REPORT #548

TAX SECTION

New York State Bar Association

1986 Tax Reform Act Seminars

October 30, 1986

Table of Contents

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1986 Tax Reform Act Seminars

SESSION FOUR: EFFECT OF THE 1986 ACT ON CORPORATE ACQUISITIONS

Chair: Richard J. Hiegel, Esq.
Cravath, Swaine & Moore

Panel: Richard D'Avino, Esq.
Deputy Tax Legislative Counsel
Department of the Treasruy

James M. Peaslee, Esq.
Cleary, Gottlieb, Steen & Hamilton

Michael L. Schler, Esq.
Cravath, Swaine & Moore

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Repeal of the General Utilities Doctrine by the Tax Reform Act of 1986

by

Richard J. Hiegel
Michael L. Schler

A. Description of the New Statutory Provisions

A1. General Rule for Complete Liquidations. Section 336(a), of the 1986 code provides that gain or loss is recognized to a liquidating corporation (including an S corporation) on the distribution of property in completed liquidation as is the property were sold to the distributee at its fair market value. Under section 336 (b) if the distributed property is subject to a liability or the distributee shareholder assumes a liability of the corporation in connection with the distribution, the fair market value of the property is treated as being not less than the amount of the liability. Section 333 (relating to elective one-month liquidations in which recognition of gain is limited to the corporation's earnings and profits and/or money and stock or securities received) and Section 337 (relating to nonrecognition of gain or loss on sales of assets followed by a complete liquidation) of the 1954 Code are repealed. Section 338 remains in the 1986 Code, but the deemed asset sale resulting from an election under that Section becomes fully taxable to the target corporation rather than being protected by Section 337.

A2. Exceptions. (a) Under sections 336(c) and 361(b), the general rule does not apply to a distribution of property (including a distribution of property by an S corporation) to the extent that there is nonrecognition of gain or loss with respect to the property under the reorganization provisions or under Section 355, except that, with respect to Section 355 transactions, the Treasury is authorized by amended Section 367(e) to prescribe regulations providing for recognition of gain where the distributee is a foreign person. Amended Section 361(c) makes clear that gain (but not loss) is recognized to a distributing corporation on a distribution of property as “boot” in an otherwise tax-free reorganization or Section 355 transaction.

(b) Under Section 337 of the 1986 Code, the general rule does not apply to a distribution of property to an “80-percent distributee” in a Section 332 liquidation, or to a transfer of property by a liquidating corporation in a Section 332 liquidation in satisfaction of indebtedness owed to an “80-percent distributee”, except where:

> (i) such distributee is a tax-exempt organization (unless the organization uses the property in an unrelated trade or business; in that case, if it later disposes of the property, any gain not in excess of the amount not recognized on the liquidation is includible in unrelated business taxable income; or if the property ceases to be used in an unrelated trade or business, the organization is treated as having disposed of the property on the date of such cessation at the property's then fair market value), or
>
> (ii) such distributee is a foreign corporation.(unless regulations provide otherwise in certain circumstances, such as where the property continues to be used in a trade or business in the United States. (Section 367(e)(2); Conference Report, 11-202)).

An 80-percent distributee is defined as a corporation which meets the 80-percent stock ownership requirements specified in Section 332(b), which are conformed to the Section 1504(a)(2) requirements (i.e., 80 percent of both voting power and value). In a consolidated return context, status as a Section 332 liquidation will apparently be determined by taking into account the ownership aggregation rules of Treas. Reg. § 1.1502-34. However, as to the additional 80-percent distributee requirement, the Conference Report (at II-202) states that “the conferees anticipate that, in a consolidated context, the Treasury Department will consider whether aggregation of ownership rules similar to those in Sec. 1.1502-34 of the regulations should be provided for purposes of determining status as an 80-percent distributee".[1/]

(c) Under Section 453B(d), no gain or loss is recognized to a liquidating corporation with respect to an installment obligation distributed in a Section 332 liquidation if the basis of the obligation is carried over to the distributee under Section 334(b)(1).

A3. <u>Limitations on Recognition of Loss.</u> (a) Under Section 336(d)(1), no loss is recognized to a liquidating corporation on a distribution of property to a related person (within the meaning of, Section 267 [2/]) if (i) the distribution is not pro rata, or (ii) the property distributed was acquired by the liquidating corporation in a Section 351 transaction or as a contribution to capital within the five-year period ending on the date of the distribution (or the basis of the property distributed is determined, in whole or in part, by reference to the adjusted basis of such property).

(b) Section 336(d) (2) provides that, for purposes of determining the amount of loss recognized by a liquidating corporation on any sale, exchange or distribution of property acquired in a Section 351 transaction or as a contribution to capital, the adjusted basis of the property is reduced (but not below zero) by the excess, if any, of the adjusted basis of the property immediately after its acquisition over its fair market value at that time, if the acquisition of the property was part of a plan the principal purpose of which was to recognize loss by the liquidating corporation in connection with the liquidation. Any contribution of property within the two-year period ending on the date of adoption of the plan of liquidation is presumed to be part of a loss recognition plan (even if the property was

[1/] As discussed below, whether such aggregation rules will be provided for this purpose is significant in determining whether the so-called "mirror subsidiary" structure can be used under the 1986 Code.

[2/] Persons related to a corporation under Section 267 include (i) an individual who owns, actually or constructively, more than 50 percent in value of the corporation's stock and (ii) any member of the corporation's controlled group (within the meaning of Section 1563(a), but substituting more than 50% for at least 80%).

sold before the plan was formally adopted) except as provided in regulations. The Conference Report (at II-200-01) states that:

> (i) although a contribution made more than two years prior to the adoption of a plan of liquidation might be made with a prohibited purpose, the basis adjustment rule is expected to be applied only in the most rare and unusual circumstances in such a case;
>
> (ii) it is intended that the Treasury Department will issue regulations providing that the presumed prohibited purpose for contributions of property within two years prior to the adoption of a plan of liquidation will be disregarded unless there is no clear and substantial relationship between the contributed property and the conduct of the corporation's current or future business enterprises;
>
> (iii) it is expected that the regulations will permit the allowance of a loss from the disposition of any of the assets of a trade or business (or a line of business) that are contributed to the corporation, assuming there is a meaningful relationship between the contribution and the utilization of the corporate form to conduct a business enterprise (i.e., the contributed business, as distinguished from a portion of its assets, is not disposed of immediately after the contribution); and
>
> (iv) it is expected that the basis adjustment rule will generally not apply to a corporation's acquisition of property during the first two years of its existence.

The Treasury Department is authorized by Section 336(d)(2)(C) to prescribe regulations providing that, where the adoption of a plan of liquidation occurs in a taxable year following the date on which the tax return including the loss disallowed by the basis adjustment rule is filed, the liquidating corporation may recapture the disallowed loss on its tax return for the year in which the plan is adopted instead of filing an amended return for the loss year.

A4. Nonliquidating Distributions. Under Section 3ll(b) of the 1986 Code, gain (but not loss) is recognized to a corporation on the distribution of property in any nonliquidating distribution as if the property were sold to the distributee at its fair market value. The fair market value of the property is treated as being not less than the amount of any liability to which the property is subject or which is assumed by the distributee. All the exceptions and special rules in Section 311 of the 1954 Code are repealed, except the exception for redemptions by a regulated investment company of its stock upon the demand of a shareholder (which appears in Section 852(b)(6) of the 1986 Code).

A5. Expansion of Section 338(h)(10). To the extent provided in regulations, Section 338(h)(10) is expanded to include in the term “selling consolidated group” any affiliated group of corporations that includes the target corporation whether or not the group files a consolidated return. An election under this Section in a case where the buyer makes a Section 338 election results in the recognition of gain or loss on only the target corporation's assets and not on the target corporation's stock, and also leaves any net operating losses of the target corporation in the selling consolidated group. In addition, Section 336(e) provides that under regulations a corporation which sells, exchanges or distributes all the stock of another corporation meeting the requirements of Section 1504(a)(2) may elect to treat the transaction as a disposition of all the assets of such other corporation, and in that case no gain or loss is recognized on the sale, exchange or distribution of stock. The Conference Report (at II-204) cautions that the regulations should provide special liquidation-reincorporation rules, so that, for example, net operating losses may not be used to offset liquidation gains where there is a transfer of stock to persons related to the transferred corporation within the meaning of Section 368 (c).

A6. Conversion of C Corporation to S Corporation. Under Section 1374 of the 1986 Code, a corporate-level tax is imposed on an S corporation for any taxable year beginning in the recognition period in which it has a recognized built-in gain. The amount of the tax is computed by applying the highest corporate marginal rate of tax on ordinary income or capital gain, as the case may be, to the lesser of (a) the recognized built-in gains of the S corporation for the taxable year, or (b) the amount which would be the corporation's taxable income if it were not an S corporation for the taxable year. Net operating losses, capital losses and business credits can be carried forward from C corporation years (but not from S corporation years) to offset the lesser of (a) or (b) or the tax thereon. “Recognition period” means the 10-year period beginning with the first taxable year for which the corporation was an S corporation, [3/] and “recognized built-in gain” means any gain recognized during the recognition period on the disposition of any asset except to the extent that the S corporation establishes that (i) the asset was not held by it at the beginning of the recognition period, or (ii) such gain exceeds the excess, if any, of the fair market value of the asset at the beginning of the recognition period over its adjusted basis at that time. The tax does not apply to a corporation that was always an S corporation (including any predecessor corporation, except as provided in regulations), and the amount of recognized built-in gain taken into account for any taxable year cannot exceed the excess, if any, of the net unrealized built-in gain over the recognized built-in gains for prior taxable years. “Net unrealized built-in gain” means the amount, if any, by which the fair market value of the assets of the S corporation at the beginning of the recognition period exceeds the aggregate adjusted basis of such assets at that time.

A7. <u>Effective Dates and Transitional Rules.</u>

(a) The new recognition provisions apply to:

(i) any distribution in complete liquidation, and any sale or exchange, made by a corporation after July 31, 1986, unless the corporation is completely liquidated before January 1, 1987

[3/] One version of the Concurrent Resolution would in effect have begun a new ten-year recognition period for any S corporation upon its receipt of assets from a C corporation in a carryover basis transaction. The new provision would only have applied to the subsequent disposition of those particular assets by the S corporation.

(ii) any Section 338 transaction for which the acquisition date occurs after December 31, 1986; and

(iii) any nonliquidating distribution made after December 31, 1986.

However, if the corporation is completely liquidated before January 1, 1988, the new provisions do not apply to any distribution or sale or exchange:

(i) made pursuant to a plan of liquidation adopted before August 1, 1986;

(ii) made by a corporation if 50 percent or more in value of the voting stock is acquired on or after August 1, 1986, pursuant to a binding written contract in effect before that date; or

(iii) made by a corporation if substantially all its assets are sold on or after August 1, 1986, pursuant to one or more binding written contacts in effect before that date.

Moreover, the new provisions do not apply to a Section 338 transaction consummated before January 1, 1988, if a qualified stock purchase of the corporation is made on or after August 1, 1986, pursuant to a binding written contract in effect before that date. For purposes of the one-year extension of the effective date, transactions are treated as pursuant to a plan of liquidation adopted before August 1, 1986, if before November 20, 1985:

(i) the Board of Directors of the liquidating corporation adopted a resolution to solicit shareholder approval of a Section 336 or 337 transaction, or the Board of Directors or the shareholders approved such a transaction:

(ii) an offer to purchase a majority of the voting stock of the liquidating corporation was made, or the Board of Directors approved, or recommended approval to the shareholders of, an acquisition of the corporation; or

(iii) a ruling request concerning a Section 336 or 337 transaction involving the liquidating corporation was submitted to the Internal Revenue Services.

(b) The new corporate-level tax on S corporations is effective for taxable years beginning after December 31, 1986, but only in cases where the first taxable year for which the corporation is an S corporation is pursuant to an election made after December 31, 1986; thus, the new tax can be avoided completely if the election is made in 1986 for the taxable year 1987, although existing Section 1374 will apply in that case.

(c) In the case of (i) a complete liquidation [4/] before January 1, 1989, (ii) a Section 338 transaction the acquisition date of which is before January 1, 1989, and (iii) a corporation that becomes an S corporation for a taxable year beginning before January 1, 1989, [5/] the new provisions do not apply to the applicable percentage of each gain or loss that would otherwise be recognized thereunder, if the fair market value of all the stock of the corporation in question on the date of adoption of the plan of liquidation (or, if greater, on August 1, 1986) does not exceed $10 million, and more than 50 percent in value of such stock is owned, actually or constructively, by 10 or fewer qualified persons (meaning individuals, estates and certain trusts). [6/] “Applicable percentage” means 100 percent if the fair market value of the corporation's stock is less than $5 million, and it means 100 percent reduced proportionately if the fair market value of the corporation's stock is between $5 million and $10 million. This transitional rule does not generally apply to ordinary gain or loss, short-term capital gain

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[4/] One version of the Concurrent Resolution would have expanded this provision, consistent with the Conference Report at II-207, to include distributions not in complete liquidation (e.g., partial liquidations).

[5/] One version of the Concurrent Resolution would have amended this rule, consistent with the Conference Report at II-206, to permit the S corporation election to be made before January 1, 1989, rather than to require that such election be effective for a taxable year beginning before that date.

[6/] The Act provision omits a five-year holding period requirement described in the Conference Report at II-206. One version of the Concurrent Resolution would have added this requirement.

or loss, or gain or loss from the disposition of installment obligations.

B. Acquisitions in a World without General Utilities

B1. General Considerations. (a) It is obviously beneficial to complete transactions (and to make subchapter S elections) before the end of 1986 unless a transitional rule applies. In this connection, note that an acquiring corporation (hereinafter P) need only acquire 80% of the stock of a target corporation (hereinafter T) by the end of 1986 in order to be eligible to make a Section 338 election governed solely by the 1954 Code. As long as the remainder of the stock of T is acquired within one year of the "acquisition date" (the date 80% ownership is reached), even if all or part of the remainder is acquired during 1987, the surrogate tax under 1954 Code Section 338(c)(1) will be avoided.

(b) Even if a transitional rule is available, it will frequently be advisable to act before the end of 1986. Reasons include (1) the lower individual and corporate capital gains tax rates in 1986, (2) the fact that the transitional rule for small corporations does not prevent recognition of ordinary income and short-term capital gain, and (3) the benefits of an early subchapter S election even for a corporation eligible for transitional relief, including the benefit of starting the running as soon as possible of the three-year rule of existing Section 1374.

(c) As indicated above, Section 338 continues to exist in the 1986 Code, but with full gain recognition arising upon the deemed sale of assets when a Section 338 election is made. In the absence of special circumstances, the asset step-up will not be worth this cost, and thus the election will not be made. In this situation, just as under current law, it will remain essential that P make a protective carryover election under Section 338. Only in this way can P be sure that the Service will not force it into an unwanted Section 338 election by reason of some real or imagined violation of the consistency rules of Section 338. *See* Treas. Reg. § 1.338-4T(f)(1).

(d) Adverse effects of the new provisions may be mitigated if T has net operating loss carryovers. An asset sale by a liquidating T will not give rise to double tax if the losses are large enough to offset the gains (leaving the same result as under present law). Moreover, if P buys the stock of T and makes a Section 338 election under the 1986 Code, new Section 382 will not limit use of the carryover against gain arising as a result of the election. In fact, because of the severe limitations otherwise placed on T's post-acquisition use of loss carryovers, the Section 338 election may be the most efficient use of such losses. The discussion below assumes that T does not have loss carryovers.

(e) The new provisions may give rise to new opportunities for loss corporations to play an intermediary role. Such a corporation could buy the stock of T and then sell the assets of T to one or more unrelated corporations. Gain arising on the asset sale would be sheltered by the losses of the intermediary, and the ultimate purchasing corporations would frequently be willing to pay more for assets than T could obtain for its stock. This approach raises obvious step transaction and Section 269 concerns. If it works in a particular situation, the result is a step-up in asset basis without any corporate level tax (except ITC recapture).

(f) It may also be possible for a corporation <u>without</u> its own losses to act as an intermediary. The technique is based on a fundamental anomaly of the consolidated return regulations, namely that if P buys the stock of T and T sells an appreciated asset immediately thereafter, any gain recognized to T will cause P’s stock basis in T to increase above its fair market value by the same amount. Thus, the intermediate corporation can buy the stock of T, sell most of the <u>assets</u> for cash to a third party, and then sell the <u>stock</u> of T (holding the remaining assets) at fair market value. Because of the rule described above, the sale of the stock of T will result in a tax loss equal to the aggregate tax gain on the asset sales. As a result, aside from the possibility of ordinary recapture income on the asset sales not being offset by capital loss on the stock sale, most of the assets of T will obtain a stepped up basis without anyone paying corporate level tax on the appreciation. The Treasury seems to have ample authority to change this result if it desires to do so. See Section 337(d)(1) of the 1986 Code, authorizing regulations to ensure that the purposes of the repeal of General Utilities may not be circumvented by any other provision of law or regulations (including the consolidated return regulations).

B2. Special Considerations Where P Buys All the Stock of T Which Is Unaffiliated or Is the Parent of an Affiliated Group. (a) As a general matter, in this situation T shareholders will end up with less cash under the new regime. If P buys assets for the same price as under current law, the corporate level tax presently avoided by Section 337 will reduce the proceeds to the shareholders. If P buys the stock of T and would have made a Section 338 election under current law, it will generally pay less because of the inability to make the election. On the other hand, if P would not have made a Section 338 election under current law, it might not reduce its purchase price for T stock (although the increase in capital gains tax rates will still reduce the net proceeds to T shareholders, and P might pay less for the stock because of the possible end of the mirror subsidiary technique discussed below).

(b) Because of the prohibitive double tax on an asset sale (assuming T is not a subchapter S corporation), it seems that almost all acquisitions of this type will be stock purchases, followed by a protective carryover election under Section 338.

(c) In this situation, will P be able to use the "mirror subsidiary" technique to dispose of unwanted assets of T without recognizing gain? This is one of the most controversial questions arising under the 1986 Act. The technique can be illustrated where T has two assets, each with a basis of $0 and value (to a buyer receiving a $0 basis) of $100. P creates two wholly owned subsidiaries of itself, P1 and P2, capitalizing each with $100 cash. P1 and P2 each buy 50% of the stock of T and T liquidates into P1 and P2 under Section 332 (see Treas. Reg. § 1.1502-34). While each asset retains a $0 basis in the hands of the transferee corporation, P has a $100 tax basis in the stock of each corporation and can sell the stock in either corporation at its fair market value of $100 without recognizing any gain. This technique raises numerous questions and has been the subject of no less than four inserts in the Congressional Record. [7] Only a brief discussion of the controversy is given here.

(i) Does the technique work under current law? It does as a technical matter, and Section 269 seems difficult to apply by its literal terms. PLR 8642051 approves the acquisition structure and the subsequent Section 332 liquidation, but does not deal with the consequences of a sale of the stock of a mirror subsidiary. Serious concerns would arise under Section 332 as well as under step transaction principles if P had. "pre-sold" the stock of P1 or P2 before its acquisition of T.

(ii) In the absence of new Treasury Regulations, will the technique work in 1987? The authors of this paper believe the answer is no (because it will work only if P1 and P2 are considered 80-percent distributes of T, and they read the Conference Report language quoted in A2(b) above to condition the aggregation of ownership necessary to produce this result on the affirmative issuance of Treasury Regulations). However, this conclusion is controversial, is directly supported by two statements of Representative Rostenkowski, and is directly contradicted by two statements of Senators Dole and Packwood.

(iii) What power does the Treasury have to issue regulations on the aggregation of ownership question, and what should it do? Section 337(d)(1) of the 1986 Code, as well as the language of the Conference Report quoted above, appear to give the Treasury broad discretion without taking a substantive position. The Rostenkowski comments at one point indicate that the Treasury does not even have discretion to permit aggregation in an acquisition context, and in any event make clear that the

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[7] See (1) Sept. 25, 1986 Cong. Rec. at H 8358 (floor statement of Representative Rostenkowski preceding House passage of H.R. 3838); (2) Sept. 27, 1986 Cong. Rec. at S 13958 (colloquy between Senators Dole and Packwood preceding Senate passage of H.R. 3838); (3) Oct. 2, 1986 Cong. Rec. at E 3389 (extension of remarks by Representative Rostenkowski); and (4) Oct. 17, 1986 Cong. Rec. at S 17055 (colloquy between Senators Dole and Packwood).

Treasury should not permit aggregation. The Dole/Packwood comments, while recognizing the broad discretion granted the Treasury, state that it should not act to prohibit aggregation.

(d) The controversy about mirror subsidiaries appears to be rapidly becoming irrelevant to the real world. Another technique has recently come to light [8/] that also allows P to dispose of unwanted assets without gain recognition, but that does not depend on aggregation of ownership (or Section 332 at all, for that matter). Rather, the technique depends on the same principle of the consolidated return regulations described in B1(f) above. To illustrate, suppose T is a holding company with no assets other than the stock of T1 and T2. Suppose the stock of T1 (and underlying assets of T1) have a basis of $10 and value of $25. Suppose the stock of T2 (and underlying assets of T2) have a basis of $15 and value of $75. P buys the stock of T for $100. If P then wants to sell T2, T dividends the stock of T1 to P. T has Section 311 gain of $15, which is deferred under Treas. Reg. 5 1.1502-13, and Pts basis in T is immediately reduced by the $25 distribution (from $100 to $75). P then sells the stock of T for its value of $75, triggering the deferred gain of $15, a stock basis increase in T of $15, and a resulting loss on the stock sale of $15. P has sold T2 without recognizing any net gain, and holds the stock of T1 with a tax basis equal to fair market value. [9/] Any number of preexisting subsidiaries of T could have been distributed to P, some to be retained and some to be sold, with the total deferred gain triggered by the sale of T exactly offset by the resulting loss on the sale of T itself. The result is essentially the same as the mirror. Moreover, just as with the mirror, the buyer of stock from P obtains assets with a carryover tax basis from T.

[8/] This technique apparently first appeared in print in Sheppard, Room Full of Mirrors: Enforcing General Utilities Repeal, Tax Notes, Oct. 20, 1986, at 281, 282.

[9/] While this fair market tax basis might seem inconsistent with P's protective carryover election for T, the stock of a target affiliate (such as T1) qualifies for an exception to the carryover basis rule. See Code Section 338(h)(6)(A); Treas. Reg. § 1.338-4T(f)(5). This exception would not apply if assets held directly by T (or stock of a newly formed subsidiary of T) were distributed by T to P, although other exceptions might be available.

B3. Special Considerations Where P Buys Stock or Assets of a Subsidiary of an Affiliated Group. (a) Under current law, P will prefer to buy assets of a corporate subsidiary as compared to stock (or to buy stock with a Section 338(h)(10) election) in order to obtain a stepped up asset basis without additional cost. However, the existence of Section 338 will frequently make a stock purchase a realistic alternative. The seller, on the other hand, has two reasons under current law for preferring to sell stock rather than assets. First, its stock basis will generally. be higher than its asset basis (see Section 312(k)). Second, the gain on the stock sale will be entirely capital gain rather than partly ordinary recapture income.

Under the 1986 Code, P will have an increased relative preference for an asset purchase, because of the absence of a fallback on a stock purchase followed by a Section 338 election. On the other hand, the seller will have a decreased relative dislike for an asset sale, because the capital gain rate will be the same as the ordinary income rate. As a result, the new law will likely increase the number of asset sales (and Section 338(h)(10) elections) in this situation.

(b) A dilemma arises under existing law where P buys a division of a target corporation which includes stock of a subsidiary. P must either make a Section 338 election for the subsidiary, or else make a protective carryover election for the subsidiary and accept a carryover basis in the directly acquired assets. The former choice will frequently be a reasonable approach under current law. Under the 1986 Code, the choice remains the same, but the Section 338 election becomes unrealistic because of the increased tax liability arising as a result of the election. Accordingly, it will become more important than ever that in this situation a Section 338(h)(10) election be made for the subsidiary, or instead that all the assets be contributed to the subsidiary and only the stock of the subsidiary be purchased.

(c) A very unusual result arises when P is buying the stock of a controlled foreign corporation. Under Treas. Reg. § 1.338-5T (g)(2) and (3), if P makes a Section 338 election, any resulting increase in the target's earnings and profits which is not sheltered by Section 337 (see Section 1248(d)(2)) increases the seller's Section 1248 amount of ordinary income on the sale. As a result, a seller will normally require an indemnity from P against this increased tax liability, and P is not likely to make the election. Under the 1986 Code, however, starting in 1988 there will be no disadvantage to the seller from P's election, because of the gain limitation rule of Section 1248(a) and because capital gain rates will be the same as ordinary income rates. P can thus freely make the election in order to eliminate existing earnings and profits of the target, and to reduce future earnings and profits through enhanced depreciation deductions.

OUTLINE: OF SECTION 382 OF TSE INTERNAL REVENUE CODE AS AMENDED BY THE TAX RFORM ACT OF 1986

By

James M. Peaslee
Shlomo Cohen

I. BACKGROUND.

A. Purpose of Section 382. Section 382* is intended to avoid "trafficking" in loss carryovers by restricting the availability of net operating loss ("NOL") carryovers of a corporation following changes in the ownership of the stock of that corporation. (By operation of section 383, these rules also apply to carryovers of o6&er losses, such as capital losses, and of certain credits, such as investment tax credits, research credits, minimum tax credits and foreign tax credits.)

B. Old Section 382. Old section 382 provided two separate rules governing the carryover of NOLs:

1. Taxable purchases. In the case of taxable purchases of stock, NOL carryovers were unaffected unless:

   (i) the 10 largest shareholders of the corporation had increased their stock ownership by 50 percentage points (not by 50 percent) over a two-year period and

   (ii) the corporation discontinued a trade or business that it had conducted prior to the change in ownership (or was not engaged in any active trade or business).

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* References herein to "section 382" are to that section as amended by the Tax Reform Act of 1986 ("TRA 1986"). References to "old section 382" are to that section as in effect before the effective date of section 382.

If <u>both</u> of these tests were met, then the corporation's NOL carryovers were eliminated.

2. <u>Tax-free reorganizations.</u> Following tax-free reorganization, a corporation's NOL carryovers were unaffected unless the former loss corporation's shareholders had less than a 20 percent continuing stock interest in the surviving corporation. If the continuing stock interest was less than 20 percent, the NOL carryovers were reduced by 5 percent for each percentage point that the continuing stock interest was less than 20 percent.

3. <u>Practical Effect.</u> Old section 382 rarely applied in practice to taxable acquisitions because of the change of business requirement. It also rarely applied to reorganizations for the reason that, when the loss corporation was acquired through a subsidiary, in applying the 20 percent continuity test, the value of the former loss corporation's shareholders' stock was compared with the value of the equity of the subsidiary, <u>not</u> the value of the equity of the parent. Also, old section 382 did not apply to "B" reorganizations. Finally, old section 382 did not affect built-in losses (potential tax losses that were unrealized at the time of an acquisition).

C. <u>Prior Attempts to Amend Old Section 382.</u> The provisions of old section 382 were substantially amended by the Tax Reform Act of 1976. The amended version of section 382 potentially disallowed NOL carryovers completely if there was a change in ownership regardless of whether a business was continued. This was thought to be too harsh and the effective date of amended section 382 was repeatedly postponed. As a practical matter, it never came into effect. (Technically, amended section 382 was in effect during three separate periods, the last of which began on January 1, 1986; in each case, however, it was later repealed on a retroactive basis.)

D. Section 382 Under TRA 1986.

1. General rule. As amended by TRA 1986, section 382 provides, in general, that following change in the ownership of a corporation's stock aggregating more than 50 percentage points over a 3-year period (regardless of whether the change occurs as a result of taxable purchases, reorganizations or a combination of both), NOL carryovers (including built-in losses) are generally not reduced, but the maximum amount of taxable income that can be offset with those carryovers or losses in years ending after the change in ownership is limited. The annual limit equals the product of (x) the value of the corporation at the time of the change in ownership and (y) a prescribed rate fixed at that time equal to the long-term Federal rate, adjusted for the difference between interest rates on taxable and tax-exempt bonds. In addition, the annual limitation is scaled back if the loss corporation has more than a *de minimis* amount of investment assets, and NOL carryovers are completely disallowed if the corporation does not meet a generous business continuity test for two years following the change in owner-ship.

2. Rationale. This rule (except for the business assets and business continuity requirements) reflects the so-called “neutrality principle” under which an acquiror of a loss corporation is permitted to utilize that corporation's NOL carryovers to the same extent that the loss corporation itself would have been able to realize benefits from those carryovers. The annual limitation is intended to approximate the income that the corporation would have produced as a return on its equity and thus the income that could have been sheltered by the NOL carryovers absent the acquisition. The limitation incorporates its own economic tax avoidance test in that the limitation will be

more significant the greater the amount of NOL carryovers is by comparison with the value of the loss corporation.

3. No escape because of continuity of business. It is important to bear in mind that, unlike old section 382, which required that, in the case of a taxable stock purchase, both a change of ownership and a change of business test be met before a corporation's NOL carryovers would be affected the application of section 382 under TRA 1986 is triggered solely by an ownership change. Thus, the limitations imposed by section 382 become effective following the requisite ownership change even though the corporation maintains exactly the same businesses (or, indeed, expands those businesses) that it had operated prior to the change in ownership. Also, in the reorganization context, the limitations cannot be avoided through a subsidiary acquisition.

4. The “Great Compromise”. The compromise reflected in section 382 is a considerable expansion in the circumstances where the section will apply in exchange for greater leniency under the section in allowing utilization of NOL carryovers. For the first time, section 382 will be a factor in all acquisitions of loss companies, even where the transaction is not tax driven.

II. OVERVIEW.

This section outlines the framework of section 382 and briefly defines some of the terms used in the statute. Each of these concepts will be discussed in greater detail below.

A. Triggering Mechanism.

1. Ownership change. Section 382 applies following an “ownership change”. An ownership change takes place if following an “owner shift involving a 5-percent shareholder” or an “equity structure shift” the percentage of stock owned by one or more

"5-percent shareholders" has increased by more than 50 percentage points over the lowest percentage of stock owned by such shareholders during the "testing period".

2. Owner shift involving a 5-percent shareholder. Generally, any change in stock ownership involving a "5-percent shareholder".

3. Equity structure shift. Generally, an acquisitive reorganization. This definition can be expanded in regulations to include recapitalizations and public offerings.

4. 5-percent shareholder. An owner of 5 percent or more of a corporation's stock. However, owners of less than 5 percent of such stock are not ignored; instead, all such owners are aggregated and treated as a single 5-percect shareholder.

5. Testing period. Generally, the shorter of (a) the tree calendar year period prior to any owner shift involving a 5-percent shareholder or any equity structure shift or (b) the period since the last ownership change.

6. Attribution rules. Generally follows section 318 rules except that, inter alia, (i) stock held by a corporation is always attributed to that corporation's shareholders regardless of the size of individual holdings; (ii) stock attributed from an entity to its owners is no longer treated as being held by that entity, (iii) stock held by owners of an entity are not attributed to that entity, and (iv) all options are treated as having been exercised if such treatment would result in an ownership change. The rules in (i) through (iii) are intended to ensure that changes in ownership are measured by looking to the ultimate beneficial owners.

7. Stock. Generally, for purposes of determining whether an ownership change has occurred, includes all stock other than straight preferred stock that would not be considered stock in testing whether a consolidated return can be filed.

B. Effect of Application of Section 392.

1. General rule. In post-change taxable years, taxable income may be offset by pre-change losses only to the extent of the "section 382 limitation" for that year.

(i) Section 382 limitation. Equals file value of the loss corporation multiplied by the long-term tax-exempt bond rate. If the section 382 limitation exceeds taxable income, that excess is carried forward to increase the next year's section 382 limitation.

(ii) Value of loss corporation. Equals the value at the time of the ownership change of the loss corporation's stock including straight preferred stock (even though changes in ownership of such stock would not be counted for purposes of determining whether an ownership change has occurred).

(iii) Long-term tax-exempt bond rate. Determined by reference to the long-term Federal rate determined under section 1274, adjusted to reflect differences between actual market rates on taxable and tax-exempt bonds.

2. Special rules.

(i) Built-in losses and gains. Any built-in loss (at time of an ownership change) that is recognized within five years after the ownership change is subject to the same limitations on utilization as pre-change NOL carryovers. Built-in gains recognized in the same period increase the section 382 limitation. A *de minimis* rule provides that these rules apply to built-in losses or built-in gains only if the net amount of built-in losses or gains, respectively, is greater than 25 percent of the fair market value of the corporation's assets at the time of the ownership change.

(ii) Anti-stuffing rules. Capital contributions intended to increase the section 382 limitation are not taken into account. If made within two years prior to an ownership change, that intention is irrebutably presumed except as provided in regulations.

(iii) Investment assets. If one-third or more of the corporation's gross assets consist of investment assets, then the value of the corporation for purposes of the Section 382 limitation is reduced by the excess of the value of such assets over any debt attributable to such assets.

C. Other Limitations.

1. Continuity of business enterprise. If the loss corporation does not continue a business for two calendar years following an ownership change, all of its NOL carryovers are eliminated. Continuation of a business is tested under the continuity of business enterprise test that applies to reorganizations.

2. Section 269. Provisions of section 269 reducing or eliminating NOL carryovers following an acquisition whose principal purpose is to make use of those carryovers are retained.

3. Case law principles. Common law limitations on carryover of NOLs (*i.e.*, *Libson Shops*

doctrine) do <u>not</u> apply to transactions subject to section 382.

4. <u>Consolidated return regulations.</u> Separate return limitation year (“SRLY”) and consolidated return change of ownership (“CRCO”) rules of consolidated return regulations-continue to apply.

5. <u>Anti-Leslie Fay rule.</u> The Treasury is given extremely broad authority to prescribe regulations to preclude the use of partnerships, other pass-through entities or other means to avoid the purposes of section 382. These regulations, which as applied to partnerships will most likely be retroactive to transactions after the date of enactment of TRA 1986, are to be directed specifically against the <u>Leslie Fay</u>-type transaction in which special allocations of partnership taxable income without corresponding current allocations of economic benefit are made to partners having NOL carryovers.

D. <u>Special Rules.</u>

1. <u>Bankruptcy.</u> In the case of a corporation reorganized in title 11 proceedings, section 382 does <u>not</u> apply if pre-bankruptcy creditors and stockholders own 50 percent of the stock following the reorganization. Stock exchanged for a creditor claim is not included in this rule unless that claim (i) has been held by the exchanging creditor since 18 months prior to the filing of the bankruptcy petition or (ii) arose in the ordinary course of the creditor's business and has been continuously held by such creditor. If the special bankruptcy rule is applicable, the corporation's NOL carryovers are reduced in part.

2. <u>Thrift institutions.</u>

(i) <u>Insolvent thrifts.</u> Until 1989, thrifts reorganized under section 368(a)(3)(D)(ii) are not subject to section 382 limitation provided that shareholders and creditors (including depositors) retain an ongoing 20 percent stock interest (treating deposits which continue through the reorganization as stock).

(ii) Solvent thrifts. Generally, subject to rules applicable to other corporations. Under regulations to be issued that would apply only prospectively but in any event not before 1969, a mutual-to-stock conversion and public stock offering may result in an ownership change if the value of the newly issued stock exceeds depositors' equity.

E. Effective Dates. Generally, section 382 applies in the case of an ownership change on or after January 1, 1987. However, the testing period for post-1986 ownership changes would begin not earlier than May 6, 1986 or (if later) the date of an ownership change occurring after May 6, 1986 and before the end of 1986. Somewhat more lenient rules will most likely apply to reorganizations.

III. DETAILED DESCRZFTION OF SECTION 382.

A. Ownership Change. Section 382 is triggered by an “ownership change”. An ownership change occurs if after either an owner shift involving a 5-percent shareholder or an equity structure shift, the percentage of loss corporation stock owned by one or more 5-percent shareholders exceeds by more than 50 percentage points the lowest total percentage holdings of those shareholders during the testing period. All transactions daring the testing period are counted even if they are isolated events and not part of a plan to acquire the loss corporation.

Example: On January 2, 1987, Corp L is owned equally by 4 shareholders: A, B, C and D. On that date, A buys B's 25 percent interest. On June 30, 1989, in a transaction unrelated to A's purchase of B's stock, E buys the stock held by

C and D. There is an ownership change on June 30, 1989 because on that date A's percentage interest (50%) exceeds by 25 percentage points his lowest interest in Corp L during the preceding 3 years and E's interest exceeds by 50 percentage points his lowest interest (zero) during that period, resulting in a total increase of 75 percentage points.

1. Owner shift involving a 5-percent shareholder. An owner shift involving a 5-percent shareholder includes any change in the percentage stock ownership of 5-percent shareholders, regardless of how that change is effected, including a change that results from a reorganization or other corporate transaction, or from redemptions or issuances of stock. For these purposes, a 5-percent shareholder includes any shareholder who holds 5 percent of the corporation's stock either before or after the change in stock ownership. In general, any transaction affecting the ownership of stock of a corporation, ether than a pro rata redemption, exchange or distribution of stock, would be an owner shift involving a 5-percet shareholder.

   Example: A holds 5 percent of Corp L’s stock. A purchase or a sale by A of 1 percent of Corp L's stock is an owner shift involving a 5-percent shareholder.

   Example: B holds 4 percent of Corp L's stock. A purchase by B of 1 percent of Corp L's stock is an owner shift involving a 5-percent shareholder.

   Example: A holds 5 percent of Corp L's stock. Corp L’s stock. Corp L redeems 1 percent of A's Corp L stock in a non-pro rata redemption. This constitutes an owner shift involving a 5-percent shareholder.

2. Equity structure shift. Includes a reorganization within the meaning of section 368(a)(1) except for (i) a divisive “D” or

"G" reorganization or (ii) an "F" reorganization.

See, however, paragraph 4 below for illustrations of transactions that may be treated as equity structure shifts under regulatory authority. Because an equity structure shift would almost invariably also constitute an owner shift involving a 5-percent shareholder, the only significance of qualifying as an equity structure shift is that a special rule may apply to segregate groups of public shareholders (see paragraph 4 below) and a different effective date may apply (see Part-VII below).

3. Definitions and computational rules.

(i) Stock. For purposes of determining whether there has been an ownership change, all stock is included, whether common or preferred, except stock that would not be treated as such for purposes of the consolidated return rules (i.e., nonvoting, nonconvertible nonparticipating preferred stock that is not issued at a significant discount).

Under regulatory authority granted in TRA 1986, however, securities that would otherwise be treated as stock may be treated as nonstick and vice versa.

Example: Corp A wishes to sell its subsidiary Corp L to P. In order to avoid an ownership change, Corp L issues to Corp A a straight preferred stock with nominal voting rights that represents more than 50 percent of the value of Corp L. Corp A sells the common stock of Corp L to P and retains the preferred stock. Under regulations, the preferred stock may be ignored in determining whether an ownership change has occurred.

Example: Corp L has outstanding a class of nonvoting straight preferred stock. That stock becomes voting stock because of the failure of Corp L to pay dividends. Under regulations, the preferred stock may continue to be treated as non-stock.

(ii) 5-percent shareholder. Changes in stock ownership are measured by aggregating increases in the ownership of stock by “5-percent shareholders” (owners of 5 percent of more of a corporation's stock). However, all owners of less than 5 percent are aggregated and treated as a single 5-percent shareholder (a “section 382 public shareholder”). Thus, any sale of stock by a 5-percent shareholder to other shareholders will be counted as an increase in stock ownership by a 5-percent shareholder regardless of the size of the holdings of the other shareholders. The only sales that will not be counted are sales by one less than 5-percent shareholder t o another.

Example: Corp L is held by a single shareholder. In a public offering, stock of Corp L that represents 60 percent of the stock of Corp L outstanding after the offering is sold to public investors, with no investor acquiring as much as 5 percent of the Corp L stock. This would constitute an ownership change because the section 382 public shareholder has increased its ownership of Corp L stock from zero to 60 percent.

The 5 percent rule apparently is a rule of convenience. Holders of 5 percent or more of the stock of an SEC reporting company are required to disclose their holdings under Rule 13d. Thus, 5 percent holdings are more easily tracked by the corporation. There is not, however, a perfect congruence between the 5-percent shareholder rule of section 382 and the rules relating to Rule 13d filings because the attribution and aggregation rules differ substantially. In addition, the statutory definition of a 5-percent shareholder includes a person who owned 5 percent of the stock of a corporation <u>at any time</u> during the testing period. However, a person who previously filed under Rule 13d and reduced his ownership to below 5 percent is not required to report subsequent acquisitions until the 5 percent threshold is reached again. Thus, it may occasionally be difficult to track the 5-percent shareholders of a corporation.

<u>Example:</u> Stock of Corp L is held 47 percent by less than 5-percent shareholders who are treated as a section 382 public shareholder, 47 percent by A and 6 percent by B. C buys A's stock. B sells 1/3 of his 6 percent stake into the market. B is still treated as a 5-percent shareholder; consequently, his remaining 4 percent stake is <u>not</u> aggregated with the interests of the section 382 public shareholder so as to increase that public shareholder's interest by 6 percent. Instead, the 47 percentage point increase in C's interest is combined with a 2 percentage point increase in that public shareholder's interest for an aggregate increase in percentage ownership of 49 percent. No ownership change has occurred.

<u>Example.</u> Corp L is widely-held with no individual 5-percent shareholders. A buys 50 percent of Corp L's stock. B buys all of A's stock. A is still treated (for the balance of the testing period) as a 5-percent shareholder. Therefore, a purchase of a single share of Corp L stock by A would create an ownership change, with no way for Corp L to be aware of the purchase (in the absence of an agreement with A).

Note that Example 12 in the Statement of the Managers of the House-Senate Conference Committee that considered TRA 1986 (the “Conference Report”) is inconsistent with the statutory definition in that it aggregates the nominal stock holdings of a former 5-percent shareholder with the holdings of the section 382 public shareholder. However, because this question was not at issue in the example, it would be stretching to attach much significance to the example on this point.

4. Special rules for segregating public shareholders.

(i) Acquisitive reorganizations. A reorganization in which a loss corporation is combined with another corporation can result in an ownership change because of the increase in the ownership of stock of the loss corporation by the shareholders of the other party to the reorganization. In a case where both the loss corporation and that other party have less than 5-percent shareholders, the true increase in ownership of the loss corporation would be understated if the two groups were treated as a single section 382 public shareholder. Accordingly, in the case of an equity structure shift that is a reorganization with more than one party, section 382 treats the less than 5-percent shareholders of each party as a separate section 382 public shareholder that is considered to be a 5-percent shareholder.

Example: Corp P and Corp L are each widely-held with no individual 5-percent shareholders. On January 2, 1987, Corp P and Cow L merge, forming Corp PL. Corp P shareholders receive 60 percent of the stock of Corp PL in the merger, while Corp L shareholders receive 40 percent. Even though Corp L and its successor Corp PL are owned 100 percent by public shareholders before and after the merger, there is nonetheless an ownership change with respect to Corp L because the pre-merger public shareholders of each of Corp P and Corp L are treated as separate 5-percent shareholders and the interest of the former Corp P public shareholders in Corp L has increased from zero, to 60 percent. The merger is not, however, an ownership change with respect to Corp P because the ownership interest in

Corp PL of the former Corp L shareholders has only increased from zero to 40 percent.

(ii) Special rule for stock offerings. Under regulatory authority to be applied prospectively only, in the case of a public offering of shares of a corporation that has public shareholders before the offering, the pre-offering group of public shareholders may generally be segregated from the new group of public shareholders, with each group being treated as a different section 382 public shareholder. As a result, the increase in ownership by the new public shareholders would be counted in full in determining whether an ownership change has occurred.

Example: Corp L is widely-held with no individual 5-percents shareholders. The value of the Corp k stock is $500 million. On January 2, 1987, Corp L issues stock with a value of $750 million. Assuming that regulations relating to public offerings have been issued with an effective date of January 1, 1987, an ownership change has occurred because the new group of Corp L public shareholders have increased their ownership interest from zero to 60 percent ($750 million/$1,250 million) except to the extent that it can be demonstrated that the new Corp L stock has been purchased by old shareholders.

Example: Same facts as above except that the January 2, 1987 offering involves only $300 million of new equity. No ownership change occurs because the new group of public shareholders have increased their percentage ownership interest only to 37.5 percent ($300 million/$800 million).

Question: Will the regulations, when issued, treat a public secondary offering by a 5-percent shareholder as an equity structure shift thereby creating a new section 382 public shareholder, or as a sale that only increases the percentage interest of the preexisting section 382 public shareholder? The distinction is important in analyzing subsequent purchases of stock from public shareholders.

Example: Corp L is held 60 percent by less than 5-percent shareholders and 40 percent by B. On January 2, 1987, B's stock in Corp L is sold to the public in a secondary offering. On July 1, 1987, C purchases 30 percent of the Corp L stock from the public. Assume that if there were two section 382 public shareholders, C's purchase would be considered to be made *pro rata* from each (*see* paragraph (iv) below). If the secondary offering of B's stock created a new section 382 public shareholder, the purchase by C would trigger an ownership change arising out of the increase of 30 percentage points in C's ownership interest combined with an increase of 28 percentage points in the interest of the new section 382 public shareholder (the 40 percentage point secondary offering less the 12 percentage point interest deemed to have been purchased from that section 382 public shareholder by C). Alternatively, if the secondary offering did not create a new section 382 public shareholder, the 30 percentage point increase in C's ownership interest would reduce, by an equal amount, the increase in the old section 382 public shareholder's interest, so that the aggregate increase in ownership would remain at 40 percent.

Note: The Conference Report indicates that even prior to the effective date of regulations that will treat a public offering as an equity structure shift, stock purchased in a public offering by a company with no pre-offering 5-percent shareholders (*i.e.*, with a single section 382 public shareholder owning 100% of the shares) would be treated as acquired by one or more 5-percent shareholders to the extent such offering is made through a firm commitment underwriting in which each underwriter acquires 5-percent or more of the stock, because each such underwriter would be counted as a 5-percent shareholder. Upon the distribution of the stock by the underwriters to the public, the percentage interest held by the section 382 public shareholder, which was reduced as a result of the transitory ownership by the underwriters, would once again be increased. As a practical matter, however, this rule would have little significance if the offering were consummated prior to January 1, 1987. If the underwriters who were treated as 5-percent shareholders acquired more than 50 percent of the corporation's stock, the ownership change would be treated under the rules of old section 382 (see the discussion of effective dates in Part VII below); consequently, the NOL carryovers would not be affected so long as the corporation's business was not changed. Alternatively, if those underwriters did not acquire more than 50 percent of the corporation's stock, so that the offering did not itself result in an ownership change, there would be not be a greater risk than before the offering that subsequent purchases of stock would result in an ownership change. Subsequent purchases of stock from public shareholders by a new 5-percent shareholder would result in an increased percentage ownership interest by the purchasing 5-percent shareholder coupled with a corresponding decrease in the percentage ownership interest of the section 382 public shareholder, so that the public offering, in effect, could not be combined with subsequent transactions so as to trigger an ownership change. It seems very unlikely that regulations would divide public shareholders into different groups because of a public offering that occurred before the effective date of such regulations only for purposes of determining whether transactions occurring after that effective date are to be treated as ownership changes.

(iii) Special rule for recapitalizations: Regulations will also be issued that will segregate different groups of public shareholders following a recapitalization.

Example: Corp L is widely-held with no person owning 5 percent of its stock. After the issuance of regulations relating to recapitalizations, 60 percent of the Corp L stock is redeemed for preferred stock that is not treated as "stock" for purposes of the definition of ownership change. An ownership change occurs because the remaining common shareholders are treated as a separate section 382 public shareholder that has increased its percentage ownership interest in Corp L stock by 60 points (from 40% to l00%).

Note: Similar rules would apparently apply in the case of a redemption for cash.

(iv) Multiple transactions. In determining whether an ownership change has occurred, owner shifts involving 5-percent shareholders and equity structure shifts that occur within the testing period are combined. The total increase in percentage ownership of 5-percent shareholders is calculated simply by comparing the current ownership of such shareholders with their ownership throughout the testing period. In the case of acquisitions following an equity structure shift that results in the creation of two section 382 public shareholders, however, section 382 provides that subsequent acquisitions of stock from the public are deemed to have been made on a proportionate basis from each section 382 public shareholder unless the actual source can be shown.

Example: Corp P and Corp L are each widely-held with no shareholder owning as much as 5-percent. On January 2, 1987, Corp P and Corp L merge, forming Carp PL. Corp P shareholders receive 40 percent of the stock of Corp PL in the merger, while Corp L shareholders receive 60 percent. As discussed in paragraph (i) above, the merger does not cause an ownership change with respect to Corp L. On June 1, 1987, X purchases 15 percent of the Corp PL stock in the market. Of that 15 percent purchase, 9 percent (60% x 15) is deemed (unless it can be demonstrated otherwise) to have been made from the former Corp L shareholders (who are 60% shareholders of Corp PL) and 6 percent (40% x 15%) from the former Corp P shareholders. Thus, no ownership change has been effected with respect to Corp PL as a successor to Corp L because the increase in the percentage ownership of its stock is 49 points (15% held by X; 34% held by the former Corp P shareholders who had received 40% in the merger but who are deemed to have sold 6% to X).

Example: Same as above, except that Corp P had been owned entirely by an individual B; and none of X's stock is bought from B. In that case, because B's interest is not in fact reduced by X's purchase, an ownership change occurs. (B has increased his interest in the Corp L component of Corp PL from zero to 40% while X has increased his interest from zero to 15%.)

5. Attribution rules. Generally, new section 382 follows the section 318 attribution rules, with the following exceptions:

(i) Family members: owner of stock and spouse, children, parents and grandparents are treated as a single individual. It is not clear, however, how this mechanism avoids double-counting of stock. Thus, for example, a single share of stock owned by a parent would, on the face of the statute, be attributed separately to <u>each</u> of that person's children. Presumably, this result was not intended.

(ii) <u>Attribution to entities</u> (<u>i.e.</u>, partnerships, corporations, estates and trusts): None, except to extent provided in regulations. Thus, if Corp P owns stock of Corp L and Corp P forms a subsidiary (Corp S), Corp S is not treated as a new owner of Corp L stock.

(iii) <u>Options</u> (including warrants, convert ible debt, contingent purchase price arrangements, puts, stock subject to a risk of forfeiture, and contracts to acquire stock): Except as provided in regulations, any such option is treated as exercised <u>if</u> that treatment would result in an ownership change. Inconsistent assumptions may apply to different options if that would result in an ownership change. If an option is considered to be exercised, then the actual exercise is disregarded.

The extension of this rule to contracts to acquire stock seems unwarranted in cases where the contracts are subject to substantial conditions precedent.

If section 382 limitations have applied because an option was assumed to have been exercised and the option in fact expires unexercised, the corporation may file an amended return for relevant years, subject to the applicable statute of limitation. (In the case of an option with. a life in excess of 4 years, this may entail filing a protective refund claim.)

<u>Example.</u> Corp L has outstanding 1,000 shares of common stock which are owned equally by A and B. Corp L grants identical options to purchase 1,100 shares of newly issued stock each of A and an unrelated investor C. An ownership change occurs because it is assumed that the C option is exercised but

that the A option is not. Query whether the result would be different if a single option to purchase 2,200 shares were granted to a corporation owned jointly by A and C?

(iv) Attribution from entities: An entity (corporation, partnership, trust or estate) “looked through” so that all stock owned by is treated as owned by the holders of interests in the entity in proportion to their interests, without regard to the minimum 50 percent stock ownership generally required for corporation-to-shareholder attribution under section 318.

Example: Corp P owns all of the stock of Corp L, and distributes the Corp L stock pro rata to its shareholders. No ownership change occurs because, for purposes of section 382, shareholders of Corp P are deemed to have held the Corp L stock even before the distribution.

Example: Corp L is held equally by 5 shareholders. A holding company structure for Corp L is adopted through the contribution of all of the stock bf Corp L to newly-organized Corp HC in exchange for the stock of Corp HC. No ownership change occurs because the former Corp L holders are deemed, under the attribution rules, to continue to own the Corp L stock hold by Corp HC.

(v) Coordination of attribution rule with 5-percent shareholder rule:

In general, less than 5-percent shareholders of a corporation that is a stockholder in a loss corporation are aggregated and treated as a separate shareholder from other less than 5-percent shareholders of the loss corporation.

Example: Corp P and Corp L are widely-held. Each has no shareholder owning 5-percent or more. Corp P purchases all of the stock of

Corp L. An ownership change occurs with respect to Corp L because all of its stock is now owned, under the attribution rule, by the public shareholders of Corp P whereas, before the purchase, all of that stock had been owned by the public shareholders of Corp L.

There is some confusion as to how the rule that aggregates less than 5-percent shareholders for purposes of the attribution rules relates to the rule that treats less than 5-percent shareholders of a loss corporation as a separate 5-percent shareholder.

Question: Assume that Corp L is owned entirely by public shareholders. Corp P, which is 50 percent owned by an individual, A, and 50 percent owned by public shareholders, purchases, alternatively, 4 percent or 6 percent of the stock of Corp L from public shareholders of Corp L. To what extent is Corp P's purchase counted as an increase in ownership by a 5-percent shareholder of Corp L? Clearly, where Corp P purchases less than 5 percent of the stock of Corp L, Corp L is in no better a position to separately account for that purchase than if Corp P had been an individual. Therefore, the fact that there are less than 5-percent shareholders of Corp P should not require that their interest be accounted for separately from the interest of the other public shareholders of Corp L. On the other hand, if Corp P purchases 6 percent of Corp L, the fact that A would be considered to own less than 5 percent of Corp L should not result in the combination of A's interest with that of the public shareholders of Corp L.

The right results would be achieved if two rules were adopted: (1) In the case where a corporation (Corp P) has an interest in the stock of the loss corporation (Corp L), all of the direct shareholders of Corp P owning individually less than 5 percent of the stock of Corp P would be aggregated and treated as a single individual who has no other interest in Corp L (<u>i.e.</u>, the attribution rules would not be further applied to that group). (2) All owners of stock of Corp P (determined after applying the first rule) who own individually less than 5 percent of Carp L would be aggregated and treated as one individual who has no other interest in Corp L.

Applying these suggested rules to the facts in the question above, the public shareholders of Corp P would be treated as one individual, so that Corp P would be considered to be owned equally by two individuals (A and the public). Since Corp P owns less than 10 percent of Corp L, the two shareholders of Corp F (each of whom owns by attibution less than 5 percent of Corp L) would be further aggregated and treated as a single individual with no other interest in Corp L. Thus, where Corp P purchases 4 percent of the stock of Corp L, the stock owned by Corp P would be aggregated with the stock owned by other less than 5-percent shareholders of Corp L. On the other hand, where Corp P buys 6 percent of the stock of Corp P, Corp P would be treated as a 5-percent shareholder of Corp L.

B. <u>Testing Period:</u> Generally, a rolling three calendar year period preceding any owner shift involving a 5-percent stockholder or any equity structure shift.

<u>Exceptions:</u>

1. Following any ownership change, the testing period for determining whether a <u>second</u> ownership change has occurred does not start before the day following the day on which the preceding ownership change occurred.

2. Generally, the testing period does not start before the first

day of the first taxable year in which the NOL carryovers arose. Except as provided in regulations, this rule will not apply to corporations with unrealized built-in losses (that are subject to the section 382 limitation as discussed in Part IV.D.2(iii) below). Regulations, however, will provide that the testing period will not start before the year in which any such built-in loss arose.

C. Other Rules Relating to Triggering of Section 382.

1. Stock acquired by gift, upon death, incident to a divorce, or from a spouse, is treated as if the acquiror had owned the stock during the period that it was owned by the transferor, so that such transfer would not contribute to an ownership change. Otherwise, there is no general exception for carryover basis transactions and any relief in the case of transfers between related parties must come from the ownership attribution rules.

2. Special rules apply so that certain acquisitions by an ESOP of 50 percent or more of the stock of a corporation, or acquisitions by participants from an ESOP, are not counted in determining whether an ownership change has occurred.

3. Changes in relative stock ownership attributable solely to fluctuations in the fair market value of different classes of stock are not counted in determining whether an ownership change has occurred.

   Example: On January 2, 1987, Corp L has an equity value of $100 million, of which $45 million is represented by common stock and $55 million by voting preferred. Both classes of stock are owned by A. On that date, B purchases all of the common stock. No ownership change occurs because B’s increase in percentage ownership does not exceed 50 percent. By April 1, 1987, the relative value of the preferred stock decreases so that B’s percentage ownership of both classes of Corp L stock (taken in the aggregate) increases to 55 percent. An ownership change does not occur because of the changes in value. On the other hand, if B purchased on April 1, 1987 a single share of preferred stock from A, an ownership change would, it seems, occur because the increase in B’s ownership interest would not then be attributable solely to a change in value.

IV. EFFECT OF OWNERSZIP CFANGE.

A. In General. If the application of section 382 is triggered by an ownership change, then “pre-change losses” may reduce taxable income in a “post-change year” only up to the “section 382 limitation” for that year.

B. Pre-change Losses. Includes (i) NOL carryovers to the taxable year in which the ownership change occurs and (ii) NOLs generated in that year, to the extent allocable to the period preceding the date of the ownership change (“change date”). The allocation will generally be made ratably, i.e., by reference to the number of days in the taxable year preceding and following the change date. Unrealized but economically accrued losses of the corporation may also be treated as pre-change losses. See paragraph D.2(iii) below.

C. Post-change Year. Any taxable year ending after the change date. This would include the taxable year in which the ownership change occurs. Under a special rule, however, the section 382 limitation for that year applies only to taxable income generated after the change date, calculated, generally, on a ratable basis.

Note: While income and losses for the year in which an ownership change occurs are determined, generally, on a ratable basis, recognized built-in gains or losses, and any gain arising out of a section 338 election made in connection with the ownership change, and possibly under regulations gain from discrete sales of assets prior to the change date, would be excluded from the income or losses that are subject to ratable allocation. Regulations may also provide that a corporation may elect to close its books on the change date for purposes of allocating income or losses to the pre-change and post-change portions of that year.

D. Section 382 Limitation.

1. General Rule. The “section 382 limitation” for any taxable year equals the product of (x) the value of the loss corporation and (y) the “long-term tax-exempt” bond rate.

(i) “Value” of the loss corporation. Value is determined based on the value of the corporation's stock immediately prior to the ownership change. Thus, in the case of an ownership change triggered by, for example, a merger of Corp L into Corp P the value of the loss corporation would refer only to the value of Corp L. Similarly, in a consolidation of 3 corporations, 2 of which undergo ownership changes in the consolidation, separate section 382 limitations would apply to each of those 2 corporations based on their respective pre-consolidation values.

Under a special rule, if a redemption occurs at the time of or after an ownership change “in connection with” the ownership change, then value is determined on the basis of the post-redemption stock value. Example 23 in the Conference Report suggests that the "in connection with" standard may be read broadly to include any redemption that is contemplated at the time of the ownership change. Regulations will provide that other corporate contractions will be treated in a manner similar to redemptions.

For purposes of determining "stock" value, all stock is counted, including preferred stock that would not be treated as stock for purposes of determining whether an ownership change has occurred. Regulations may provide rules treating other equity-flavored interests (such as options, warrants, convertible debt) as stock for these purposes.

Generally, the latest price paid for stock of the loss corporation would be the best evidence of value. However, where the ownership change is effected through a purchase of stock at a price that reflects a "control premium", the value of the loss corporation cannot be determined simply by "grossing-up" the cost of that stock. Instead, regulations may allow the value to be determined by "grossing up" the cost of ail the acquired loss corporation stock if a control block is acquired within a 12-month period.

(ii) Long-term tax-exempt bond rate. Generally equal to the highest long-term applicable Federal rate ("AFR"), as determined under section 1274(d), for the month in which the ownership change occurs or the preceding two months, adjusted for the difference between taxable and tax-exempt rates. In making this adjustment, the AFR will not be simply tax-effected to reflect the 34 percent corporate tax rate but will, instead, be adjusted to reflect the actual spread between the AFR and market rates on a diversified pool of long-term, prime quality, general obligation tax-exempt bonds. The rate will be based on the date of the ownership change and not on an earlier contract date. However, stock that is subject to a purchase contract may be considered to have been purchased under the attribution rules so that an ownership change may occur on the contract date.

2 Special rules relating to section 382 limitation.

(i) Short taxable years. Regulations will provide for a prorated section 382 limitation based on the number of days in the taxable year compared with 365.

(ii) Carryovers. The section 382 limitation for any taxable year will be increased by any excess section 382 limitation from previous years, *i.e.*, the amount, if any, by which the section 382 limitation in a previous taxable year exceeded the amount of taxable income in that year that was offset by pre-change losses.

(iii) Built-in gains and losses.

(a) In general. The section 382 limitation for any taxable year that falls in whole or in part within the "recognition period" is increased by the amount of "recognized built-in gains" for that year, while any recognized built in losses for any such taxable year are subject to the section 382 limitation in the same manner as pre-change NOL carryovers. The "recognition period" is the five calendar year period beginning on the change date.

(b) Built-in gain rules.

Net unrealized built-in gain. A corporation can have recognized built-in gains only if it has a “net unrealized built-in gain”. A corporation's net unrealized built-in gain is the excess, if any, of the fair market value of all of its assets over their basis at the time of ac ownership change. This calculation reflects a netting of unrealized gains and losses.

De minimis rule. If net unrealized built-in gain does not exceed 25 percent of the fair market value of the corporation's assets at the time of the ownership change, the net unrealized built-in gain of the corporation is considered to be zero. For purposes of applying the de minimis rule, cash, cash items, and any marketable security if the value of such security does not differ substantially from its adjusted basis, are disregarded.

Recognized built-in gain. Gain recognized upon disposition of an asset is recognized built-in gain to the extent the taxpayer can demonstrate that such gain existed economically on the change date. However, the aggregate amount of recognized built-in gains for any taxable year cannot exceed the net unrealized built-in gain, as defined above, less the amount of recognized built-in gains for prior taxable years. (Because net unrealized built-in gain takes into account assets with respect to which there is a built-in loss, this cap is necessary in order to avoid recognition of individual built-in gains that exceed, in the aggregate, the net unrealized built-in gain.)

Note: A special rule increases the section 382 limitation by the amount of gain recognized as a result of a section 338 election (to the extent not already taken into account in computing recognized built-in gains for the taxable year). Accordingly, while the repeal of _General Utilities_ under TRA. 1986 will generally make the exercise of a section 336 election uneconomic, it may be advantageous to make the election for an acquired corporation with NOL carryovers in order to obtain a stepped-up basis while sheltering any gain to the extent of pre-acquisition losses (without limitation under section 382).

(c) Built-in loss rules.

Definitions. A corporation can have recognized built-in losses only if it has a net unrealized built-in loss. The definition of “net unrealized built-in lost” is parallel to the definition of “net unrealized built-in gain”, including a similar 25 percent _de minimis_ rule. The definition of “recognized built-in loss” for a taxable year is parallel to the definition of “recognized built-in gain”, except that the burden is on the taxpayer to show that a recognized loss is _not_ a recognized built-in loss. Under regulations to be issued, amounts that accrue before the change date but are not deductible until a later date, such as amounts deferred under the rules of section 267 or section 465, will be treated as built-in losses. In a legislative compromise, depreciation deductions cannot be treated as built-in losses under the regulations, but the Treasury is directed to issue a report with respect to this issue not later than January 1, 1989.

Operating rules. Recognized built-in losses are subject to the same limitations as pre-change NOL carryovers. Amounts disallowed because of the operation of the section 392 limitation may be carried over to succeeding taxable years under rules similar to the rules for the carrying forward of NOLs (presumably for a maximum of 15 years following the year in which the loss was reorganized). Section 382 does not contain ordering rules that would determine whether recognized built-in losses are utilized prior to pre-change losses. Apparently, it is intended that built-in losses would be utilized first under general tax principles that provide for first utilizing a current year loss before the offsetting of taxable income by NOL carryforwards from prior taxable years.

(d) Need for appraisals. Because the burden of proof is on the taxpayer to demonstrate that gains are recognized built-in gains and losses are not recognized built-in losses, there will often be a need to obtain appraisals of the assets of a loss corporation even though the transaction giving rise to the ownership change would not cause the basis of those assets to be restated for tax purposes.

(iv) Anti-stuffing rules.

(a) General. In determining the value of a loss corporation for purposes of calculating the section 382 limitation, capital contributions that are made principally for the purpose of increasing the value of the corporation (and, thereby, the section 382 limitation) are not taken into account. For these purposes, except as provided in regulations, any capital contribution within the 2-year period preceding the ownership change will be irrebutably presumed to have been made for the purpose of increasing the value.

(b) Exceptions. The Conference Report indicates that it is anticipated that the regulations, when issued, will exclude from the 2-year presumption:

i. Capital contributions made in connection with the formation of a corporation, unless the incorporation involved assets with built-in losses;

ii. Capital contributions received before the first year in which any NOLs or built-in losses arose; and

iii. Capital contributions made in order to meet working capital requirements.

In addition, the regulations may also consider the extent to which capital contributions should not reduce the corporation's value because of subsequent distributions or because the capital contribution is allocable to investments in nonbusiness assets that would, in any event, reduce the section 382 limitation.

(c) Note on liquidations of loss subsidiaries. In the case of an affiliated group of corporations that includes some loss corporations, the section 382 limitation would ordinarily apply to each loss corporation separately because an ownership change with respect to the common parent typically would result in an ownership change with respect to each group member under the ownership attribution rules. While the anti-stuffing rules would significantly inhibit pre-change capital contributions to loss corporations, they would not affect the. Pre-change liquidation of loss corporations into profitable parent corporations. Assuming that the liquidated corporations were solvent, NOL carryovers and other tax attributes would be continued in the parent. It would seem that the parent's assets could then be taken into account in determining the value of the loss corporation for purposes of subjecting those attributes to limitation under section 382.

(V) Nonbusiness assets.

(a) General: The value of the loss corporation for purposes of calculating the section 382 limitation is also reduced by the excess of the value of any, nonbusiness assets of the corporation at the time of time ownership change over indebtedness of the corporation attributable to such assets.

i. De minimis rule. The nonbusiness assets rule does not apply unless l/3 of the corporation's gross assets consist of nonbusiness assets.

ii. Nonbusiness assets. Defined as assets held for investment. Generally would include cash and marketable stock or securities except to the extent necessary as an integral part of the corporation's business (such as insurance company reserves or inventory of a securities dealer).

iii. Subsidiaries. Stock in a 50 percent or more owned corporate subsidiary (measured by both value and voting power) would be ignored for these purposes and the assets held by the subsidiary would be attributed to the parent. Apparently, a less than 50 percent interest in another corporation would be treated as a nonbusiness asset. There is no indication as to whether similar rules would apply to a joint venture in noncorporate form. Thus, it is not clear whether an allocable portion, of the assets of a joint-venture partnership in which a loss corporation has a 40 percent interest would be attributed to the parent or whether the interest in the joint venture would be considered a nonbusiness asset (as it would be if held in the form of corporate stock).

iv. Allocation. Debt would be allocated to a corporation's nonbusiness assets in the same proportion as the fair market value of such assets held by the corporation is of the fair market value of all of the corporation's assets. Apparently, tracing would not be allowed even in clear cases such as nonrecourse debt. There is no express statutory rule for aggregating the liabilities of affiliated corporations, although this may be implied to the extent assets are aggregated.

v. Exceptions. These rules would not apply to corporations that qualify as regulated investment companies, real estate investment trusts or real estate mortgage investment conduits (“REMICs”). Although not entirely clear, the exception is apparently based on a corporation's status immediately following an ownership change. The rationale for this exception is not stated but may be that such entities are considered to be in the business of holding investment assets.

E. Successive Ownership Changes.

Section 382 contains no special rule governing the section 382 limitation in the case of a second ownership change. Apparently, if a second ownership change occurs at a time when the value of the loss corporation and/or the long-term tax-exempt bond rate are lower than at the time of the earlier ownership change, the section. 382 limitation that applies to NOL carryovers from periods before the first ownership change in succeeding .taxable years would be correspondingly decreased. It should be noted that the Senate Finance Committee Staff Report of May, 1985 (which was the genesis of section 382) did contain an express limiting formula in this situation.

F. Application to Other Losses and Credits.

By application of section 383, old section 362 applied to carryovers of other losses and credits, including capital loss carryovers and foreign tax credits, investment tax credits and research credits. The Conference Report indicates that section 382 under TRA 1986 is similarly intended to apply to those carryovers and to carryovers of passive activity losses and credits and minimum tax credits. As drafted, however, the statute appears to make no reference to carryovers of passive activity losses and credits.

V. OTHER LIMITATIONS ON NOL CARRYOVERS.

A. Continuity of Business Enterprise.

While the application of section 382 generally results only in limitations on the utilization of NOL carryforwards, if the loss corporation fails to maintain continuity of its business enterprise for a 2-caiendar year period after the ownership change, its section 382 limitation for any taxable year ending after the change date will be reduced to zero (except for amounts attributable to recognized built-in gains or gain attributable to a section 338 election). Thus, a corporation that fails the continuity of business enterprise test in the second year following an ownership change would be required to amend its return for the previous year to the extent that any pre-change NOL carryovers had been utilized to offset taxable income.

The continuity of business test is the same test that applies in tax-free reorganizations (and less stringent than the change of business test under old section 382(a)). This test is met if the corporation continues its historic business or uses a significant portion of its historic business assets in a business. Changes in business locations or employees would not ordinarily pose a problem.

B. Section 269; Libson Shops.

Section 269, relating to acquisitions for the principal purpose of making use of favorable tax attributes, continues to be applicable. The practical significance of section 269 is likely to be significantly diminished, however, because it will be a rare case when the opportunity to use tax attributes, as limited by section 382, is the principal purpose for an acquisition. The Conference Report also indicates that the Libson Shops doctrine will not be applicable to transactions that are subject to section 382.

C. Consolidated Return Regulations.

The separate return limitation year (“SRLY”) and consolidated return change of ownership (“CRCO”) rules applicable to corporations filing consolidated returns will not be affected by TRA 1986. It is not clear whether the 50 percent change in stock ownership that is necessary to invoke the CRCO rules, which is based on old section 382 (a), will be conformed to the definition of an ownership change.

D. Anti-avoidance Regulations.

Broad regulatory authority is granted to issue regulations to prevent the avoidance of the purposes of section 382 through the use of relaxed persons, pass-through entities or other intermediaries. In particular, the Conference Report indicates that this authority should be used to prevent the use of Leslie Fay-type partnerships in which taxable income is allocated to a loss partner without a corresponding current allocation of economic benefit. Such regulations could limit the utilization of losses to offset income (rather than change the allocation of income), and could require that income that may not be offset with losses be taxed at the highest marginal tax rate. The Conference Report indicates that the regulations with respect to partnerships would be effective for transactions after the date of enactment of TRA 1986. Other regulations may (but need not) be prospective in the discretion of the Treasury.

VI. SPECIAL SITUATIONS.

A. Bankruptcy Reorganizations.

1. General rule. The section 382 limitation will not apply to an ownership change of a loss corporation that was in a bankruptcy proceeding prior to the change, if (i) such change resulted from a transaction ordered by the bankruptcy court or pursuant to a court approved plan and (ii) shareholders and creditors (immediately before the ownership change) own at least 50 percent of the corporation's stock (based on value and voting power) immediately after the ownership change. Stock received by a creditor in exchange for debt is counted for this special rule only if (i) the debt has been held by that creditor for at least 18 months prior to the commencement of the

bankruptcy proceeding or (ii) creditor is the original creditor and the debt arose in the ordinary course of the loss corporation's business.

2. Reduction of NOL carryovers. In cases where the special bankruptcy rule is applicable, the corporation's NOL carryovers will be reduced by:

   (i) 50 percent of the amount of discharge of indebtedness income that would have been recognized as a result of the stock-for-debt exchange but for the nonrecognition of such income that applies in the case of debtors that are in bankruptcy proceedings; and

   (ii) an amount equal to the interest paid or accrued on the debt that was exchanged for stock during the period beginning on the first day of the third taxable year before the taxable year in which the ownership change occurred.

3. Subsequent ownership change.

   In any case in which the special bankruptcy rule is applicable, if a second ownership change occurs within a 2-year period, all NOL carryovers from taxable years before the first ownership change will be eliminated.

4. Election out.

   In light of the limitations on the NOL carryovers of a corporation that is subject to the special bankruptcy rule, in certain circumstances a loss corporation may prefer to be subject to the generally applicable section 382 limitation rather than take advantage of the special bankruptcy rule. Regulations will provide for an election out of the special bankruptcy rule. In such a case (or in any other situation where a corporation in a title 11 case is not governed by the special bankruptcy rule), the value of the corporation for purposes of determining the section 382 limitation is calculated immediately after the ownership change, thereby taking into account stock acquired by creditors in the reorganization.

5. <u>Workouts.</u>

While the special bankruptcy rule does not apply to informal workouts outside the jurisidiction of a bankruptcy court, the Treasury is directed to study informal workouts and report to Congress by January 1, 1988.

B. <u>Thrift Institutions.</u>

1. <u>Insolvent thrifts.</u> Rules similar to those applicable to bankruptcy reorganizations apply to a thrift institution undergoing a “G” reorganization pursuant to section 368(a)(3)(D)(ii) and to an equity structure shift or issuance of stock that is an integral part of the transaction. Under this special rule, the section 382 limitation will not be triggered so long as shareholders and creditors (<u>including</u> depositors) maintain a continuing 20 percent stock interest in the thrift (counting deposits as stock for this purpose). The reductions in NOL carryovers applicable to bankruptcy reorganizations and complete disallowance rule for an ownership change within two years do <u>not</u> apply in this context. This special rule does not apply to transactions after December 31, 1988.

2. <u>Solvent thrifts.</u> Solvent thrift institutions would, generally, be treated under the rules applicable to other corporations. In the case of thrift institutions that undergo a mutual to-stock conversion coupled with an offering of stock, the Conference Report

generally indicates that depositors' equity interests would be treated as stock. If principles similar to those that are intended to apply under the public offering regulations (discussed in Part III.A.4(ii) above) were applied to such a transaction, an ownership change would occur if the value of the newly issued stock exceeds the value of the equity of the depositors (represented by their interests in a liquidation account) even though none of the stock is acquired by individual 5-percent shareholders. The reason is that the new group of public shareholders would be treated as a separate 5-percent shareholder that has increased its ownership interest by more than 50 percentage points. However, a special effective date rule provides that, while such regulations may be issued with regard to thrift conversions, they could not have an effective date before January 1, 1989.

It is not certain, however, to what extent thrifts will be able to take advantage of this two-year window. First, the effective date rule applies only to an offering of stock to less than 5-percent shareholders who would, in the absence of regulations, be aggregated with depositors' interests. If, however, the stock offering involved stock of a thrift holding company (as is often the case), the shareholders of the holding company might be segregated in any event from the thrift depositors because those shareholders would own equity interests in a different corporation from the depositors. Second, an offering that involves a firm commitment underwriting could result in an ownership change regardless of the status of regulations that treat the offering as an equity structure shift (<u>see</u> Part III.A.4(ii) above). An attempt was made to extend the special thrift transitional rule to firm commitment underwritings through a proposed concurrent resolution that made a number of technical changes in TRA. 1986; however, the resolution was not passed by Congress.

Hopefully, these two open points will be favorably resolved.

VII. EFFECTIVS DATES.

Section 382 applies to (i) an ownership change that follows an equity structure shift arising out of a plan of reorganization adopted on or after January 1, 1987 or (ii) an owner shift involving a 5-percent shareholder occurring on or after that date. If section 382 does not apply to a transaction because of the effective date provisions, old section 382 will apply to that transaction.

The effective date rule for equity structure shifts is clearly intended to shield a reorganization from the application of section 382 so long as the plan of reorganization is adopted by December 31, 1986, even if the transaction is not consummated until after that date. However, because virtually every equity structure shift also constitutes an owner shift involving a 5-percent shareholder, the post-1986 consummation of the transaction would technically be treated as an ownership change that is independently subject to section 382.

Despite the January 1, 1987 effective date, any equity structure shift or owner shift involving a 5-percent shareholder that occurs after May 5, 1986 is included in determining whether there has been a post-1986 ownership change unless that transaction was counted toward a pre-1087 ownership change. Thus, for example, if an ownership change occurred on December 31, 1986, no transactions that took place in 1986 would be counted in determining whether an ownership change takes place in post-1986 years. By contrast, if changes in stock ownership that did not amount to a 50 percentage point ownership increase took place after May 5, 1986 but before January

1, 1987, those transactions could be counted in determining whether a post-1986 ownership c3ange occurs.

Consequently, corporations with NOL carryovers that are contemplating transactions that would trigger the application of section 382 but would not have resulted in the application of old section 382 (such as a sale of more than 50% of the corporation's stock not accompanied by a change of business) would do well to effect those transactions before 1987. (Query whether a loss corporation could intentionally create a pre-1987 ownership change that would be governed under old section 382 by issuing an option that is unlikely to be exercised but that, under the attribution rules discussed in Part III.A.5(iii) above, would be deemed to have been exercised.)

A special transition rule applies to an ownership change resulting from an exchange of debt for stock in a bankruptcy case or a “G” reorganization if a petition in such case was filed before August 14, 1986.

<u>Allocation of Purchase Price, Related Party Sales. Stock Pedemption Payments, Golden Parachute Payments and Extraordinary Dividends Received by Corporate Shareholders under the Tax Reform Act of 1986</u>

by

Richard J. Hiegel
Michael L. Schler

A. <u>Allocation of Purchase Price</u>

A1. Section 1060 of the 1986 Code provides that in the case of any applicable asset acquisition, for purposes of determining both the buyer's basis in the acquired assets and the seller's gain or loss on the transaction, the consideration received for the assets is to be allocated among them using the method prescribed by the Treasury Regulations under Section 338(b)(5), which under Temp. Treas. Reg § 1.338(b)-2T is the so-called “residual” method. In addition, both the buyer and the seller are required under regulations to file information reports with the Internal Revenue Service setting forth the amount of consideration allocated to goodwill or going concern value and other prescribed information. “Applicable asset acquisition” means any transfer, direct or indirect, of assets constituting a trade or business and with respect to which the buyer’s basis is determined wholly by reference to the consideration paid there for (including a Section 1031 transaction with boot). The new provision applies to any acquisition of assets after May 6, 1986, unless the acquisition is made pursuant to a binding contract in effect on that date and at all times thereafter.

A2. Although both parties must use the residual method, they are not required to agree on the allocation of the consideration to the assets sold or to include any allocation in the contract of sale. The Senate Report (at p. 255) states that a group of assets will constitute a trade or business for purposes of Section 1060 if their character is such that goodwill or going concern value could under any circumstances attach to the assets; a group of assets constituting a trade or business under Section 355 will in all events be considered a business for Section 1060 purposes, and businesses that are not active businesses under Section 355 will also be subject to the rule. The provision applies to indirect sales of businesses, such as a sale of a partnership interest, where the purchasing partner's share of the basis of the partnership’s assets reflects his purchase price.

B. Related Party Sales

B1. Section 1239, which treats as ordinary income any gain recognized on a sale or exchange of depreciable property between a husband and wife, between the taxpayer and a corporation or partnership that is 80 percent owned by the taxpayer and/or the taxpayer's spouse, and between corporations and partnerships that are 80 percent owned by the taxpayer and/or the taxpayer spouse, is amended to:

(a) reduce the requisite ownership percentage from at least 80 percent to more than 50 percent;

(b) add the additional categories of related persons described in Section 267(b)(3), (10), (11) and (12) (i.e., members of the same controlled group; a corporation and a partnership more than 50 percent owned by the same persons; two S corporations more than 50 percent owned by the same persons; and an S corporation and a C corporation more than 50 percent owned by the same persons); and

(c) replace the present constructive ownership rules in Section 1239(c)(2) with rules similar to those in Section 267(c) (other than “sidewise” attribution among partners), which define family to include brothers, sisters, ancestors and lineal descendants as well as spouse but do not attribute ownership to corporations, partnerships, estates or trusts from their shareholders, partners or beneficiaries.

B2. Under current law, Section 453(g) disallows installment treatment on sales of depreciable property between Section 1239 related parties in certain cases, and Section 453(e) accelerates installment gain on a sale to a related party (generally based on Section 318 attribution) in certain circumstances where the related party resells the property. The 1986 Code amendments to Section 1239 automatically expand the scope of the disallowance under Section 453(g). Moreover, the definition of related parties for purposes of Section 453(e) is expanded to include all the relationships described in Section 267(b) as well as Section 318(a) (other than the option rule). In addition, Section 453(g) is amended, as to sales of depreciable property between related persons: (i) to treat contingent payments that can be valued, as well as noncontingent payments, as received in the year of sale; (ii) to require, in the case of contingent payments the fair market value of which cannot reasonably be ascertained, ratable recovery of basis by the seller; and (iii) to prohibit the purchaser in such a case from increasing the basis of the acquired property by any amount before the seller includes such amount in income.

B3. Section 707(b)(2), which treats as ordinary income any gain recognized on a sale or exchange between a partnership and a more-than-80 percent partner or between two more-than-80 percent commonly owned partnerships where the property sold or exchanged is not a capital asset in the hands of the transferee, is amended to reduce the requisite ownership percentage to more than 50 percent.

B4. The related party amendments apply to sales made after the date of enactment of the 1986 Act (October 22, 1986), other than sales pursuant to a binding contract in effect on August 14, 1986, and at all times thereafter. Although the changes made to Sections 1239 and 707 may only be significant for taxable years for which there is a differential between the capital gain and ordinary income tax rates (generally, 1987), the installment sale changes are of more lasting significance.

C. Stock Redemption Payments

C1. Section 162(1) of the 1986 Code disallows any deduction for any amount paid or incurred by a corporation in connection with the redemption of its stock, except for interest, dividends paid allowable as a deduction under Section 561 and any amount paid or incurred in connection with the redemption of stock in a regulated investment company which issues only stock redeemable upon the demand of a shareholder. This provision applies to any stock redemption and not just those made in hostile takeover situations. The Conference Report states (at II-168-69) that it is intended that:

(a) the denial of deductibility will extend to amounts paid “indirectly” by a corporation--e.g., by a controlling shareholder, controlled subsidiary or other related party;

(b) while the disallowance provision should be construed broadly, it should not be applied to disallow deductions for otherwise deductible amounts paid in a transaction that has no “nexus” with the redemption other than being proximate in time or arising out of the same general circumstances, such as a payment in discharge of the corporation's obligations under an employment contract with a departing employee whose stock is redeemed (whether or not the employment contract and the redemption were separately negotiated), and payments in settlement of litigation or in discharge of other types of contractual obligations or potential legal obligations to the extent that it is clearly established that the payment does not represent consideration for the stock or expenses related to its acquisition (such as legal, accounting, brokerage, transfer agent, appraisal and similar fees) and is not a payment that is a fundamental part of a “standstill” or similar agreement (unless there is no redemption of stock owned by the payee);

(c) the Internal Revenue Service will scrutinize any transaction that is proximate in time to a redemption (even though not directly related thereto) to determine whether the amount purportedly paid in the transaction is reasonable (or, presumably, a disguised redemption payment); even where the parties have countervailing tax interests, the parties’ stated allocation of the total consideration between the redemption and the unrelated transaction will be respected only if it is supported by all the facts and circumstances; and

(d) no inference should be drawn regarding the character of stock redemption payments in the hands of the payee or the deductibility of such payments under the 1954 Code.

C2. The disallowance provision is effective for payments made on or after March 1, 1986.

D. Golden Parachute Payments.

D1. Section 280G is amended to exclude the following types of payments from the definition of parachute payment:

(a) any payment by a corporation that immediately before the change of ownership or control was a “small business corporation” as defined for subchapter S purposes;

(b) any payment by a corporation if immediately before the change of ownership or control: no stock of the corporation was readily tradable on an established securities market or otherwise (except that the Treasury Department may by regulations prescribe that this requirement is not met where a substantial portion of the assets of any entity consists, directly-or indirectly, of stock in the corporation and interests in such entity are readily tradable); the payment was approved by the holders of more than 75 percent of the voting power of all outstanding stock of the corporation; and there was adequate disclosure to shareholders of all material facts concerning all payments that (but for this provision) would be parachute payments with respect to a disqualified individual:

(c) reasonable compensation for personal services to be rendered after the change of ownership or control (and the amount treated as an excess parachute payment is correspondingly reduced only by reasonable compensation for services rendered prior to the change of ownership or control); and

(d) any payment to or from a plan qualified under Section 401(a), an annuity plan described in Section 403(a) or a simplified employee pension as defined in Section 408(b).

D2. Section 280G(b)(2)(B) is amended to require that the Internal Revenue Service establish that an agreement violates a generally enforced securities law or regulation before a payment made pursuant to such agreement will be treated as a parachute payment.

D3. Under Section 280G(d)(5) of the 1986 Code, all members of an affiliated group as defined in Section 1504 (without regard to Section 1504(b)) are treated as a single corporation. Under Section 280G(c), a highly compensated individual is defined to include only an individual who is (or would be if the individual were an employee) a member of the group consisting of the highest paid one percent of employees of the corporation or, if less, the highest paid 250 employees of the corporation.

D4. The golden parachute provisions are effective as if they were included in Section 280G as enacted by the Deficit Reduction Act of 1384.

E. Extraordinary Dividends Received by Corporations

E1. Section 1059 is amended to provide that if a corporation receives an extraordinary dividend before it has held the stock for more than two years before the dividend announcement date, the basis of the stock is reduced (but not below zero) by the nontaxed portion of the dividend (generally, 80 percent thereof), and any nontaxed portion of the dividend that does not reduce basis is added to any gain recognized on a disposition of the stock. “Dividend announcement date” means the date on which the corporation declares, announces or agrees to the payment of a dividend, whichever is earliest. The Conference Report (at II-164) states that an agreement to pay a dividend may be formal or informal, but it generally does not include a broad agreement in a joint venture arrangement to pay dividends as funds are available. The basis reduction rule will not apply even if the holding period of stock before a dividend announcement date is less than two years where the stock is held for the entire period of existence of the paying corporation (and any predecessor), such corporation (and any predecessor) does not have any earnings and profits except those accumulated during that period (except as provided in regulations) and the inapplicability of the rule is not inconsistent with its purposes.

E2. Under current law, an extraordinary dividend is determined by reference to the taxpayer's adjusted basis in the stock; amended Section 1059 provides an election to the taxpayer to use fair market value instead. Amended Section 1059 also treats as an extraordinary dividend any amount treated as a dividend under Section 301 in the case of a non-pro rata redemption or a partial liquidation under Section 302(e). On the other hand, a special rule is provided under which a qualified preferred dividend (i.e., a fixed preferred dividend on stock not in arrears as to dividends when acquired by the taxpayer) is treated as an extraordinary dividend only if the actual rate of return on the preferred stock exceeds 15 percent, or if not and if the taxpayer disposes of the stock within five years, only to the extent that the actual rate of return exceeds the stated rate of return. “Actual rate of return” is computed by taking into account dividends paid during the period the taxpayer held the stock and the lesser of the taxpayer's adjusted basis for the stock or its liquidation preference; “stated rate of return” is the annual rate of the preferred dividend payable with respect to the stock expressed as a percentage of its adjusted basis or liquidation preference. For an example of this computation, see the Conference Report at II-165.

E3. Section 1059 as amended applies to dividends declared after July 18, 1986, except that the provision treating partial liquidations and non-pro rata redemptions as extraordinary dividends is applicable only to such distributions declared after the date of enactment of the 1986 Act (October 22, 1986).