the total increase in the percentage interests in the loss corporation of less than 5-percent shareholders and 5-percent shareholders would be only the increase in the interests of the less than 5-percent shareholders, or (100-b)y/(x+y). A trigger would occur if this amount was greater than 50 (*i.e.*, if (100-b)y/(x+y)> 50)). Solving this inequality, a trigger would occur if y/x)> 50/(50-b)). This would never be true if b was equal to or greater than 50 (*i.e.*, if 5-percent shareholders owned 50% or more of each of P and L before the merger). If there were no common 5-percent shareholders of L and P (b=0), the inequality would be true if y > x (or, in words, if P was larger than L). The greater the size of P by comparison with L, the lower the percentage of common ownership required to prevent the merger from qualifying as a trigger. For example, if P was twice the size of L (i.e., y was twice x), the inequality would be true only if b was less than 25. To see why this makes sense, suppose that x is 100 and y is 200 and before the merger C owned 25 shares of L and 50 shares of P. The only shareholder group that would increase its interest in the loss corporation as a result of the merger would be the shareholders other than C holding 150 shares of P. Since those shares would represent only a 50-percent interest in P following the merger, the merger would not be a trigger.

5-percent shareholder owns a greater percentage of P than L. If b equals or exceeds a, the total increase in the percentage interest in the loss corporation of less than 5-percent shareholders and 5-percent shareholders would be (100-b)y/(x+y) + (ax +by)/(x+y) - a, or, restated, (100-a)y/(x+y). A trigger would occur if this amount was greater than 50 (i.e., if (100-a)y/(x+y) > 50). Solving this inequality yields: y/x > 50/(50-a). This is the same as above except that a is substituted to b because a now represents the measure of common ownership of P and L by C.