REPORT # 578

TAX SECTION

New York State Bar Association

Qualified Nonrecourse Financing --
Report on Selected Issues to be Addressed in Regulations

February 22, 1988

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TAX SECTION
New York State Bar Association

February 22, 1988

Report on Qualified Nonrecourse Financing

Dear Bill:

On behalf of the Tax Section of the New York State Bar Association, I enclose a report containing recommendations for regulations to be issued under Section 465(b)(6) of the Internal Revenue Code. Section 465(b)(6), which was added by the Tax Reform Act of 1986, provides an exception to the application of the at-risk rules of Section 465 in the case of “qualified nonrecourse financing” (or “QNF”) secured by real property. The recommendations are intended to clarify the application of the QNF exception to situations which appear to be within the intended scope of the provision, as described by the legislative history, and to prevent ambiguities in the statute from unnecessarily impeding legitimate transactions while remaining faithful to the purpose of the Congress in providing this limited exception to the at-risk rules.

The report was drafted principally by Ronald A. Morris, Joseph Lipari, David E. Kahen and William B. Brannen.

Specifically, the report makes recommendations as to (i) the application of the QNF exception to an enterprise which undertakes activities in addition to the holding of real property; (ii) the consequences of furnishing collateral in addition to real property to secure a financing; (iii) the treatment of a purchaser of real property subject to debt; (iv) the effect of borrowings consummated before or after the acquisition of real property; (v) various issues relating to persons qualified to be QNF lenders and to sales of loans; and (vi) the effect of guarantees by third parties.

Specific language is proposed to apply a look-through approach to special purpose financing vehicles and other conduit arrangements in determining whether loans are made by qualified persons.

We hope that the report proves useful to you.

Sincerely,

Herbert L. Camp
Chair

William Wilkins, Esq.,
Majority Staff Director and Chief Counsel,
Senate Finance Committee,
205 Dirksen Building,
Washington, D.C. 20510.

REPORT # 578

TAX SECTION
New York State Bar Association

February 22, 1988

<u>Report on Qualified Nonrecourse Financing</u>

Dear Mr. Leonard:

On behalf of the Tax Section of the New York State Bar Association, I enclose a report containing recommendations for regulations to be issued under Section 465(b)(6) of the Internal Revenue Code. Section 465(b)(6), which was added by the Tax Reform Act of 1986, provides an exception to the application of the at-risk rules of Section 465 in the case of “qualified nonrecourse financing” (or “QNF”) secured by real property. The recommendations are intended to clarify the application of the QNF exception to situations which appear to be within the intended scope of the provision, as described by the legislative history, and to prevent ambiguities in the statute from unnecessarily impeding legitimate transactions while remaining faithful to the purpose of the Congress in providing this limited exception to the at-risk rules.

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Sincerely,

Herbert L. Camp
Chair

Robert J. Leonard, Esq.,
Chief Counsel,
House Ways and Means Committee,
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Washington, D.C. 20515.

REPORT # 578

TAX SECTION

New York State Bar Association

February 22, 1988

Report on Qualified Nonrecourse Financing

Dear Randall:

On behalf of the Tax Section of the New York State Bar Association, I enclose a report containing recommendations for regulations to be issued under Section 465(b)(6) of the Internal Revenue Code. Section 465(b)(6), which was added by the Tax Reform Act of 1986, provides an exception to the application of the at-risk rules of Section 465 in the case of “qualified nonrecourse financing” (or “QNF”) secured by real property. The recommendations are intended to clarify the application of the QNF exception to situations which appear to be within the intended scope of the provision, as described by the legislative history, and to prevent ambiguities in the statute from unnecessarily impeding legitimate transactions while remaining faithful to the purpose of the Congress in providing this limited exception to the at-risk rules.

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We hope that the report proves useful to you.

Sincerely,

Herbert L. Camp
Chair

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Joint Committee on Taxation,
1010 Longworth House Office Bldg.,
Washington, D.C. 20515.

TAX SECTION

New York State Bar Association

February 22, 1988

Report on Qualified Nonrecourse Financing

Dear Larry:

On behalf of the Tax Section of the New York State Bar Association, I enclose a report containing recommendations for regulations to be issued under Section 465(b)(6) of the Internal Revenue Code. Section 465(b)(6), which was added by the Tax Reform Act of 1986, provides an exception to the application of the at-risk rules of Section 465 in the case of “qualified nonrecourse financing” (or “QNF”) secured by real property. The recommendations are intended to clarify the application of the QNF exception to situations which appear to be within the intended scope of the provision, as described by the legislative history, and to prevent ambiguities in the statute from unnecessarily impeding legitimate transactions while remaining faithful to the purpose of the Congress in providing this limited exception to the at-risk rules.

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Specific language is proposed to apply a look-through approach to special purpose financing vehicles and other conduit arrangements in determining whether loans are made by qualified persons.

We hope that the report proves useful to you.

Sincerely,

Herbert L. Camp
Chair

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REPORT # 578

TAX SECTION
New York State Bar Association

February 22, 1988

Report on Qualified Nonrecourse Financing

Dear Don:

On behalf of the Tax Section of the New York State Bar Association, I enclose a report containing recommendations for regulations to be issued under Section 465(b)(6) of the Internal Revenue Code. Section 465(b)(6), which was added by the Tax Reform Act of 1986, provides an exception to the application of the at-risk rules of Section 465 in the case of “qualified nonrecourse financing” (or “QNF”) secured by real property. The recommendations are intended to clarify the application of the QNF exception to situations which appear to be within the intended scope of the provision, as described by the legislative history, and to prevent ambiguities in the statute from unnecessarily impeding legitimate transactions while remaining faithful to the purpose of the Congress in providing this limited exception to the at-risk rules.

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Specific language is proposed to apply a look-through approach to special purpose financing vehicles and other conduit arrangements in determining whether loans are made by qualified persons.

We hope that the report proves useful to you.

Sincerely,

Herbert L. Camp
Chair

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Tax Report #578

Qualified Nonrecourse Financing --
Report on Selected Issues to be Addressed in Regulations

New York State Bar Association
Tax Section

February 22, 1988

Qualified Nonrecourse Financing --

Report on Selected Issues to be Addressed in Regulations

This Report* contains recommendations as to regulations to be issued regarding the exception for qualified nonrecourse financing ("QNF") under the at-risk rules of section 465 of the Internal Revenue Code of 1986 (the "Code").

Summary of Recommendations

The Committee recommends as follows:

1. Borrowers should be considered at risk for at least a portion of amounts borrowed with respect to an enterprise which includes activities in addition to the holding of real property; such financing should be allocated between the real property and the other activities in accordance with the method described below (in Section A); and the portion of the financing allocated to the real property should qualify as QNF.

2. The furnishing of collateral in addition to real property to secure a financing should not affect the qualification of the financing as QNF if the additional collateral is incidental to the real property; the regulations should also address the consequences where collateral not

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* This Report was prepared by the Committee on Income from Real Property, Sherwin Kamin and Ronald A. Morris, Co-Chairmen. The Report was drafted principally by Ronald A. Morris, Joseph Lipari, David E. Kahen, and William B. Brannan. Helpful comments were received from William L. Burke, Herbert L. Camp, William M. Colby, Jill E. Darrow, John Delaney, Arthur A. Feder, Donald Schapiro, and Michael L. Schler.

incidental to the real property is pledged to the lender, and might require an allocation of the financing under one of the methods described below (in Section B).

3. A purchaser of property subject to debt should be able to treat the debt as QNF even though the purchaser is not the original borrower, if the QNF tests are met with respect to the original borrower and each successive transferee (as provided in the legislative history), or otherwise if the loan would have constituted QNF if made directly to the purchaser <u>and</u> such person has equity in the acquired property of not less than 20 percent of his acquisition cost.

4. Financing not exceeding a taxpayer's original investment in real property which secures the debt should qualify as QNF without regard to whether it is incurred at the time of acquisition of the real property and without regard to the use of the proceeds of the financing.

5. As to the identity of the lender:

a. Certain clarifications are suggested regarding the requirement that lenders be actively and regularly engaged in the business of lending money. Specific language is proposed to apply a look-through approach to special purpose financing vehicles and other conduit arrangements, under which the question of whether loans were made by qualified persons will be resolved by reference to the status of the ultimate lenders rather than that of the intermediary.

b. The status of a loan as QNF should not be affected by a sale of the loan after it is made, other than a sale made pursuant to a contract in effect at the time the loan is made (or, perhaps, a sale made or contracted for within a short period -- such as one week -- thereafter).

c. A safe harbor rule regarding interest rates (based on the APR used elsewhere in the Code) is proposed with regard to the exception for commercially reasonable financing to the general proscription against financing from related persons.

6. Guarantees or other forms of personal liability of third parties should not affect the status of a loan as QNF where the third party is actively and regularly engaged in the business of lending money and a loan from the third party would otherwise qualify as QNF; clarifications are proposed regarding the effect on QNP status of a borrower's personal liability and of partial or contingent personal liability.

Introduction

Section 503 of the Tax Reform Act of 1986, Pub. L. No. 99-514 (the “1986 Act”), amended Code section 465(c)[1/]

[1/] Except as otherwise indicated, section references are to sections of the Internal Revenue Code of 1986.

to extend the application of the at-risk rules to the activity of holding real property. The 1986 Act also added paragraph (6) to section 465(b) to provide that a taxpayer engaged in the activity of holding real property would nonetheless be considered at risk to the extent of qualified nonrecourse financing {"QNF") secured by real property used in the activity. This report discusses selected issues concerning the application of this new provision, with particular attention to issues which may be resolved through regulations.

Many of the issues under section 465(b)(6) arise in the context of recently developed financing techniques. The language of the statute is directed toward what could be called traditional mortgage sources, that is, single mortgage loans from banks or insurance companies. Due to significant structural changes in the credit markets in recent years, the types and sources of mortgage financing have expanded greatly to encompass features of the corporate securities markets. Although these credit markets offer owners of real estate substantial economic benefits through greater access to investment capital and, accordingly, lower interest rates, uncertainties regarding the application of the section 465(b)(6) exception to the at-risk rules have forced some taxpayers to forego these economic benefits to avoid the possibility that the at-risk rules will limit their utilization of losses.

The recommendations made in this Report reflect what appears to be the legislative intent underlying the QNF exception to the at-risk rules: to permit a taxpayer to deduct losses in excess of the amounts for which he would otherwise be regarded as being at risk, where the circumstances suggest (i) that deductions have not been inflated as a result of an overvaluation of the real property used in the activity and (ii) that the taxpayer is likely to have or can reasonably be expected to acquire "real equity" in the activity.[2/]

Discussion

A. Activity of Holding Real Property

The QNF rules apply only "in the case of an activity of holding real property" (I.R.C. §465(b)(6)(A)) and only to financing "borrowed . . . with respect to the activity of holding real property" (I.R.C. §465(b)(6)(B)(i)). The activity of holding real property is defined in section 465(b)(6)(E) as including "the holding of personal property and the providing of services which are incidental to making real property available as living accommodations," but as not including the holding of mineral property. These inclusions and exclusions mirror similar language in the exclusion of the activity of holding real property from the

[2/] See H.R. Rep. No. 426, 99th Cong., 1st Sess. 293 (1985) (the "1986 Act House Report"); S. Rep. No. 313, 99th Cong., 2d Sess. 748 (1986) (the "1986 Act Senate Report**).

at-risk limitation under prior law,[3/] which language was intended to prevent application of the at-risk limitation to losses from the ownership and operation of a hotel or motel or the renting of furnished apartments.[4/]

Questions may be raised as to the consequences of an activity that involves not only the holding of real property but also the use of other assets or the provision of services not described in the language of section 465(b)(6)(E) quoted above -- e.g., the operation of a restaurant (other than in connection with the provision of living accommodations, such as in the hotel context) in a building acquired by the restaurateur. Prior to 1986, section 465(c)(3)(D) specifically provided that any holding of real property would be treated as a separate activity, with the result that losses from that activity would not be limited by the at-risk rules. The House Committee Report pertaining to the 1978 amendments, which extended the application of the at-risk limitation to all activities other than the holding of real property,[5/] suggested computing the loss allocable

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[3/] See also H.R. Rep. No. 841, 99th Cong., 2d Sess. II-136 (1986) ("1986 Act Conference Report"): "[T]o the extent an activity is not subject to the at-risk rules by virtue of sec. 465(c)(3)(D)) [sic] of present law, it will be treated under the conference agreement as the activity of holding real property."

[4/] H.R. Rep. No. 1445, 95th Cong., 2d Sess. 70 (1978).

[5/] This activity was defined, as noted above, to include the holding of personal property and the provision of services incidental to making real property available as living accommodations, e.g., the operation of a hotel.

to real property by allocating the income or loss from the overall activity based on the proportion of the deductions from the activity attributable to the real property, or by assuming that income from the real property equals the fair rental value thereof (so that the loss attributable to the real property, if any, would be equal to the excess of the deductions attributable to the real property over its rental value).[6]

No similar language regarding the segregation of income or loss attributable to real estate which is used as part of a broader activity appears in section 465(b)(6), but there is also no indication in the 1986 statute or legislative history that a different result was intended. Nor is there any apparent policy reason to prevent borrowers from being at risk as to a portion of a financing which otherwise qualifies as QNF and which is allocable (in some reasonable way) in part to the acquisition or carrying of real property and in part to other purposes. Accordingly, regulations should provide that borrowers will be at risk for at least a portion of QNP borrowed with respect to an enterprise which includes activities in addition to the holding of real property, and should also set forth permissible methods of allocation, such as the methods suggested in the 1978 House Report, discussed above.

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[6] H.R. Rep. No. 1445, supra, at 70-71.

B. Secured by Real Property

The final phrase of section 465(b)(6)(A) provides that a taxpayer will be treated as at risk with respect to its share of QNF “which is secured by real property used in [the activity of holding real property].” Questions may arise as to financing which is secured not only by real property but also by other property. Such additional security falls into two categories. First, a lender may ask for security interests in assets related to the real estate, such as through assignments of rents, condemnation proceeds, and casualty claims, and (through UCC security filings) in personal property used in connection with the operation of the real estate. Second, a lender may seek additional credit support such as pledges of other assets by the borrower,[7] or guarantees by the borrower or a third party. (Other issues raised by the existence of guarantees are discussed in Section C(4) below.)

In this regard, it must be recognized that lenders, by the nature of their interest in a transaction, attempt to get as much security as their borrowers are willing to give in order to limit their risk. Borrowers are frequently willing to go along

[7] A pledge of assets not used in the activity by the borrower to secure a nonrecourse loan will generally increase the borrower's amount at risk even if the QNF provision does not apply to that loan. See I.R.C. §465 (b)(2)(B); but see I.R.C. §465(b)(3) (regarding certain borrowings from related persons).

with such requests since granting lenders additional security generally does not cost borrowers anything aside from a possible diminution in their ability to secure other loans. Accordingly, collateral in addition to real property is often furnished in situations in which the real property by itself is worth significantly more than the amount of the loan, and the borrower, therefore, has substantial equity in the venture.

Since the statute does not require by its terms that QNP be secured only by real property, it does not appear that providing additional collateral would preclude the application of the QNF exception to any part of the financing. Where the additional collateral consists of property incidental to the real property, such as furnishings, an assignment of rents, or a pledge of stock or a partnership interest in an entity whose sole asset is the real property,[8/] the additional collateral should be ignored for this purpose.

Where, however, the additional collateral includes property not incidental to the real property, it is unclear whether and to what extent the QNP exception may be applicable. Arguments may be made for each of the following approaches:

1. That the QNF exception not apply to any part of a financing secured by additional collateral (other than collateral incidental to the real property). This rule has the advantages of simplicity and ease of administration, but would lead to harsh results in situations where all or a part of the financing could have been borrowed against the real property alone. One practical problem that could arise in connection with this rule might

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[8/] If the entity holds assets in addition to the real property, allocation questions would arise similar to those discussed in the text following this note.

perhaps be eased by providing that, where a portion of the debt can be satisfied only from the real property in the event of a foreclosure, the QNF exception could apply to that portion of the loan, as it might if that portion had been structured as a separate loan.

2. That debt secured by additional collateral should be allocated first to such additional property, to the extent of the value of the additional collateral at the time the loan is made;[9/] the balance of the debt (if any) would be treated as secured by real property. This rule would produce a fairer result than the rule stated above where the bulk of the value of the collateral is attributable to the real property. It would, however, require valuation of the additional collateral, but that requirement should not present great difficulty in the many cases in which the additional collateral will consist of certificates of deposit, marketable securities, or other property of readily ascertainable value.

3. That debt secured by additional collateral should be allocated in accordance with the relative values of the real property and the additional collateral. While this may be, in concept, the “correct” means of allocating the debt, one possible consequence of the adoption of this rule could be that the overvaluation of property to procure tax advantages, which is one of the abuses at which the at-risk rules are aimed,[10/] could become the means of avoiding the full impact of those rules.

[9/] The borrower may be at risk with respect to debt so allocated under other provisions of section 465, e.g., section 465(b)(2)(B) (relating to pledges of property not used in the activity).

[10/] See, e.g., H.R. Rep. No. 432, 98th Cong., 2d Sess. 1509 (1984).

4. That the entire amount of a financing should be allocated to the real property component of the collateral to the extent of the value of the real property or a specified percentage (e.g., 80%) of that value, on the rationale that the borrower could have borrowed that amount on a nonrecourse basis secured solely by the real property; the borrower, therefore, should be able to take advantage of the QNF exception to that extent. This, however, attaches even greater importance to the value of the real property, and the over-valuation concern described above would militate even more strongly against this approach.

A related question is whether the personal liability of a third party, if permitted by regulations with respect to QNF (see section 465(b)(6)(B)(iii) and the discussion in Section C(4) below), should be treated as additional collateral, and taken into account in determining whether and to what extent the financing is "secured by real property" for purposes of section 465(b)(6)(A). The proper answer appears to be that personal liability of a third party, in the form of a guarantee, a letter of credit, or otherwise, should be treated for this purpose as incidental to the real property where the sole recourse of the third party in the event of a default by the borrower is to a security interest in the real property (e.g., a letter of credit issued by a bank in exchange for a nonrecourse mortgage on real property). Other types of guarantees should be taken into account under one of the approaches described above.

Accordingly, regulations should provide that where collateral in addition to real property is pledged to the lender, the amount for which the taxpayer is considered at risk with respect to such debt under section 465(b)(6) will be the entire amount of the loan, if the additional collateral consists solely of property incidental to the activity of holding real property or treated as incidental to the activity of holding real property, with respect to other situations the regulations should adopt one (or some combination) of the alternatives described above, with the goal being a practicable rule that is not prone to abuse but that also does not present traps for the unwary or unnecessarily impede ordinary financing practices.

C. Definition of QNF

Qualified nonrecourse financing is defined in section 465(b)(6)(3) as financing (i) borrowed by the taxpayer with respect to the activity of holding real property, (ii) borrowed from a qualified person or a Federal, State, or local government or instrumentality thereof, or guaranteed by any such government, (iii) with respect to which no person is personally liable (except to the extent provided in regulations), and (iv) which is not convertible debt. Various issues raised by requirements (i) through (iii) are discussed below.

1. Borrowed by the Taxpayer

Questions as to the satisfaction of the QNF requirements are likely to arise in connection with sales or other transfers of real property where the transferee will receive the property subject to an existing debt. Under a literal reading of the statute such debt appears not to qualify because it was not "borrowed" by the transferee. The House and Senate Reports to the 1986 Act state, however, that nonrecourse debt which constituted QNF in the hands of the original borrower may constitute QNF as to the transferee if all the criteria for QNF are satisfied with respect to the transferee, and as to subsequent transferees if the debt was QNF with respect to each preceding owner.[11/]

Limiting QNF treatment to debt which satisfies the QNF requirements both as to the transferee and as to each prior owner could make it difficult for a purchaser of property subject to debt to be confident that section 465(b)(6) applies to that debt. In many cases the purchaser of the property will not be able to assure himself that he has enough information concerning the existing debt for the period prior to his purchase to conclude with sufficient certainty that the debt was QNF with respect to all prior owners.[12/] Consequently, such a purchaser may be forced to arrange for new financing to replace the existing financing for no reason other than to assure himself that the debt is QNF.

The legislative history does not proscribe adoption through regulations of a more generous rule to the effect

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[11/] 1986 Act House Report, at 294; 1986 Act Senate Report, at 750.

[12/] A related question is whether a borrowing which constituted QNF at the time the debt was incurred may be disqualified later even without a transfer of the property, for example because of a sale of the debt obligation by the lender (see discussion in Section C(3)(ii), below).

that a loan taken "subject to" by a transferee of the property will constitute QNF if that loan would have so qualified if made directly to the transferee at the time of the transfer, and it is not apparent what perceived abuse (if any) was intended to be foreclosed through the narrower rule stated in the House and Senate Reports,

It is conceivable, however, that abuses could arise if the QNF status of the financing with respect to the original borrower or subsequent transferees is ignored, for example, in the context of a loan made by an unqualified person (e.g., a seller or a person related to the borrower) which is later taken "subject to" by a transferee of the property as to whom the lender constitutes a qualified person. Any abuse seems unlikely, however, in situations where the transferee has substantial equity in the property transferred, such as where the transferee would meet the 20 percent equity requirement contained in the definition of "qualified commercial financing" in the investment credit at-risk rules.[13]

Accordingly, we recommend that regulations adopt the rule regarding transferees which is stated in the Committee Reports cited above, and provide in addition that a taxpayer who cannot establish that a debt taken "subject to" was QNF as to the original borrower and each transferee preceding

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[13] I.R.C. 346(c)(8)(D)(ii)(II).

the taxpayer may nonetheless treat the debt as QNF if it would have so qualified if made directly to the taxpayer at the time of its acquisition <u>and</u> the taxpayer's equity in the real property is not less than 20% of the consideration paid (including any debts assumed or taken subject to).

Other problems may arise where the money borrowed is to be distributed or otherwise transferred by the borrower to a shareholder or related entity for use in the activity. Some of the issues are described in the discussion in Section C(3)(i)(<u>B</u>) below of "securitized financings" employing special purpose financing vehicles.

2. <u>Borrowed with Respect to the Activity of Holding Real Property</u>

One basic question is whether financing secured by real property will necessarily be regarded as QNF increasing the borrower's amount at risk where the proceeds are used for purposes unrelated to the activity of holding real property, or to replace other financing the proceeds of which were used for other purposes. The requirement in section 465(b)(6)(B)(i) that QNF be borrowed "with respect to" the activity of holding real property could be read to mean that the proceeds of the financing must be used in the activity in which the real property is being used, since the requirement that the financing be secured by property used in the activity is separately stated in section 465(b)(6)(A), This clause, however, may simply have been picked up from the definition of the analogous concept of qualified commercial financing in the investment credit at-risk rules without much thought as to its meaning (if any) in the context of section 465(b)(6); and the better analysis appears to be that the use of the proceeds of the financing should not be relevant, particularly since a contrary rule would establish an unjustified distinction between taxpayers who arrange for financing in order to acquire property and others who purchase property for cash and then “borrow out” a portion of their equity.

On the other hand, if the timing of a loan and the use of proceeds are irrelevant to a determination of QNF status, taxpayers would be able to increase their amounts at risk with respect to appreciated real property to amounts exceeding their investment in the property. While an activity will almost never be able to generate losses in excess of the basis of the assets used in that activity, there may be reason to be concerned about manipulation through the aggregation of activities: for example, a partnership might be able to increase its partners' amounts at risk with respect to certain real estate properties by arranging for QNF with respect to others. This concern may be dealt with by limiting amounts at risk under section 465(b)(6) to the taxpayer's investment in the property securing the QNF (including the acquisition cost and the cost of improvements made after the initial acquisition).

Accordingly, regulations should permit financing to qualify as QNF without regard to whether the financing was incurred at the time the property was acquired and without regard to the use of the proceeds, but the taxpayer's amount at risk under section 465(b)(6) should be limited to its original investment (including improvements) in the property securing the QNF.

Another problem in construing the “with respect to” requirement arises in the common situation in which permanent financing must be drawn down before the funds are needed in the activity and is invested in (and secured by) certificates of deposit or other temporary investments until the funds are expended in the project. For example, a purchaser of property may be required, in order to lock in a favorable interest rate, to draw down a loan before the seller of the property is ready to close the sale; or a loan commitment for permanent financing which is arranged to pay off a construction loan may require the borrower to draw down the loan before all or a portion of the construction is completed and to place some or all of the funds in escrow until the building is complete (the portion of such funds needed to pay for tenant improvements may not be spent for years, depending upon how quickly the building is leased).

The taxpayer in these situations would probably not be at risk with respect to such borrowing until the funds are utilized, since until such time the permanent loan would be secured primarily by the certificates of deposit or other temporary investments rather than by the real property, Even if the proposal made earlier in this section to disregard the timing of a financing or the use of proceeds is not adopted, however, regulations should clarify that the intervening temporary investment of the funds will not affect the determination of QNF status at such time as the funds begin to be used directly in the real property activity.

3. Identity of Lender

To qualify as QNF a financing must be borrowed from a “qualified” person or from any Federal, State, or local government or instrumentality thereof, or be guaranteed by any such government. Section 465(b)(6)(D) defines qualified persons as having the meaning set forth in section 46(c)(8)(D)(iv), concerning the investment credit at-risk rules, except that notwithstanding subclause (I) of that definition a lender related to the borrower may constitute a qualified person if the loan is “commercially reasonable and on substantially the same terms as loans involving unrelated persons.” The discussion below focuses on three issues: (i) the definition of qualified persons under the investment credit at-risk rules, (ii) the application of the qualified person requirement to debt sold by the original lender and to subsequent transferees of such debt, and (iii) the types of financing from related persons which should qualify under the “commercially reasonable” exception.

i. Definition of qualified person

(A) In general

Under the investment credit at-risk provision to which section 465(b)(6) makes reference, a qualified person must be "actively and regularly engaged in the business of lending money." In addition, the lender cannot be a person related to the borrower, a person from whom the borrower acquired the property, or a person who receives a fee with respect to the borrower's investment in the property.[14/]

Analysis of 1986 and earlier legislative history concerning the definition of qualified lenders suggests that the "actively and regularly engaged" requirement should be given a more liberal interpretation than a literal reading of the provision would suggest. The "qualified person" definition as first described in the committee reports per- training to the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34 ("ERTA") included only banks, savings and loan associations, credit unions, and insurance companies regulated under Federal, State or local law,[15/]

14/ I.R.C. §46(c)(8)(D)(iv). The lender also cannot be related to the person from whom the property was acquired or to any person who received a fee with respect to the taxpayer's investment in the property. For purposes of these requirements related persons are defined by reference to section 465(b)(3)(C) and include, for example, family members and greater-than-10% partners and shareholders.

15/ *See* S. Rep. No. 144, 97th Cong., 1st Sess. 66 (1981).

but was then modified before enactment to include as qualified lenders pension trusts and other persons “actively and regularly engaged in the business of lending money,”[16/] The references to specific categories of lenders were deleted in 1984 as part of a broad revision and simplification of the investment credit at-risk rules in an effort to make them more workable. In light of the nature of the changes in that year and since there is no indication in the 1984 legislative history of any intention to narrow the qualified person definition, it seems probable that any lender which was qualified under the 1981 legislation remained qualified after 1984 even if it was neither an “active” nor a “regular” lender in the ordinary sense of these terms. The 1986 Act Senate Report confirms this reading through the statement that qualified persons “generally would include, for example, a bank, savings and loan association, credit union, or insurance company regulated under Federal, State, or local law, or a pension trust.”[17/]

The foregoing suggests at a minimum that regulations should define qualified persons to include most or all of the specific categories of lenders listed in the legislative history without requiring further inquiry as to whether such entity has been “actively and regularly engaged in the business of lending money,” and also suggests that a liberal interpretation of this phrase should be promulgated (with respect to persons not in the categories listed above) that is consistent with the overall

16/ ERTA §211(f)(1); see also H.R. Rep. No. 215, 97th Cong., 1st Sess. 215 (1981).

17/ 1986 Act Senate Report, at 749. The House and Senate Reports to the 1986 Act both indicate that the exception for QNF is based upon the exception for qualified commercial financing in the investment credit at-risk rules which in turn contain the definition of qualified persons to which section 465(b)(6) makes reference. 1986 Act House Report, at 294; 1986 Act Senate Report, at 749.

legislative intent to limit deductions arising from an overvaluation of property without impeding the use of arm's-length commercial financing.[18/] Thus, a newly formed or previously inactive subsidiary of a bank, insurance company, pension fund, or other person actively and regularly engaged in the business of lending money should be a qualified lender.[19/] In addition, some sort of safe-harbor definition would be helpful to establish how "active" and "regular" a person not in the specific categories enumerated above must be to constitute a qualified lender, e.g., by reference to the number of loans made in a specified period and to the degree of involvement in the making of loans.

Other open questions include whether qualified persons include lenders which have heretofore made loans (e.g., consumer finance loans) of a type different from the contemplated QNF loan, or which make loans as an incident to their primary business -- e.g., the sale of goods on open account or, perhaps, margin loans made by a stock brokerage firm. Some guidance might be derived from Q&A-2 in Temporary Regulation

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18/ See 1986 Act House Report, at 293.

19/ A related question is whether a REMIC, which almost by definition has no business history prior to its acquisition of loans, may be a "qualified person." Under the literal terms of the statute it appears that such entities could not qualify except, perhaps, to the extent a rule of the type described in text applied; but the House Ways and Means Committee Report (included in H.R. Rep. No. 391, 100th Cong., 1st Sess. (1987)) on Title X of the Omnibus Budget Reconciliation Bill of 1987 (H.R. 3545), as passed by the House on October 29, 1987, states (at 1169): "The committee wishes to clarify that a mortgage fund in which any class of beneficial interest is registered with the Securities and Exchange Commission shall be a person which is considered for this purpose as actively and regularly engaged in the business of lending money." Identical language appears in the Senate Finance Committee Report on revenue provisions of the Omnibus Budget Reconciliation Act of 1987 (see RIA reprint dated November 5, 1987, at 271).

section 1.133-1T, which construes the term “actively engaged in the business of lending money” in section 133(a)(3) (relating to ESOPs) as requiring that loans be made to the public on a regular and continuing basis and other than in connection with the purchase of goods and services from the lender or related party. Greater precision would be desirable, however, in defining the meaning of “regularly” engaged for purposes of the at-risk rules. In addition, it should be clarified that foreign banks, insurance companies, and pension trusts will be qualified lenders if actively and regularly engaged in the business of lending money, thereby overriding any negative inference that might arise (concerning whether those entities could be qualified lenders) because of references in the legislative history regarding qualified persons and in the ERTA definition of qualified persons to banks, insurers, and pension trusts organized under or regulated by Federal, State, or local law.

Clarification is also needed regarding the requirement in section 46(c)(8)(D)(iv)(III) that a qualified lender (or a person related to the lender) not receive a fee with respect to the borrower’s investment in the property. Loan commitment fees, processing fees, inspection fees, and the like, are routinely paid to obtain financing which, in a broad sense, is related to the borrower's purchase or other investment in real property. Since this restriction appears to have been aimed at promoter financing,[20/] regulations should clarify that a lender (or a person related to the lender) may receive the types of fees which are typically paid in financing transactions

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[20/] See S. Rep. No. 97-144, supra, at 66; H.R. Rep. No. 432, at 1510.

(B) "Securitized" Financings

It may also be appropriate to recognize in regulations that developments in the credit markets have significantly altered the sources of funds for mortgage loans. Until recently, mortgage loans were made almost entirely by financial institutions such as those described in the legislative history to ERTA. The former structure of the credit markets may be described in simplified terms as follows: the public would deposit or invest its funds with financial institutions and those institutions would, in turn, relend those funds to borrowers.

Over the past few years, the credit markets have changed substantially; this development is referred to colloquially as the "securitization" of real estate financing, meaning that mortgage debt instruments are designed so that they can be issued and sold to small institutions or the public in the same manner as corporate stock and debentures. Financial institutions are acting less as lenders in the traditional sense, and more like brokers who bring together those who wish to borrow funds and those able to lend.

The rationale for the requirement that QNF be borrowed from qualified persons appears to be that those lenders are unlikely to make a loan without first determining that the real property offered as security is not overvalued.[21/] It would be consistent with this rationale to provide that loans issued to the public which are placed by an entity, such as an investment bank, that is actively and regularly engaged in the business of placing such loans will be treated as having been made by a

[21/] See, e.g., 1986 Act House Report, at 293 ("In the case of arm's length third party commercial financing . . . the lender is much less likely to make loans which exceed the property's value or which cannot be serviced by the property. . . .").

qualified person. Such an approach would also be consistent with the encouragement Congress has sought to give to the securitization of mortgage-backed obligations, for example, by approving the creation of REMICs.

If it is concluded that a financing placed by a financial institution with persons who do not themselves satisfy the requirements of “qualified persons” cannot constitute QNF, regulations should provide that, at a minimum, the borrower may treat the portion of the financing funded by each person as a separate loan for purposes of section 465, and therefore is at risk to the extent the loans are placed by the financial institution with qualified persons. Under that approach a taxpayer could insist that at least a certain percentage of the loans be placed with qualified persons in order to give the taxpayer a sufficient amount at risk.

Another issue relates to the application of the qualified person test to securitized financings that employ special purpose financing vehicles. In many of these transactions a nominally capitalized corporation {or other entity) makes the mortgage loan to the borrower using the proceeds from the contemporaneous issuance of its own debt securities to investors. Such securities are nonrecourse debt obligations that have substantially the same terms as the underlying mortgage note and are secured by the underlying mortgage note (in some cases there is third party credit support as well). The special purpose corporation generally has no business activity other than receiving payments from the ultimate borrower on the mortgage debt and remitting them to its own lenders. This type of structure is used for various business reasons, including, where the ultimate borrower is not a corporation, to satisfy a general investor preference for corporate debt and to avoid legal restrictions on the ability of insurance companies, savings and loan associations, and certain other entities to invest in the debt of noncorporate issuers.

Obviously the special purpose corporation itself is not actively and regularly engaged in the business of lending money and, consequently, cannot be a “qualified person.” However, the ultimate lenders often are. It is not clear under existing authority whether the qualified person test should be applied by looking through the special purpose funding corporation to the ultimate lenders.

The role of the special purpose funding corporation probably could be disregarded, since in some cases it functions as a mere conduit for the ultimate lenders and has no economic substance,[22/] Under such substance over form characterization, the ultimate lenders would be viewed as making the mortgage loan directly to the ultimate borrower. Alternatively, the special purpose corporation arguably could be viewed as functioning as a nominee or agent for the ultimate lenders, holding and administering the underlying mortgage debt for their benefit.[23/]

[22/] Cf. Aiken Industries, Inc. v. Commissioner, 56 T.C. 925 (1971), acq. on another issue, 1972-2 C.B. 1, and Rev. Rul. 84-153, 1984-2 C.B. 383(both disregarding a conduit financing corporation for tax treaty purposes).

[23/] See, e.g., Bollinger v. Commissioner, 807 F.2d 65 (6th Cir. 1986), cert, granted, 107 S. Ct. 3183 (1987); Ourisman v. Commissioner, 760 F.2d 541 (4th Cir. 1985); and Roccaforte v. Commissioner, 708 F.2d 986 (5th Cir. 1983), reh’g denied, 715 F.2d 577. It is possible to view the nominee issue as being whether the special purpose corporation is the nominee of the borrower. In that case, the special purpose corporation might not be regarded as a nominee, at least where the borrower owns the special purpose corporation.

Aside from these technical arguments, there are sound policy reasons why the qualified person test should be applied by looking through any such special purpose funding corporation. First, the substance of these transactions clearly is that the ultimate lenders are the true lenders, since the special purpose corporation has no significant assets other than the underlying mortgage note. The lenders to a special purpose corporation police a securitized financing transaction the same way that they would if they were making a mortgage loan directly to the ultimate borrower. Hence, a look-through rule would not appear to involve any potential for abuse. Second, if the look-through approach were not adopted, it is possible that the qualified person test could be manipulated by using a bank, insurance company, or other qualified person instead of a special purpose corporation as the middle party. In that event, the underlying mortgage debt superficially would satisfy the qualified person test based upon the qualified person status of the middle party, even if the ultimate lenders were not qualified persons.[24/] (This type of transaction presumably would be feasible as a business matter because the debt securities would be nonrecourse obligations secured only by the underlying mortgage note, which would create no risk to the other assets of the middle party.)

In view of these considerations, we recommend that the Treasury Department issue regulations making clear that special purpose funding corporations should be looked through for these purposes (even if not generally) and the qualified person test applied by reference to the status of the ultimate

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24/ Under these facts, however, the IRS and the courts would, under general tax principles, likely disregard the status of the middle party. See generally Rev. Rul. 87-89, 1987-37 I.R.B. 16, and authorities cited therein.

lenders.[25] Due to the particular importance of this issue, we suggest the following language to accomplish this purpose:

> "If the taxpayer borrows from a corporation (or other entity) that (i) contemporaneously issues its own debt obligations that are on substantially the same terms as the mortgage note of the taxpayer and are secured by such mortgage note and (ii) has no substantial business purpose in holding such mortgage note other than to act as a conduit for the holders of such debt obligations, then the qualified person test shall be applied by looking through the corporation (or other entity) and treating the holders of its debt obligations as owning directly their proportionate interest in the underlying mortgage note of the taxpayer."

This rule would permit commercially reasonable securitized financings to qualify as QNF without contravening the policy behind section 465(b)(6) or producing any difficult line-drawing problems in practice.

ii. Sales of loans

Regulations must also describe the effect, if any, on QNF status if the lender of a loan which qualifies as QNF sells or otherwise disposes of the loan, tinder the investment credit rules financing borrowed from a qualified person remains "qualified commercial financing" notwithstanding a transfer of the loan (or entering into an agreement to do so) more than one year after the financing was made; by implication, a transfer within one year to a nonqualified lender will cause

25 If this rule is not adopted, an alternative route which taxpayers might use to avoid the qualified lender issue would be to organize the special purpose corporation as a subsidiary of the ultimate borrower, and to liquidate the corporation after the loan is made and distribute the proceeds. However, this alternative would raise the issue discussed in Section C(1) above as to whether the requirement in section 465 (b)(6)(B)(i) that the financing be borrowed by the taxpayer has been met. Where the special purpose corporation is liquidated immediately after the loan is made, its existence should be ignored as transitory and the QNF status of the loan determined by treating the financing as having been borrowed by the distribute.

the amount of the loan so transferred to become nonqualified nonrecourse financing.[26] There is no comparable provision in section 465(b)(6), and that provision may therefore be construed either as permitting a financing which was QNF when made to remain QNF without regard to a transfer of the loan soon thereafter, as requiring disqualification as QNF where the financing is transferred to a person other than a qualified lender at any time after the financing is made, or as adopting the investment credit rule regarding transfers of loans because of the reference in section 465(b)(6) to the investment credit definition of qualified persons.

There does not appear to be any compelling reason to require a lender to retain a loan for one year (or to restrict its disposition to qualified lenders only) in order for a loan to remain QNF. Such a requirement would impede the need of many lending institutions to maintain liquidity, would create an unwarranted obstacle to the current trend of securitizing mortgage-backed loans which Congress has sought to encourage in other respects, and may unjustifiably penalize the borrower where a transfer of the loan occurs for reasons beyond the control of either the borrower or the lender, such as because of a reorganization arising from a subsequent insolvency of the lender. Moreover, a borrower is likely to encounter great difficulty, for reasons described above and others, in obtaining the agreement of his lender not to assign the loan, or to assign it only to a qualified person; and may also, in the context of securitized financings, encounter difficulty in ascertaining the holder of the loan at any particular date.

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[26] I.R.C. §47(d)(2); see S. Rep. No. 97-144, supra, at 67. A similar issue may arise in connection with the application of section 881(c)(3)(A), concerning the bank exception to the repeal of the tax on portfolio interest received by foreign corporations.

Accordingly, regulations should provide that where a loan otherwise qualifying as QNF is made by a qualified person which has not entered into an agreement to dispose of the loan at the time it is made (and, perhaps, has not transferred or agreed to transfer the loan within a short period, such as one week, thereafter) to anyone other than a qualified person, subsequent transfers of the loan or interests therein will not affect its QNF status,

iii. Commercially Reasonable Financing

In order to permit QNF to be originated by institutional lenders that are prepared to finance the purchase or development of real property only in conjunction with the acquisition of a substantial equity interest in the operation and/or appreciation of the property,[27/] section 465(b)(6)(D)(ii) allows a lender which is a "related person" with respect to the borrower to be a qualified person where the financing is "commercially reasonable and on substantially the same terms as loans involving unrelated persons." The 1986 Act Conference Report discusses at some length the meaning of commercially reasonable financing,[28/] but does not provide a clear and definite means of determining whether the interest rate of a loan (let alone its other terms) is commercially reasonable. In light of the potentially disastrous consequences to the borrower of a failure of the loan to qualify as commercially reasonable financing, regulations should provide a safe harbor, such as a presumption that loans bearing an interest rate which is within a range of interest rates based on the applicable Federal rate (see I.R.C. §1274(d)) have been made on commercially

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[27/] See 1986 Act Senate Report, at 748.

[28/] Act Conference Report, at II-135.

reasonable terms.[29/] If such a safe harbor is provided, the range of interest rates should be broad (since second mortgages and certain other types of loans may be made at commercially reasonable rates which are substantially higher than the AFR) and it must be made clear that the safe harbor is not exclusive, so that financing at rates outside the safe harbor range may nonetheless qualify as commercially reasonable.

4. Personal Liability for Repayment

Except to the extent that regulations provide otherwise, QNF does not include any financing with respect to which any person is personally liable.[30/] The purpose of this requirement appears to be to prevent the borrower from being treated as at risk with respect to amounts borrowed which exceed the value of the real property used in the activity (e.g., on the basis of a promoter's guarantee); but this provision may also prevent financing from constituting QNF in common business situations which do not appear to present any threat of abuse of the type to which the at-risk rules are directed. For example, we understand that Japanese banks prefer not to make mortgage loans directly but rather to provide a letter of credit to a borrower in exchange for a mortgage on the real property: the borrower may then use the letter of credit to borrow funds through a debt offering to the public.

[29/] The appropriateness of a safe harbor test based on the AFR is suggested by a statement in the 1986 Act Conference Report in regard to interest rates which will be considered commercially reasonable, to the effect that a loan which would be a “below-market loan” under section 7872(e) is likely not to be commercially reasonable (id., at II-135); section 7872(e)(1) in turn defines below-market loans as including demand loans with interest payable at a rate less than the AFR.

[30/] I.R.C. §465 (b)(6)(B)(iii).

(In one case, it was explained that the preference of the Japanese banks to issue letters of credit rather than making the loans themselves arose from the different impact of these financing structures on Japanese credit maintenance requirements.) Similar questions may arise where a debt is secured directly or indirectly by an obligation of a third party.

To resolve these questions regulations should provide that, in general, personal liability of a third party for the repayment of a loan (including the furnishing of a letter of credit) will not prevent the loan from constituting QNF if a loan to the borrower from the third party would constitute QNF.

Loans for which the borrower itself is personally liable, either directly or through an indirect guarantee of the loan, probably should not constitute QNF, but regulations should generally provide for the inclusion in the borrower's amount at risk under section 465(b)(2) of amounts for which the borrower bears personal liability.[31/]

[31/] One question that would have to be resolved is the interplay between the QNF provision and section 465(b)(3). Specifically, a guarantee by the borrower of a loan from a related person which, if nonrecourse, would constitute QNF under the commercially reasonable financing rule, might cause the loan to be excluded from the borrower's amount at risk under section 465(b)(3), which provision prevents a partner from being at risk for recourse loans from other partners in connection with activities enumerated in section 465(c)(1) (see I.R.C. §465(c)(3)(D)) and, perhaps, in connection with other activities (see Rev. Rul. 80-327, 1980-2 C.B. 23; Proposed Reg. §1.465-8(a)). Resolution of this question depends on issues regarding the application of section 465(b)(3) which are beyond the scope of this Report.

A related question not resolved by the statute is whether financing as to only part of which some person is personally liable, or for which someone is initially personally liable but will cease to be liable under the terms of the financing before it is repaid, may constitute QNF to the extent that, or in the period during which, no person is personally liable. For example, it is a common feature of mortgage loans on newly constructed properties that the borrower provide credit support (either by guaranteeing a portion of the debt or by providing a third party guarantee) until sufficient leases have been entered into with tenants so that the building meets minimum debt coverage requirements, at which time the guarantees will expire. The IRS has already taken the position in the context of the allocation of liabilities to partners under section 752 that the recourse and nonrecourse portions of a loan may be separately allocated,[32] and a recent decision of the Tax Court[33] may provide support for a bifurcation approach in the at-risk context. Without regard to whether regulations approve of bifurcation in other contexts, the personal liability of a borrower for a portion of a financing otherwise qualifying as QNF should not prevent the nonrecourse portion from constituting QNF, since such arrangements do not appear to have any potential for abuse.

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[32] Rev. Rul. 84-118, 1984-2 C.B. 120. It has been suggested that, in general, such loans may be bifurcated and the nonrecourse portion qualify as QNF, but the Committee has not resolved this question because of the potential for abuse in certain situations and because its resolution raises issues beyond the scope of this Report.

[33] Follender v. Commissioner, 89 T.C. No. 66 (1987) (taxpayer held at risk to extent of principal amount of partnership debt, with respect to which he assumed personal liability to the extent of the principal amount, but not for interest (which was payable at maturity)).

With respect to personal liability that is reduced over time, regulations should provide that debt which was not originally QNF solely because of the personal liability of the borrower will become QNF as and to the extent the amounts for which the borrower is personally liable are reduced.

Finally, regulations should also address the effect of provisions common in financing documents which provide that the borrower will be personally liable for repayment of the principal amount of the loan in the event of certain actions or circumstances not authorized by the agreement between the parties: e.g., misrepresentation of facts or misappropriation of funds. Such contingencies should be disregarded for purposes of QNF classification except where the conditions precedents to personal liability in fact occur.

TAX SECTION
New York State Bar Association

February 22, 1988

Hon. Lawrence B. Gibbs
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 3000
Washington, D.C. 20224

Dear Larry:

I am leased to forward to you the enclosed Supplemental Report on Section 382 (Including Temporary Regulations) prepared by our Committee on Net Operating Losses. The report supplements the report of that Committee on section 382 that was submitted in 1986, prior to the enactment of the Tax Reform Act. The report was written by James M. Peaslee and Matthew A. Rosen, Co-Chairs of the Committee, Robert Rothman and Shlomo Cohen. Helpful comments on the report were received from Dale Collinson, Arthur A. Feder, Andrew Feiner, Stuart Goldring, Carol Goldstein, Leslie Hoffman, Robert Jacobs, Donald Schapiro and Michael Schler.

The two principal topics of the report are the Temporary Regulations under section 382 issued last August and the application of section 382 to affiliated groups. In addition to numerous technical comments on the Regulations, the Report recommends changes relating to the definition of 5-percent shareholder, the treatment of “stock” as “non-stock” and vice versa, and the rules governing options. The Report includes a summary of the Regulations. In the area of affiliates groups, the Report makes recommendations relating to the definition of ownership change, the calculation and application of the section 382 limitation, the treatment of built-in gains and losses, and the application of the continuity of business enterprise test, the “anti-stuffing rules”, the SRLY and CRCO rules, and the bankruptcy exception in section 382(1)(5). It also

comments on the allocation of income for the year in which an ownership change occurs in a case where some treatment of affiliated groups that do not file consolidated returns.

In addition to these topics, the Report comments on the built-in gain and loss rules in section 382(h), additional issues relating to the valuation of stock, and corporate contractions.

Although many of the suggestions in the Report can be implemented through regulations, technical corrections to the statute are suggested in the discussion of built-in gains and losses (part III of the report), the discussion of the bankruptcy exception (part IV.H.) and with respect to effective dates, the discussion of corporate contractions in part VI.

We understand that there may be aspects of section 382 not addressed in either of our reports that are proving to be troublesome for practitioners and the Service. We plan to prepare a further report on that and would appreciate your suggestions as to specific areas where you believe that additional comments would be helpful.

Sincerely,

Herbert L. Camp

cc: William Nelson, Esq.
Peter K. Scott, Esq.
D. Kevin Dolan, Esq.
Mr. Donald E. Osteen
Mr. Keith Stanley

TAX SECTION

New York State Bar Association

February 22, 1988

Hon. O. Donaldson Chapoton
Assistant Secretary for Tax Policy
Department of the Treasury
Main Treasury Building
15th and Pennsylvania Avenue, N.W.
Room 3120
Washington, D.C. 20220

Dear Don:

I am leased to forward to you the enclosed Supplemental Report on Section 382 (Including Temporary Regulations) prepared by our Committee on Net Operating Losses. The report supplements the report of that Committee on section 382 that was submitted in 1986, prior to the enactment of the Tax Reform Act. The report was written by James M. Peaslee and Matthew A. Rosen, Co-Chairs of the Committee, Robert Rothman and Shlomo Cohen. Helpful comments on the report were received from Dale Collinson, Arthur A. Feder, Andrew Feiner, Stuart Goldring, Carol Goldstein, Leslie Hoffman, Robert Jacobs, Donald Schapiro and Michael Schler.

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Very truly yours,

Herbert L. Camp

cc: Denis Ross, Esq.
Tom Wessel, Esq.

TAX SECTION

New York State Bar Association

February 22, 1988

William Wilkins, Esq.
Majority Staff Director and
Chief Counsel
Senate Finance Committee
205 Dirksen Building
Washington, D.C. 20510

Dear Bill:

I am leased to forward to you the enclosed Supplemental Report on Section 382 (Including Temporary Regulations) prepared by our Committee on Net Operating Losses. The report supplements the report of that Committee on section 382 that was submitted in 1986, prior to the enactment of the Tax Reform Act. The report was written by James M. Peaslee and Matthew A. Rosen, Co-Chairs of the Committee, Robert Rothman and Shlomo Cohen. Helpful comments on the report were received from Dale Collinson, Arthur A. Feder, Andrew Feiner, Stuart Goldring, Carol Goldstein, Leslie Hoffman, Robert Jacobs, Donald Schapiro and Michael Schler.

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We understand that there may be aspects of section 382 not addressed in either of our reports that are proving to be troublesome for practitioners and the Service. We plan to prepare a further report on that and would appreciate your suggestions as to specific areas where you believe that additional comments would be helpful.

Very truly yours,

Herbert L. Camp

TAX SECTION

New York State Bar Association

February 22, 1988

Mr. Randall W. Weiss
Deputy Chief of Staff
Joint Committee on Taxation
1010 Longworth House Office
Building
Washington, D.C. 20515

Dear Randall:

I am leased to forward to you the enclosed Supplemental Report on Section 382 (Including Temporary Regulations) prepared by our Committee on Net Operating Losses. The report supplements the report of that Committee on section 382 that was submitted in 1986, prior to the enactment of the Tax Reform Act. The report was written by James M. Peaslee and Matthew A. Rosen, Co-Chairs of the Committee, Robert Rothman and Shlomo Cohen. Helpful comments on the report were received from Dale Collinson, Arthur A. Feder, Andrew Feiner, Stuart Goldring, Carol Goldstein, Leslie Hoffman, Robert Jacobs, Donald Schapiro and Michael Schler.

The two principal topics of the report are the Temporary Regulations under section 382 issued last August and the application of section 382 to affiliated groups. In addition to numerous technical comments on the Regulations, the Report recommends changes relating to the definition of 5-percent shareholder, the treatment of “stock” as “non-stock” and vice versa, and the rules governing options. The Report includes a summary of the Regulations. In the area of affiliates groups, the Report makes recommendations relating to the definition of ownership change, the calculation and application of the section 382 limitation, the treatment of built-in gains and losses, and the application of the continuity of business enterprise test, the “anti-stuffing rules”, the SRLY and CRCO rules, and the bankruptcy exception in section 382(1)(5). It also

comments on the allocation of income for the year in which an ownership change occurs in a case where some treatment of affiliated groups that do not file consolidated returns.

In addition to these topics, the Report comments on the built-in gain and loss rules in section 382(h), additional issues relating to the valuation of stock, and corporate contractions.

Although many of the suggestions in the Report can be implemented through regulations, technical corrections to the statute are suggested in the discussion of built-in gains and losses (part III of the report), the discussion of the bankruptcy exception (part IV.H.) and with respect to effective dates, the discussion of corporate contractions in part VI.

We understand that there may be aspects of section 382 not addressed in either of our reports that are proving to be troublesome for practitioners and the Service. We plan to prepare a further report on that and would appreciate your suggestions as to specific areas where you believe that additional comments would be helpful.

Very truly yours,

Herbert L. Camp

cc: Paul Jacokes, Esq.

TAX SECTION

New York State Bar Association

February 22, 1988

Robert J. Leonard, Esq.
Chief Counsel
House Ways and Means Committee
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

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