NYSBA

NEW YORK STATE BAR ASSOCIATION

One Elk Street, Albany, New York 12207 PH 518.463.3200 www.nysba.org

TAX SECTION

2024-2025 Executive Committee

JIYEON LEE-LIM
Chair
Latham & Watkins LLP
1271 Avenue of the Americas
New York, NY 10021
212/9061298
ANDREW R. WALKER
First Vice Chair
212/530-5624
LAWRENCE M. GARRETT
Second Vice chair
202/327-6987
LUCY W. FARR
Secretary
212/450-4026
COMMITTEE CHAIRS:
Attributes
Andrew Herman
Gary Scanlon
Bankruptcy and Operating Losses
Stuart J. Goldring
Brian Krause
Compliance, Practice & Procedure
Megan L. Brackney
Elliot Pisem
Consolidated Returns
William Alexander
Shane J. Kiggen
Corporations
William A. Curran
Vadim Mahmoudov
Cross-Border Capital Markets
Jason R. Factor
Craig M. Horowitz
Cross-Border M&A
Adam Kool
Ansgar A. Simon
Debt-Financing and Securitization
John T. Lutz
Eschi Rahimi-Laridjani
Estates and Trusts
Austin Bramwell
Alan S. Halperin
Financial Instruments
Jeffrey Maddrey
Elena V. Romanova
"Inbound" U.S. Activities of Foreign Taxpayers
Peter J. Connors
S. Eric Wang
Individuals
Brian C. Skarlatos
Libin Zhang
Investment Funds
James R. Brown
Pamela Lawrence Endreny
New York City Taxes
Alysse McLoughlin
Irwin M. Slomka
New York State Taxes
Paul R. Comeau
Jack Trachtenberg
"Outbound" Foreign Activities of U.S. Taxpayers
Kara L. Mungovan
Peter F. G. Schuur
Partnerships
Meyer H. Fedida
Amanda H. Nussbaum
Pass-Through Entities
Edward E. Gonzalez
Eric B. Sloan
Real Property
Marcy Geller
Jonathan R. Talansky
Reorganizations
Joshua M. Holmes
David M. Rievman
Spin-Offs
Tijana J. Dvornic
Michael T. Mollerus
Tax Exempt Entities
Dahlia B. Doumar
Stuart Rosow
Taxable Acquisitions
Richard M. Nugent
Sara B. Zablotney
Treaties and Intergovernmental Agreements
David R. Hardy
William L. McRae

MEMBERS-AT-LARGE OF EXECUTIVE COMMITTEE:

Jennifer Alexander
Y. Bora Bozkurt
Erin Cleary
Yvonne R. Cort
Peter A. Furci
Lorenz Haselberger
Stephen M. Massed
Joshua Micelotta
Elizabeth Pascal
Arvind Ravichandran
Yaron Z. Reich
David M. Schizer
Paul Seraganian
Stephen E. Shay
Michael B. Shulman
Patrick E. Sigmon
W. Wade Sutton
Linda Z. Swartz
Davis J. Wang
Jennifer S. White

Report No. 1490
February 21, 2024

The Honorable Lily Batchelder
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Daniel I. Werfel
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable William M. Paul
Principal Deputy Chief Counsel
and Deputy Chief Counsel
(Technical)
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Report No. 1490 - Report on the Application of Section 382(l)(5) and (l)(6) to Consolidated Groups

Dear Ms. Batchelder and Messrs. Werfel and Paul:

I am pleased to submit Report No. 1490 of the Tax Section of the New York State Bar Association, which discusses the application of Section 382(l)(5) and (l)(6) to consolidated groups.

We appreciate your consideration of our Report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully Submitted,

Jiyeon Lee-Lim
Chair

FORMER CHAIRS OF SECTION:

Peter L. Faber
Alfred D. Youngwood
David Sachs
J. Roger Mentz
Willard B. Taylor
Herbert L. Camp
James M. Peaslee
Peter C. Canellos
Michael L. Schler
Richard L. Reinhold
Steven C. Todrys
Harold R. Handler
Robert H. Scarborough
Samuel J. Dimon
Andrew N. Berg
Lewis R. Steinberg
David P. Hariton
Kimberly S. Blanchard
Patrick C. Gallagher
David S. Miller
Erika W. Nijenhuis
Peter H. Blessing
Jodi J. Schwartz
Andrew W. Needham
Diana L. Wollman
David H. Schnabel
Stephen B. Land
Michael S. Farber
Karen Gilbreath Sowell
Deborah L. Paul
Andrew H. Braiterman
Gordon E. Warnke
Robert Cassanos
Philip Wagman

Enclosure

Cc:

Krishna Vallabhaneni
Tax Legislative Counsel
Department of the Treasury

Shelley de Alth Leonard
Deputy Tax Legislative Counsel and Special Counsel
Department of the Treasury (Office of Tax Policy)

Brett S. York
Deputy Tax Legislative Counsel
Department of the Treasury

Erika W. Nijenhuis
Senior Counsel
Department of the Treasury (Office of Tax Policy)

Colin Campbell, Jr.
Associate Tax Legislative Counsel
Department of the Treasury (Office of Tax Policy)

Mark A. Schneider
Associate Chief Counsel (Corporate)
Internal Revenue Service

Lisa A. Fuller
Deputy Associate Chief Counsel (Corporate)
Internal Revenue Service

Russell G. Jones
Special Counsel to Associate Chief Counsel (Corporate)
Internal Revenue Service

Robert Liquerman,
Special Counsel, Associate Chief Counsel (Corporate)
Internal Revenue Service

Report No. 1490

New York State Bar Association Tax Section

Report on the Application of Section 382(l)(5) and (l)(6) to Consolidated Groups

February 21, 2024

Table of Contents

I. Introduction 1

II. Summary of Recommendations 2

III. Background 6

A. The Section 382 Limitation in General 6

B. Purpose and Legislative History of Section 382 7

C. Special Rules for Loss Corporations in Title 11 or Similar Cases 9

D. Application of Section 382 to Consolidated Groups 12

IV. Discussion 15

A. Threshold Questions 15

B. Section 382 Bankruptcy Provisions Should Apply on a Single-Entity Basis 17

C. Group to Which Single-Entity Approach Applies 21

D. Proposed Criteria for Qualifying Under Section 382(l)(5) 25

E. Effect of Intra-Group Exchanges and Assumptions 36

F. Treatment of Indebtedness Originally Incurred by a Nonmember 36

G. Determination of Whether Indebtedness Arose in the Ordinary Course 37

H. Recomputation of Pre-Change Losses and Excess Credits 38

I. Departure of a Member Within Two Years Following an Ownership Change to Which Section 382(l)(5) Applies 38

J. Treas. Reg. § 1.269-3(d) Continuity-of-Business Test 40

K. Section 382(l)(6) Should Apply on a Single-Entity Basis if the Tested Entity is a Debtor in the Title 11 Case 40

L. Loss Group Treated as Single Entity To Determine Value Under Section 382(l)(6) 41

I. Introduction

This report ("**Report**")[1] of the Tax Section of the New York State Bar Association discusses the application of Section 382(l)(5) and (l)(6) (the "**Section 382 Bankruptcy Provisions**") to members of consolidated groups.[2] Regulations have been reserved on this topic since 1991, when in an explanation of a notice of proposed rulemaking, Treasury noted that "[d]epending on the issue and the circumstances," future "rules may adopt a single entity approach," which would treat members of the consolidated group as divisions of a single corporation.[3] The consolidated return regulations generally take a single-entity approach in applying Section 382, and we believe that this approach also is appropriate for its bankruptcy provisions. As in 1991 and in 2008, when we similarly requested guidance regarding the application of the Section 382 Bankruptcy Provisions, recent economic conditions have caused a considerable number of enterprises to experience distress, and we believe that the need for guidance in this area is acute. We therefore offer rules for applying the Section 382 Bankruptcy Provisions on a single-entity

[1] The principal author of this report is Patrick E. Sigmon, with substantial assistance from Bradford Sherman, Shea Jendrusina and Eytan de Gunzburg. Helpful comments were received from Lawrence M. Garrett, Stuart J. Goldring, Kevin M. Jacobs, Jiyeon Lee-Lim, Vadim Mahmoudov, Richard M. Nugent, Arvind Ravichandran, Michael L. Schler, Linda Swartz, Philip Wagman and Sara B. Zablotney. This report reflects solely the views of the New York State Bar Association Tax Section and not those of the New York State Bar Association's Executive Committee or its House of Delegates. Unless otherwise specified, any reference to "**Section**" in this Report is a reference to a section of the Internal Revenue Code of 1986, as amended (the "**Code**"), and any reference to "Treas. Reg. §" is a reference to a section of the regulations promulgated thereunder (the "**regulations**") by the U.S. Department of the Treasury ("**Treasury**," including as applicable the Internal Revenue Service (the "**IRS**")).

[2] We have requested guidance on this topic previously. *See* New York State Bar Association Tax Section, Report No. 679, *Report on Suggested Bankruptcy Tax Revenue Rulings* (Jan. 8, 1991) (the "**1991 Report**"). Our prior report, written during the 1990-1991 recession (and before the promulgation of the regulations under Treas. Reg. §§ 1.1502-90 to 1.1502-99), sought to assist the IRS in providing "workable rules for a host of issues that arise regularly in common bankruptcy and restructuring transactions," while noting that there was not necessarily a "central beacon . . . directing the various answers provided . . . other than [that they] . . . reach sensible and practical results consistent with understood policy objectives." In our 1991 Report, we requested that the IRS issue certain revenue rulings concerning the application of Section 382(l)(5) and Section 382(l)(6) in a consolidated group context. The requests in this Report are consistent with those proposed rulings, which applied the single-entity approach, but we elaborate here on the considerations raised in those rulings and request formal guidance consistent with the policies underlying Section 382 and the consolidated return regulations as they have developed, particularly following significant revisions in the 1990s.

In addition to the 1991 Report, we also sought guidance on additional issues related to the application of Section 382(l)(5) and 382(l)(6), including specifically with respect to their application to consolidated groups, during the 2007-2009 recession in a letter to Assistant Treasury Secretary Eric Solomon and IRS Commissioner Douglas H. Shulman. New York State Bar Association Tax Section, Report No. 1163, *Guidance on Economic Downturn Issues* (Aug. 19, 2008) (the "**2008 Letter**"). In this Report, we expand on our request outside of consolidation for guidance regarding their application to consolidated groups, and we renew our requests in the 2008 Letter for guidance regarding (i) the treatment for Section 382(l)(5) purposes of stock received pursuant to the exercise of subscription rights, (ii) the determination of when a creditor will be treated as participating in formulating a plan of reorganization for the purpose of Treas. Reg. § 1.382-9(d)(3)(i), and (iii) the calculation of the Section 382(l)(5) "interest haircut" when debt is satisfied with both equity and other consideration.

[3] Regulations Under Section 1502 of the Internal Revenue Code of 1986; Operation of Sections 382 and 383 With Respect to Consolidated Groups [CO-132-87], 56 Fed. Reg. 4194, 4197 (Feb. 4, 1991).

basis, with certain limited exceptions, and we ask Treasury and the IRS to consider issuing definitive guidance on that basis.

Part II of this Report contains a summary of our recommendations. Part III provides relevant background on Section 382, its bankruptcy provisions, and its application to consolidated groups of U.S. corporations. Part IV provides analysis supporting our recommendations.

This Report does not address the treatment of foreign-parented groups[4] or other multi-member groups that are not consolidated, nor does it address the treatment of nonconsolidated entities owned by consolidated groups. We would be pleased to address these topics in a subsequent report if requested by Treasury.

II. Summary of Recommendations

We believe that Sections 382(l)(5) and (l)(6) should apply to consolidated groups as indicated below and that Treasury should promulgate regulations[5] consistent with the following core recommendations:

1. If one or more members depart a consolidated group pursuant to an order of the court or a plan of reorganization confirmed by the court in a title 11 or similar case, the group's losses should be allocated under Treas. Reg. § 1.1502-21(b) before determining whether the group or departing member(s) have ownership changes, determining whether Section 382(l)(5) or (l)(6) applies, or imposing a Section 382 limitation.

2. Section 382(l)(5) should apply on a single-entity basis if the following criteria are satisfied:

    a. The Tested Entity or its qualifying predecessor (each as defined below) is a debtor in the title 11 or similar case[6]; and

[4] In particular, we believe foreign-parented U.S. consolidated groups present unique issues that may merit deviation from the general rules for application of the Section 382 Bankruptcy Provisions to consolidated groups discussed in this Report. For example, a foreign parent may or may not be in insolvency proceedings in its home jurisdiction and may or may not have available to it any practical path to a recognition or other insolvency proceeding in the United States. We do not make recommendations regarding the treatment of foreign-parented consolidated groups in this Report. It may therefore be appropriate to reserve the application of the Section 382 Bankruptcy Provisions in that context for further study when offering guidance in the purely domestic context.

[5] We believe that Treasury has authority under Sections 382(m) and 1502 to adopt our proposals. Section 382(m) directs Treasury to prescribe regulations as may be necessary or appropriate to carry out the purposes of Section 382, and Section 1502 directs Treasury to prescribe regulations as it deems necessary to clearly reflect the income tax liability of any consolidated group (and each member thereof) and authorizes Treasury to prescribe rules that are different from those which would apply if the members filed separate returns. We note that, in formulating the recommendations set forth in this Report, we have given regard to the text of Section 382 and deviated only where, and then only to the extent, we believe necessary to serve the underlying policy of Section 382 in the consolidated return context.

[6] In this Report, we use the phrases "**debtor**," "**title 11 debtor**" and "**debtor in the title 11 or similar case**" to refer to an entity that has filed a bankruptcy case. *See* 11 U.S.C. § 101(13) ("The term 'debtor' means person or

(….continued)

b. The requirements of Section 382(l)(5)(A)(ii) are satisfied with respect to the Tested Entity, treating (i) as pre-change shareholders of the Tested Entity, all pre-change external shareholders of the Pre-Change Tested Group (as defined below) and (ii) as qualified creditors of the Tested Entity, all pre-change external holders of otherwise qualified indebtedness issued by Qualified Obligors (as defined below) of the Pre-Change Tested Group.

c. Notwithstanding subparagraph (b) above, if (i) pursuant to an order of the court in the title 11 case or a confirmed title 11 reorganization plan (or otherwise in connection with such title 11 case), stock of one or more subsidiary members of the Post-Change Group (as defined below) is issued to persons in exchange for consideration other than pre-change stock of the Pre-Change Tested Group or otherwise qualified indebtedness issued by Qualified Obligors and (ii) a principal purpose of such issuance is to permit the Post-Change Group to qualify for the application of Section 382(l)(5) with respect to the ownership change, then Section 382(l)(5) should not apply with respect to such ownership change unless the requirements of Section 382(l)(5)(A)(ii) would have been satisfied (determined as described in the preceding paragraph (b)) if the Tested Entity were treated as also having issued to those persons an amount of its own stock having a value equal to the value of the subsidiary stock actually issued to them in respect of that other consideration.

As used in this Report

- "**Tested Entity**" means:

  i. With respect to a member that continues as a member of a consolidated group which experiences an ownership change, the common parent or its qualifying successor;

  ii. With respect to a member that ceases to be a member of the consolidated group, where the member or its qualifying successor continues to be consolidated with other departing members as part of a newly constituted consolidated group, the parent of the new consolidated group;

  iii. With respect to a member that ceases to be a member of the consolidated group, where the member or its qualifying successor continues to be consolidated with other departing members as part of a new loss subgroup, the

municipality concerning which a case under this title has been commenced."). We use the term "**obligor**" to refer more generally to an entity that is obligated to repay indebtedness or other claims (as those terms are used in the Section 382 Bankruptcy provisions).

parent(s) of the new loss subgroup or their qualifying successor(s)[7];

iv. With respect to a member that ceases to be a member of the consolidated group, where neither the member nor its qualifying successor continues to be consolidated with other departing members, the departing member or its qualifying successor; and

v. With respect to a member that is subject to separate tracking under Treas. Reg. § 1.1502-91(d) (as part of an "**existing loss subgroup**" or as an "**existing loss member**," as applicable) and experiences an ownership change, that existing loss member or the loss subgroup parent (or parents) of that existing loss subgroup or, in either case, their respective qualifying successor(s).[8]

- "**qualifying predecessor**" means, with respect to any corporation, the predecessor of such corporation in a transaction to which Section 381(a) applies and which occurs pursuant to an order of the court in the title 11 or similar case or an approved title 11 plan of reorganization. "**qualifying successor**" has the correlative meaning.

- "**Pre-Change Tested Group**" means, (i) with respect to a Tested Entity that is an existing loss member, a parent of an existing loss subgroup or a qualifying successor to such member or parent, such loss member or such loss subgroup, and (ii) with respect to any other Tested Entity, the U.S. federal consolidated group of which the Tested Entity or its qualifying predecessor was a member before giving effect to the transaction or series of related transactions that resulted in the ownership change of the Tested Entity.

- "**Qualified Obligor**" means:

[7] In certain circumstances different loss subgroups may arise with respect to net operating losses ("**NOLs**") and a net unrealized built-in loss (a "**NUBIL**"). If there is an NOL loss subgroup described in Treas. Reg. § 1.1502-91(d)(1), we would treat that NOL loss subgroup as the Pre-Change Tested Group and its parent as the Tested Entity. If there is not an NOL loss subgroup, we would treat each NUBIL loss subgroup as a Pre-Change Tested Group with such loss subgroup's parent(s) as the Tested Entity, and we would treat any standalone new loss member with a NUBIL as a standalone Tested Entity. *See infra* note 92.

If an election to treat multiple members of a loss subgroup as loss subgroup parents is made under Treas. Reg. § 1.1502-91(d)(4), then each member treated as a loss subgroup parent should be treated as a Tested Entity (and Section 382(l)(5) should apply only if these criteria are met with respect to each Tested Entity).

[8] As discussed elsewhere in this Report, in certain circumstances an entity might be both a member of a loss subgroup that undergoes an ownership change and a continuing member of a broader consolidated group (or a subset thereof) that undergoes a concurrent ownership change. In that case, we would propose testing both the loss subgroup and the broader group under the Section 382 Bankruptcy Provisions and applying Treas. Reg. § 1.1502-93(b)(ii) (regarding anti-duplication of stock value), as appropriate.

i. Where the Tested Entity or its qualifying predecessor is the common parent of a consolidated group, any member of that consolidated group;

ii. Where the Tested Entity or its qualifying predecessor is an existing loss member, that loss member;

iii. Where the Tested Entity or its qualifying predecessor is the parent of an existing loss subgroup, any member of that existing loss subgroup; and

iv. Otherwise, (x) the Tested Entity or its qualifying predecessor and (y) any member of the Pre-Change Tested Group that is a title 11 debtor.

- The "**Post-Change Group**" to which Section 382(l)(5) or Section 382(l)(6) could apply with respect to an ownership change consists of (x) the Tested Entity and (y) any members of the Pre-Change Tested Group that are affiliated with the Tested Entity immediately after the ownership change.

3. If a Pre-Change Tested Group member issues or is deemed to issue indebtedness to a nonmember in exchange for another member's indebtedness, for the purpose of Section 382(l)(5) the holder should be treated as having owned the new indebtedness for the period the holder owned the prior indebtedness, and the new indebtedness should be treated as having arisen in the ordinary course of business if the prior indebtedness so arose.

4. Indebtedness of a Pre-Change Tested Group member that was originally incurred (treating for this purpose any indebtedness to which the preceding paragraph 3 applies as having been originally incurred when its predecessor indebtedness was originally incurred) by a corporation that was not, at the time of such original incurrence, a member of the Pre-Change Tested Group should be treated as qualified indebtedness under Section 382(l)(5)(E) only if (i) the Pre-Change Tested Group member is a Qualified Obligor and (ii) had the Pre-Change Tested Group been a standalone corporation and a Section 381(a) successor to the original obligor, such indebtedness would have been qualified indebtedness of the standalone corporation under Section 382(l)(5)(E).

5. For purposes of Section 382(l)(5), the determination of whether indebtedness arose in the ordinary course of the trade or business of the Pre-Change Tested Group should be made on a single-entity basis.

6. If Section 382(l)(5) applies to an ownership change, in recomputing pre-change losses and excess credits as if no deduction were allowed for certain interest payments to creditors becoming shareholders, the consolidated group should take into account the particular member that paid or accrued the interest.

7. If within two years after a consolidated group experiences an ownership change to which Section 382(l)(5) applies, a corporation that was a member of the Post-Change Group (a) ceases to be a member and (b) experiences an ownership change (whether in

connection with its departure from the group or otherwise), then (x) the departing member's Section 382 limitation should be zero under Section 382(l)(5)(D), and (y) the Post-Change Group's use of pre-change losses should be unaffected.

8. In determining whether an ownership change to which Section 382(l)(5) applies is made for the principal purpose of evading or avoiding Federal income tax under Treas. Reg. § 1.269-3(d), the continuity-of-business test should apply on a single-entity basis to the Post-Change Group.

9. Section 382(l)(6) should apply on a single-entity basis to the Post-Change Group if the Tested Entity or its qualifying predecessor is a debtor in the title 11 or similar case.

10. The value of a Post-Change Group for the purpose of Section 382(l)(6) should be the lesser of:

    a. The value of the stock of the Tested Entity (subject to appropriate adjustments in the case of a Tested Entity that is a qualifying successor), *plus* the value of any stock of subsidiary members of the Post-Change Group held by nonmembers; and

    b. The combined gross assets of the members of the Post-Change Group or, if applicable, their qualifying predecessors (ignoring intercompany arrangements and stock of members) immediately prior to the ownership change, appropriately adjusted to take into account any disposition of assets by Post-Change Group members or their qualifying predecessors (including stock of pre-change group members) pursuant to the plan of reorganization.

III. Background

A. The Section 382 Limitation in General

Section 382 imposes an annual limit (the "**Section 382 limitation**") on the amount of taxable income that a loss corporation may offset with pre-change losses following an ownership change.[9] A "loss corporation" is a corporation that is entitled to use an NOL or capital loss carryforwards, that has an NOL or capital loss for the current year, that may use or carry forward certain other tax attributes, or that has a NUBIL in its assets.[10] "Pre-change losses" include current-year NOLs, NOL carryforwards, disallowed business interest carried forward under Section 163(j), built-in losses recognized during a specified period and certain other tax attributes.[11]

Determining whether an "ownership change" has occurred can be a complex exercise, but in general terms, an ownership change may occur when there is an "owner shift" – a change in the

[9] Section 382(a).

[10] Section 382(k); Treas. Reg. § 1.382-2(a)(1).

[11] Section 382(d); Treas. Reg. § 1.382-2(a)(2).

percentage of the corporation owned directly or indirectly by an individual shareholder whose direct and indirect ownership exceeds 5% of the corporation's stock (by value).[12] An ownership change occurs if, after an owner shift, the percentage of stock of the corporation owned by one or more 5-percent shareholders has increased by more than 50 percentage points over the lowest percentage held by those shareholders at any time in the "testing period" (generally the three prior years).[13] In identifying 5-percent shareholders and determining owner shifts, stock owned by corporations, partnerships and other entities is attributed to their direct or indirect owners or beneficiaries.[14]

If an ownership change occurs, a corporation's Section 382 limitation is generally the value of the stock of the corporation immediately before the ownership change, multiplied by the long-term tax-exempt rate then in effect.[15] However, a corporation's Section 382 limitation will generally be reduced to zero for any post-change year if the corporation does not continue its pre-change business enterprise at all times during the two-year period beginning on the date of the ownership change (the "**general 382 COBE requirement**").[16] A corporation may carry forward any unused portion of its Section 382 limitation for any taxable year to subsequent taxable years.[17]

B. Purpose and Legislative History of Section 382

The principal purpose of Section 382 is to prevent trafficking in losses, or the purchase and use of tax losses by taxpayers who did not incur them.[18] Section 382 was enacted in 1954 to supplement Section 269, an earlier anti-loss-trafficking provision.[19] Section 269 denies the use of tax deductions or other tax benefits where (i) any person (or persons) acquires control of a corporation for the "principal purpose . . . of evasion or avoidance of Federal income tax by securing" those benefits, and (ii) that person or corporation otherwise would not have enjoyed those benefits.[20] The IRS encountered challenges in proving the subjective intent described in

[12] Section 382(g); Treas. Reg. § 1.382-2T(e)(1).

[13] Section 382(i); Treas. Reg. § 1.382-2T(d). The testing period is shorter in certain cases, including when a prior ownership change has occurred. *See* Section 382(i)(2), (3).

[14] Section 382(l)(3); Treas. Reg. § 1.382-2T(h).

[15] Section 382(b)(1). A corporation's Section 382 limitation may be increased if the corporation had a net unrealized built-in gain (a "**NUBIG**") at the time of the ownership change and the corporation recognizes (or is deemed to have recognized) all or a portion of that gain. Section 382(h)(1).

[16] Section 382(c)(1). Notwithstanding the general rule, the corporation's Section 382 limitation will still be increased (and, thus, will not be zero) if the corporation recognizes certain pre-change built-in gains. Section 382(c)(2).

[17] Section 382(b)(2).

[18] *See* H.R. Rep. No. 1337, 83rd Cong., 2d Sess. 41-42 (1954).

[19] *Id*.

[20] Section 269(a).

Section 269, limiting its usefulness in deterring loss-trafficking.[21] In their report recommending the enactment of Section 382, the House Ways and Means Committee highlighted that the new section provided, in contrast, an objective test:

> This special limitation on net operating loss carryovers provides an objective standard governing the availability of a major tax benefit which has been abused through trafficking in corporations with operating loss carryovers, the tax benefits of which are exploited by persons other than those who incurred the loss. It treats a business which experiences a substantial change in its ownership, to the extent of such change, as a new entity for such tax purposes.[22]

Section 382 was significantly amended by the Tax Reform Act of 1986, although the objective nature of its application was preserved. The legislative history to the 1986 amendment elaborated on the need to prevent loss-trafficking. Specifically, the tax system requires corporations to report their income annually but allows them to carry losses to subsequent tax years to average out inter-year variations in income. Free transferability of losses would undermine this "averaging function" and could effectively allow a corporation to obtain reimbursement of losses through the tax system.[23] To preserve this averaging function, Congress thought it necessary to "match" losses to items of income they may offset, which it thought the 1954 version of Section 382, although providing objective rules, did not do effectively:

> Permitting the carryover of all losses following an acquisition, as is permitted under the 1954 Code if the loss business is continued following a purchase, provides an improper matching of income and loss. Income generated under different corporate owners, from capital over and above the capital used in the loss business, is related to a pre-acquisition loss only in the formal sense that it is housed in the same corporate entity. Furthermore,

[21] *See* H.R. Rep. No. 1337, 83rd Cong., 2d Sess. 41 (1954) (noting that Section 269 had "proved ineffectual . . . because of the necessity of proving that tax avoidance was the primary purpose of the transaction").

[22] *Id*. at 42.

[23] S. Rep. No. 313, 99th Cong., 2d Sess. 230-31 (1985). The General Explanation published by the Joint Committee on Taxation echoes the Senate Finance Committee's language regarding the purpose of Section 382. Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (hereinafter, the "**1986 Bluebook**"), at 294 (1987).

The Senate Finance Committee's report notes:

> The primary purpose of the special limitations is the preservation of the integrity of the carryover provisions. The carryover provisions perform a needed averaging function when they smooth out the distortions caused by the annual accounting system. If, on the other hand, carryovers can be transferred in a way that permits a loss to offset unrelated income, no legitimate averaging function is performed. With completely free transferability of tax losses, the carryover provisions become a mechanism for partial recoupment of losses through the tax system. Under such a system, the Federal Government would effectively be required to reimburse a portion of all corporate tax losses. Regardless of the merits of such a reimbursement program, the carryover rules appear to be an inappropriate and inefficient mechanism for delivery of the reimbursement.

S. Rep. No. 313, 99th Cong., 2d Sess. 230-31 (1985).

> the ability to use acquired losses against such unrelated income creates a tax bias in favor of acquisitions. For example, a prospective buyer of a loss corporation might be a less efficient operator of the business than the current owner, but the ability could make the loss corporation more valuable to the less efficient user and thereby encourage a sale.[24]

Legislators were concerned in particular about the ability of a new owner to move an income-generating business into an acquired corporation with NOL carryovers: as long as the acquired corporation also continued its prior line of business, it could use the NOL carryovers to offset income from the new line of business.[25] In matching items of income and loss, current Section 382 therefore focuses on the identity of a corporation's shareholders when it has income or incurs a loss; it restricts the use of NOL carryovers when the "shareholders who bore the economic burden of a corporation's NOLs no longer hold a controlling interest in the corporation."[26] In order to limit the disincentive to economically efficient acquisitions, revised Section 382 imposes an annual limit on the use of pre-change NOLs rather than completely disallowing them.[27]

C. Special Rules for Loss Corporations in Title 11 or Similar Cases

1. Operation

Either of two special provisions, Sections 382(l)(5) and 382(l)(6), may apply to ownership changes occurring in the context of a "title 11 or similar case."[28] If Section 382(l)(5) applies to an ownership change, no Section 382 limitation is imposed.[29] Section 382(l)(5) may apply if (a) the loss corporation is under the jurisdiction of the court in a title 11 or similar case immediately before the ownership change, and (b) after the ownership change, pre-change shareholders and creditors of the loss corporation own (as a result of being pre-change shareholders and creditors) a sufficient amount of the stock of the loss corporation (or of a controlling corporation, if also in bankruptcy) by vote and value.[30] For this purpose, pre-change creditors are treated as having received stock as a result of being pre-change creditors only to the extent that they receive stock in satisfaction of "qualified indebtedness" in a transaction ordered

[24] *Id.*

[25] *Id*. at 232.

[26] *Id*.

[27] *Id*. at 231-33. Revised Section 382 is intended to approximate the result that would obtain if the corporation's NOL carryforward were available only to offset earnings generated by the corporation's pre-change net assets and uses the long-term tax-exempt rate as a proxy for those earnings, which "was justified as a reasonable risk-free rate of return a loss corporation could obtain in the absence of a change in ownership." *Id*. at 233.

[28] Section 382(l)(5), (6). For the purposes of both paragraphs, the term "title 11 or similar case" has the meaning given in Section 368(a)(3)(A): "a case under title 11 of the United States Code, or . . . a receivership, foreclosure, or similar proceeding in a Federal or State court."

[29] Section 382(l)(5)(A).

[30] Pre-change shareholders and qualified creditors must own 50% of the new loss corporation by vote and by value, as determined under Section 1504(a)(2). Treas. Reg. § 1.382-9(b)(2).

by the court (or pursuant to a plan approved by the court) in a title 11 or similar case.[31] Qualified indebtedness, in turn, generally is (i) indebtedness that has been held by the same beneficial owner since the date that is 18 months prior to the filing of the title 11 or similar case, and (ii) indebtedness that arose in the ordinary course of business and that has been continuously held by the same beneficial owner.[32]

Although no Section 382 limitation is imposed if Section 382(l)(5) applies to an ownership change, there are potential disadvantages to its application. First, the corporation must compute the pre-change losses and excess credits that it may carry to post-change years as if no deduction were allowed for interest paid in the year of the ownership change or the prior three taxable years on debt converted into stock pursuant to the title 11 or similar case.[33] Second, if the corporation undergoes a second ownership change within two years, the Section 382 limitation following the second ownership change will be zero.[34] Moreover, while the general 382 COBE requirement does not apply to an ownership change to which Section 382(l)(5) applies, regulations promulgated under Section 269 may operate to negate that act of legislative grace: for purposes of Section 269, an acquisition occurring in connection with an ownership change to which Section 382(l)(5) applies is presumed to have been made for the principal purpose of evading income tax unless the acquired or acquiring corporation "carries on more than an insignificant amount of an active trade or business during and subsequent to the title 11 or similar case."[35] If an acquisition is made with the principal purpose of evading income tax by securing the benefit of a deduction or other favorable tax attribute, Section 269 and the regulations thereunder disallow the deduction or use of the attribute.[36]

If Section 382(l)(5) does not apply to an exchange of debt for stock in a title 11 or similar case (or to a reorganization described in Section 368(a)(1)(G)), either because the exchange does not meet the requirements of Section 382(l)(5) or because the new loss corporation elects out of its

[31] Treas. Reg. § 1.382-9(d)(1).

[32] Section 382(l)(5)(E). Tacking rules may apply to treat transferees of claims pursuant to qualified transfers as having held indebtedness for the period that it was owned by the transferor. Treas. Reg. § 1.382-9(d)(5). Additionally, in certain cases, a corporation may treat indebtedness as always having been owned by its beneficial owner immediately before the ownership change in the absence of actual knowledge to the contrary. Treas. Reg. § 1.382-9(d)(3). However, in certain cases, indebtedness is excluded from the definition of qualified indebtedness if its beneficial owner is an entity that has itself undergone a recent ownership change. Treas. Reg. § 1.382-9(d)(4).

[33] Section 382(l)(5)(B). The effect of the Section 382(l)(5) "interest haircut" may be limited in many cases to reducing a corporation's carryforwards of disallowed business interest under Section 163(j)(2).

[34] Section 382(l)(5)(D).

[35] Treas. Reg. § 1.269-3(d). This facts-and-circumstances inquiry may consider "the amount of business assets that continue to be used [and] the number of employees in the work force who continue employment" in an active trade or business, but the trade or business is "not necessarily [required to be] the historic trade or business." Treas. Reg. § 1.269-3(d)(1). The continuity of business requirement under Section 382(c) (which imposes a Section 382 limitation of zero if the new loss corporation does not continue the business enterprise of the old loss corporation for two years following the ownership change) does not apply to ownership changes governed by Section 382(l)(5). Treas. Reg. § 1.382-9(m)(1).

[36] Section 269(a); Treas. Reg. § 1.269-3(a).

application,[37] then the provisions of Section 382(l)(6) apply instead. Section 382(l)(6) provides that the value of the old loss corporation, which is used to calculate the new loss corporation's Section 382 limitation, "shall reflect the increase (if any) in value of the old loss corporation resulting from any surrender or cancellation of creditors' claims."[38] Treasury regulations operationalize this, providing that the value of the old loss corporation will be the lesser of (a) the value of the stock (including Section 1504(a)(4) preferred stock) of the loss corporation immediately after the ownership change, and (b) the value of the loss corporation's pre-change gross assets.[39]

2. Purpose

The Section 382 Bankruptcy Provisions were included in the 1986 amendments to Section 382.[40] The legislative history indicates that these provisions are intended to provide relief to a corporation if the claims of its creditors have come to represent proprietary interests in the corporation, with equity-like exposure to the performance of its underlying business.[41] In particular, holders of those claims will often have funded losses that generated the corporation's

[37] Section 382(l)(5)(G) permits a loss corporation to elect not to apply Section 382(l)(5) to a qualifying ownership change.

[38] Section 382(l)(6). The 1986 version of Section 382(l)(6) provided that the value used in calculating the Section 382 limitation "shall be the value of the new loss corporation immediately after the ownership change." This was changed to the current language by the Technical and Miscellaneous Revenue Act of 1988. The revision excludes increases in value that are attributable to new capital contributions.

[39] Treas. Reg. § 1.382-9(j)-(l).

[40] The House and Senate initially proposed different rules. The final legislation includes both, with the House proposal becoming Section 382(l)(6) and the Senate proposal becoming 382(l)(5). The House proposal is discussed at H. Rep. No. 426, 99th Cong., 1st Sess. 199-200 (1985), and the Senate proposal is discussed at S. Rep. No. 313, 99th Cong., 2d Sess. 236 (1985).

[41] The 1986 Bluebook notes:

> Under the general rule of the Act, no carryforwards would be usable after the acquisition of an insolvent corporation because the corporation's value immediately before the acquisition would be zero. In such a case, however, the loss corporation's creditors are the true owners of the corporation, although it may be impossible to identify the point in time when ownership shifted from the corporation's shareholders. Relief from a strict application of the general rule is provided, as the creditors of an insolvent corporation frequently have borne the losses reflected in an NOL carryforward.

1986 Bluebook, *supra* note 23, at 299 (internal citations omitted). *Cf.* Treas. Reg. § 1.368-1(e)(6) (treating a creditor's claim against a corporation that is in a title 11 case or that has liabilities in excess of the fair market value of its assets as a "proprietary interest" for the purpose of the continuity-of-interest test applicable to reorganizations under Section 368); *Helvering v. Alabama Asphaltic Limestone Co*., 315 U.S. 179 (1942) (determining that the continuity-of-interest test for a reorganization under Section 112(i)(1) of the Revenue Act of 1928 was satisfied where creditors of a bankrupt corporation received all of the stock of the new corporation to which it transferred its assets, since the creditors had "stepped into the shoes of the old stockholders").

Although the Joint Committee refers specifically to insolvent corporations, we do not think this rationale is limited to situations in which the pre-bankruptcy equity has become worthless, as Section 382(l)(5) expressly contemplates pre-bankruptcy shareholders receiving value.

NOL carryover but, in the absence of a special rule, Section 382 would not operate to "match" future income of the loss corporation to those losses appropriately.[42] Because it can be difficult to identify when, or even whether, an indebtedness has transitioned from temporary capital largely insulated from business performance into a proprietary interest largely dependent on business performance, Congress conditioned the application of the Section 382 Bankruptcy Provisions on a clear signal that this has occurred – namely, the commencement of a title 11 or similar case.[43]

The legislative history also notes the need for anti-abuse rules so that, for example, an investor cannot purchase the debt of a corporation in a title 11 case immediately before it converts into equity and obtain the benefits of Section 382(l)(5) as if the investor had been a long-term holder of a proprietary interest.[44]

D. Application of Section 382 to Consolidated Groups

Regulations provide that Section 382 generally applies to consolidated groups under a single-entity approach.[45] This approach is frequently used in the consolidated return regulations and treats members of a consolidated group as divisions of a single corporation.[46] The preamble to the proposed regulations (subsequently finalized with modifications) explains that this approach "reflects the ability of corporations filing consolidated returns to use each other's losses as well as the principle that the tax laws should operate in a neutral manner with respect to changes in ownership."[47] In this context, this "neutrality principle" means that "losses that arise while two or more corporations are members of one group and that are therefore available to be used

[42] 1986 Bluebook, *supra* note 23, at 299.

[43] *Id*.

[44] The 1986 Bluebook reports "concern . . . about the potential for abusive transactions:"

> For example, if there were a general stock-for-debt exception, an acquiring corporation could purchase a loss corporation's debt immediately before or during a bankruptcy proceeding, exchange the debt for stock without triggering the special limitations, and then use the loss corporation's NOL carryforwards immediately and without limitation. Alternatively, an acquiring corporation could purchase stock from the creditors after the bankruptcy proceeding, and after the loss corporation's value has been increased by capital contributions.

Id. This discussion appears to be focused on Section 382(l)(5), as the statute does not have mechanisms to limit these transactions in the (l)(6) context.

[45] Treas. Reg. §§ 1.1502-90 to 1.1502-99.

[46] Regulations Under Section 1502 of the Internal Revenue Code of 1986; Operation of Sections 382 and 383 With Respect to Consolidated Groups [CO-132-87], 56 Fed. Reg. 4194, 4195 (Feb. 4, 1991).

[47] *Id*. at 4196.

among the members should remain so available following an ownership change, subject only to the restrictions that would be imposed on a single entity in similar circumstances."[48]

Outside of the context of the Section 382 Bankruptcy Provisions, the regulations impose a group-wide Section 382 limitation on a loss group's use of pre-change consolidated attributes to offset consolidated taxable income following an ownership change.[49] A "loss group," the consolidated-group analogue of a loss corporation, is a consolidated group that is entitled to use an NOL carryover to the taxable year (that did not arise in a separate return limitation year, or "**SRLY**"), that has a consolidated NOL for the taxable year, or that has a NUBIL.[50] Pre-change consolidated attributes include any losses allocable to the period before and including the change date that cause the group to be a loss group, as well as recognized built-in losses.[51] For the purpose of determining whether an ownership change has occurred, regulations treat the group as a single entity and generally do not require separate tracking of subsidiary members' owner shifts.[52] Under the "parent change method," the determination of whether a loss group parent has experienced an ownership change is made under generally applicable Section 382 principles, and the loss group is considered to have an ownership change if the parent does.[53] Similar to the

[48] *Id*. In the more general context, the neutrality principal stands for the proposition that a corporation generally should not obtain a greater or lesser benefit from its pre-change losses than it would have obtained in the absence of an ownership change. *See* S. Rep. No. 313, 99th Cong., 2d Sess. 232 (1986).

[49] Treas. Reg. § 1.1502-91(a).

[50] Treas. Reg. § 1.1502-91(c)(1). In addition, although Treas. Reg. § 1.1502-91(c)(1) does not specifically identify 163(j) carryforwards as pre-change losses, an example in the regulations treats them as such (as does Section 382(d)(3)). *See* Treas. Reg. § 1.1502-92(e)(2)(iii) ("The disallowed business interest expense is carried over to Year 2 under section 163(j)(2) and §1.163(j)-2(c). Thus, the disallowed business interest expense carryforward is a pre-change loss.")

[51] Treas. Reg. § 1.1502-91(e).

[52] *See* Treas. Reg. § 1.1502-92(b)(1). However, anti-abuse provisions may trigger an ownership change for a subsidiary member on a separate entity basis in limited circumstances. Treas. Reg. § 1.1502-96(b)(1). For example, a subsidiary will have an ownership change if Treas. Reg. § 1.382-4(d) (which applies when a principal purpose of an option transaction is to avoid or ameliorate the impact of an ownership change and certain other criteria are met) deems an option to acquire more than 20% of the subsidiary's stock to be exercised. A subsidiary will also have an ownership change as a result of an increase, following an acquisition of ownership interests pursuant to a plan or arrangement to avoid an ownership change of the subsidiary, in 5-percent shareholders' aggregate percentage ownership of the subsidiary by more than 50 percentage points during a testing period. If a subsidiary has a separate ownership change, the amount of consolidated taxable income of the group for any post-change year that may be offset by the subsidiary's pre-change losses is limited by the subsidiary's Section 382 limitation. Treas. Reg. § 1.1502-96(b)(2)(i). The subsidiary's pre-change losses include, among other items, the allocable portion of the group's consolidated net operating loss attributable to it under Treas. Reg. § 1.1502-21(b). Treas. Reg. § 1.1502-96(b)(2)(ii).

[53] Treas. Reg. § 1.1502-92(b)(1). If the common parent is succeeded or acquired by a new common parent, the new common parent is treated as a continuation of the former parent for this purpose. Treas. Reg. § 1.1502-92(b)(3)(i). Additional "supplemental rules" apply to determine whether an ownership change has occurred when a 5-percent shareholder of the common parent increases its ownership interest in the stock of both the common parent and a consolidated subsidiary (other than through the interest in the common parent). Treas. Reg. § 1.1502-92(c). The preamble to the final regulations indicates that the supplemental rules address the "concern that taxpayers could exploit the parent change method's failure to account for minority shifts of stock." T.D. 8824, 1999-2 C.B. 62, 67.

Section 382 limitation imposed on standalone loss corporations, the Section 382 limitation imposed on a loss group is the value of the loss group before the change multiplied by the long-term tax-exempt rate.[54] The value of the loss group is equal to the value of the stock (including Section 1504(a)(4) preferred stock) of each member, other than stock owned directly or indirectly by another member.[55]

When a new member with an NOL or NUBIL joins a consolidated group, it is a "new loss member."[56] If multiple corporations join simultaneously, they may form a "loss subgroup" if they were affiliated with each other in a prior group,[57] are affiliated with each other (as described in Section 1504(a)(4)) in the new group through a common parent that is part of the loss subgroup[58] and they have a NUBIL or one of them has an NOL carryover.[59] Invoking the neutrality principle, the regulations extend single-entity treatment to loss subgroups (treating a loss subgroup, to some extent, as if it were a single new loss member).[60] The regulations require that NOLs of new loss members and loss subgroups carried over from SRLYs be separately tracked until the new loss member or loss subgroup experiences an ownership change or five years have elapsed without an ownership change.[61] Once this occurs, separate tracking ceases, and the amount of the group's consolidated taxable income that may be offset by the carried over NOLs is subject to the new loss member's or loss subgroup's 382 limitation (if any).[62]

When a member leaves a consolidated group, regulations provide that Section 382 begins to apply on a separate-entity basis with respect to the departing member.[63] If the group has a CNOL or net operating losses that may be carried forward, the portions of each that are attributable to

[54] Treas. Reg. § 1.1502-93(a)(1).

[55] Treas. Reg. § 1.1502-93(b)(1). This value may be adjusted under the rules of Section 382 or the regulations thereunder. Treas. Reg. § 1.1502-93(b)(2).

[56] Treas. Reg. § 1.1502-94(a)(1).

[57] The prior group does not need to have been consolidated. Treas. Reg. § 1.1502-91(d)(2)(i).

[58] If there is no common parent that would be part of the loss subgroup, the parent of the consolidated group can elect to treat this requirement as satisfied. This will cause each loss subgroup member to be treated as a loss subgroup parent, including in determining whether the loss subgroup has experienced an ownership change. Treas. Reg. § 1.1502-91(d)(4).

[59] Treas. Reg. § 1.1502-91(d). A loss subgroup with respect to a NUBIL additionally requires that the corporations' affiliation with each other has been continuous for five years. Treas. Reg. § 1.1502-91(d)(2).

[60] Regulations Under Section 1502 of the Internal Revenue Code of 1986; Operation of Sections 382 and 383 With Respect to Consolidated Groups [CO-132-87], 56 Fed. Reg. 4194, 4195 (Feb. 4, 1991). The neutrality principle presumes that each of the joining corporations had access to the NOL before the ownership change. Jerred G. Blanchard, Jr. et al., *Taxation of Corporations Filing Consolidated Returns* § 42.05[2][b][i] & n.838 (2023) discusses circumstances where this may not be the case.

[61] Treas. Reg. § 1.1502-96(a)(1). Separate tracking will also not be required if an ownership change occurs in the six months before the new loss member or loss subgroup joins the consolidated group.

[62] Treas. Reg. § 1.1502-91(a).

[63] Treas. Reg. § 1.1502-95(b)(1).

the departing member (and that are not absorbed by the group in the year of departure or otherwise reduced) generally are apportioned to that member and may be carried to its separate return years.[64] If the group had an ownership change prior to the member's departure, any pre-change losses with respect to that ownership change allocated to the former member remain subject to a Section 382 limitation.[65] The former member's Section 382 limitation with respect to that ownership change is zero unless the group parent apportions some of the group's consolidated Section 382 limitation to the former member.[66]

The regulations governing the application of Section 382 to consolidated groups do not address the operation of the Section 382 Bankruptcy Provisions. Treas. Reg. § 1.1502-97 has been reserved for this purpose since 1999. When Treas. Reg. §§ 1.1502-90 to 1.1502-99 were proposed in 1991, the preamble to the proposed regulations noted that "[d]epending on the issue and the circumstances in which it arises, the rules may adopt a single entity approach."[67]

IV. Discussion

The lack of guidance on when and how the Section 382 Bankruptcy Provisions apply to consolidated groups causes uncertainty when some or all members of a consolidated group undergo reorganization in a title 11 case. As explained below, we believe that, in general, the single-entity approach should extend to the Section 382 Bankruptcy Provisions, and we offer rules for applying those provisions on a single-entity basis.

A. Threshold Questions

In the context of an affiliated group of corporations filing a consolidated return, there are three threshold questions regarding the application of the Section 382 Bankruptcy Provisions: First, under what circumstances does a member of the group experience an ownership change (the "**Ownership Change Question**")? Second, if the group or any members thereof experiences an ownership change, under what circumstances does the group or those members qualify for the application of one of the Section 382 Bankruptcy Provisions (the "**Qualification Question**")? And, third, if one of the Section 382 Bankruptcy Provisions is applicable to one or more members of the group with respect to an ownership change, does the Section 382 Bankruptcy Provision apply to consolidated attributes or to attributes as determined on a separate entity basis (the "**Application Question**")?

[64] Treas. Reg. § 1.1502-21(b)(2). This allocation is generally based on the member's separate NOL(s) for the relevant year(s), computed on a separate-entity basis. Treas. Reg. § 1.1502-21(b)(2)(iv)(A)-(B). In the year of departure, the NOL carryforwards attributable to the departing member are carried first to the consolidated return year before being allocated. Treas. Reg. § 1.1502-21(b)(2)(ii)(A).

[65] Treas. Reg. § 1.1502-95(b)(2)(i).

[66] Treas. Reg. § 1.1502-95(b)(2)(ii).

[67] Regulations Under Section 1502 of the Internal Revenue Code of 1986; Operation of Sections 382 and 383 With Respect to Consolidated Groups [CO-132-87], 56 Fed. Reg. 4194, 4197 (Feb. 4, 1991).

Existing regulations under Treas. Reg. §§ 1.1502-92 and 1.1502-95 provide answers to the Ownership Change Question in the context of the general application of Section 382 to consolidated groups, and we believe the same principles should apply in the context of the Section 382 Bankruptcy Provisions. In other words, unless the generally applicable anti-abuse rules apply,[68] whether the group or any member of the group undergoes an ownership change generally should be determined by reference to whether the common parent of the group undergoes such a change.[69] However, in the case where one or more corporations cease to be members of the group, in which case separate entity principles should apply.

Existing consolidated return regulations offer no guidance as to the Qualification Question or the Application Question, although the general approach of those regulations, both as they pertain to the application of Section 382 outside of bankruptcy and as they pertain to tax losses more generally, strongly suggest a single-entity approach to implementing the Section 382 Bankruptcy Provisions in the consolidated group context, which the Service generally has adopted through its administrative guidance.[70] We believe that the Application Question is the central point of inquiry, as its answer necessarily will inform the proper approach to the Qualification Question. Therefore, we address the Application Question first in Part IV.B, and for the reasons discussed there, we believe the Section 382 Bankruptcy Provisions should apply to consolidated attributes on a single-entity basis, except to the extent appropriate to take into account any departures from the group in connection with the related title 11 case. We then take up the Qualification Question in Parts IV.C, D and K, and for the reasons discussed there we believe that it would be appropriate to determine the applicability of the Section 382 Bankruptcy Provisions using a single-entity framework, except to the extent appropriate to take into account the departure of one or more members from the group in connection with the related title 11 case. We also propose certain operating rules for the application of the Section 382 Bankruptcy Provisions in light of the recommended approaches to the Application Question and the Qualification Question.

[68] *See supra* note 52.

[69] Principles under existing regulations should also apply to determine whether a loss subgroup that is subject to separate tracking undergoes an ownership change; but in circumstances in which the Section 382 Bankruptcy Provisions may be relevant, we generally would expect any ownership change with respect to such a loss subgroup to occur either (i) concurrently with an ownership change of the consolidated parent or (ii) in connection with the departure of such loss subgroup from the larger group. We therefore do not propose special rules to address the circumstance in which the loss subgroup, but not the common parent, experiences an ownership change and remains as part of the broader consolidated group, although such an occurrence is theoretically possible.

[70] *See* PLR 201435003 (ruling that the determination whether Section 382(l)(5) applies to a loss group will be made "on a consolidated basis" based on whether shareholders and qualified creditors of the group receive at least 50% of the stock of the title 11 debtor parent); PLR 201328027 (ruling, where the loss group parent was a debtor in a title 11 case but its principal operating subsidiary was not, that no Section 382 limitation would be imposed on the group following an ownership change due to the application of Section 382(l)(5)); PLR 201306003 (same); PLR 201051019 (same, where parent and an entity disregarded as separate from a subsidiary were title 11 debtors but no other members were). The IRS's approach to Section 382(l)(6) has been mixed. *See* PLR 201435003 (providing a method for calculating the value of a loss group for (l)(6) purposes incorporating both single- and separate-entity principles); PLR 8849061 (ruling, consistent with a single-entity approach, that neither of the Section 382 Bankruptcy Provisions applies where a loss group parent is not a title 11 debtor).

B. Section 382 Bankruptcy Provisions Should Apply on a Single-Entity Basis

Outside of the bankruptcy context, regulations under Section 382 and Section 1502 generally operate to apply a single Section 382 limitation on a group-wide, single-entity basis to the consolidated losses of a loss group (or loss subgroup), and the quantum of that limitation is determined by reference to the entire equity value of the group (without duplication).[71] Similarly, when a standalone corporate taxpayer undergoes an ownership change, either in or outside of bankruptcy, any Section 382 limitation applies to the entirety of that taxpayer's relevant attributes and is determined by reference to its entire equity value or asset value, as the case may be. In our view, this approach is entirely appropriate in both cases and, absent a strong justification to the contrary that is rooted in the particulars of the Section 382 Bankruptcy Provisions, should be extended to the application of the Section 382 Bankruptcy Provisions in the consolidated context. As discussed below, we do not believe any such justification exists; rather, we believe that a single-entity approach is firmly supported by policy and administrative considerations. Accordingly, we recommend that Treasury and the Service promulgate regulations implementing the Section 382 Bankruptcy Provisions in a manner consistent with that approach.

1. Policy Considerations Support a Single-Entity Approach

The Section 382 Bankruptcy Provisions should be administered in the consolidated group context in a manner that best supports both the neutrality principle underlying Treas. Reg. §§ 1.1502-90 to 1.1502-99 and the targeted relief Congress sought to make available by enacting Sections 382(l)(5) and (l)(6). We believe that a single-entity approach does so.

a. The Neutrality Principle and Consistency With Existing Rules

As discussed above, the existing consolidated return regulations generally take a single-entity approach to Section 382 in that they determine whether an ownership change has occurred by reference to the group as a whole, apply a single Section 382 limitation to the consolidated attributes of the entire group when an ownership change occurs and determine the amount of that limitation based on the entire equity value of the group.[72] The existing regulations similarly apply single-entity concepts to the loss subgroup when a collection of formerly affiliated corporations are acquired by a consolidated group. The regulations do this primarily in service of a "neutrality principle" – group losses that could be used to offset income of the members prior to an ownership change should remain available for the members' use following the ownership change, subject only to limitations that would be imposed on a single entity in similar circumstances.[73] But a corollary benefit of this single-entity approach is that it generally

[71] *See* Part III.D, *supra*. As discussed above, there are some circumstances in which, outside of bankruptcy, a Section 382 limitation may be applied to a separate entity (*see* note 52, *supra*), even if the composition of the group's members is unchanged. However, we believe those circumstances are unlikely to be present when an ownership change occurs in a title 11 case.

[72] *See* Part III.D, *supra*.

[73] Regulations Under Section 1502 of the Internal Revenue Code of 1986; Operation of Sections 382 and 383 With Respect to Consolidated Groups [CO-132-87], 56 Fed. Reg. 4194, 4196 (Feb. 4, 1991). *See* Part III.D, *supra*.

preserves the single-entity framework for group losses reflected in Treas. Reg. § 1.1502-21 rather than requiring supplemental rules for the separate tracking of intragroup loss utilization.

Applying a single-entity approach to the Section 382 Bankruptcy Provisions similarly would adhere to the neutrality principle and dovetail with existing rules, both in the Section 382 and more general contexts.[74] On the other hand, applying a separate-entity approach to the Section 382 Bankruptcy Provisions would not be consistent with the neutrality principle. Rather, doing so would impose restrictions on group loss utilization that would not apply to a single corporation in similar circumstances. A single entity that undergoes reorganization in a title 11 case either qualifies for the application of Section 382(l)(5) or it does not. And under Section 382(l)(6), a standalone loss corporation has a single Section 382 limitation based on its overall equity value following the cancellation of any of its creditors' claims (or the pre-change gross value of all of its assets, if applicable), not multiple Section 382 limitations based on the creditor claims, net equity values or gross asset values of its various divisions.

The neutrality principle and consistency with existing rules therefore would weigh in favor of a single-entity approach to both of the Section 382 Bankruptcy Provisions.

b. Relief in the Bankruptcy Setting

Single-entity treatment is also consistent with the purposes of the Section 382 Bankruptcy Provisions.

The Section 382 Bankruptcy Provisions reflect an acknowledgment that the creditors of an insolvent corporation have over time acquired a proprietary interest in the corporation and often have funded losses that would be subject to any Section 382 limitation. Because it can be difficult to identify when this has occurred, the Section 382 Bankruptcy Provisions require the filing of a title 11 case as a proxy.[75] Under these conditions, Congress determined that it would

[74] Consistent with the single-entity approach, the Supreme Court has held that a consolidated group has a single CNOL; its individual members do not have separate NOLs. *United Dominion Indus. v. United States*, 532 U.S. 822, 831 (2001) (ruling that, in calculating under prior law the product liability loss (which could not exceed the current-year NOL) of a consolidated group, the group could include the product liability expenses of members with positive separate taxable income, as "there is no NOL below the consolidated level and hence nothing for comparison with [produce liability expenses] to produce [product liability losses] at any stage before the CNOL calculation"). Similarly, the Tax Court has held that the entirety of a consolidated group's federal income tax liability is the federal income tax liability of each member of the group. *See Globe Products Corp. v. Comm'r*, 72 T.C. 609 (1972). Moreover, insofar as the federal income tax law is concerned, a consolidated group is entitled to receive a single refund, paid to the agent of the group, without regard to which member or members may have state-law claims to the refund. *See Rodriguez v. FDIC*, 140 S. Ct. 713 (2020). A single-entity approach to the Section 382 Bankruptcy Provisions also would be consistent with the approach taken in the Code in certain analogous situations, including the limitation on the use of pre-acquisition losses of one corporation to offset built-in gains of another corporation acquiring it or acquired by it under Section 384. *See* Section 384(c)(6) ("Except as provided in regulations and except for purposes of subsection (b), all corporations which are members of the same affiliated group immediately before the acquisition date shall be treated as 1 corporation.").

[75] This is in keeping with the general goal of providing objective tests in Section 382. *See* Part III.C.2, *supra*.

be appropriate to provide relief from the zero limitation that otherwise would be imposed by Section 382.[76]

As discussed below, we generally would limit the application of the Section 382 Bankruptcy Provisions to circumstances in which the Tested Entity – generally, the parent of the relevant group or loss subgroup – is itself a debtor in a title 11 case.[77] In those circumstances, we believe that a single-entity approach is fully consistent with the policies underlying the Section 382 Bankruptcy Provisions, both as to the propriety of relief and as to the limitations on its availability. Where the Tested Entity is a debtor in a title 11 case, at least certain of the group's creditors will hold proprietary interests in the business of the group and, often, they will have funded the group's losses, directly or indirectly. Moreover, we believe that the anti-trafficking purpose of Section 382 would be adequately served by the qualification requirements of Section 382(l)(5), together with the harsh consequences under that provision of a near-term second ownership change, and the anti-stuffing protections of Section 382(l)(6), in each case, adapted to the consolidated group setting as we propose. In contrast, we believe that a separate-entity approach to the Section 382 Bankruptcy Provisions would deny relief inappropriately in many cases. It may often be the case, for example, that members of a consolidated group would fail to meet the qualification requirements of Section 382(l)(5) unless the group were "busted up" in the title 11 case.[78] Similarly, the anti-stuffing limitations in Section 382(l)(6) (and Section 382(l)(1)) would appear to render Section 382(l)(6) largely ineffectual for subsidiary members of the group under a strict separate-entity approach.

In certain fact patterns that may be present in the consolidated context, the policy rationale for the Section 382 Bankruptcy Provisions arguably could serve as a justification for departing from a single-entity approach. In particular, not all members of the group may be debtors in the title 11 case.[79] As such, not all creditors of the group may stand in the position of proprietors and, of those who do, their proprietary interest may extend only to a portion of the enterprise.[80] In either case, the creditors may not have funded losses incurred by the group or certain of its members.[81]

[76] *See* Part III.C.2, *supra*.

[77] *See* Parts IV.D and IV.K, *infra*. The Tested Entity will be the parent of the consolidated group or the existing loss subgroup unless the group breaks up pursuant to a confirmed plan of reorganization or an order of the court in the title 11 or similar case, in which case it may be a former member that becomes the parent of a new consolidated group, the parent of a loss subgroup within a new consolidated group, a standalone new loss member within a new consolidated group or a standalone corporation. *See* Part IV.C, *infra*.

[78] We discuss this issue in greater detail in Part IV.D below.

[79] We understand that a number of factors may go into the decision of which affiliated entities join in the filing of a title 11 case, including not just solvency considerations but also regulatory matters and the potential consequences of a filing under contractual arrangements (*e.g.*, leases) to which an entity is a party.

[80] As a practical matter, however, creditors of a subsidiary frequently have claims on the rest of the group's assets. *See* Jiyeon Lee-Lim & Orly C. Morgenstern, "Guarantors and Co-Obligors in the Tax World," 36 *Int'l. Tax J.* 45 (2010).

[81] Within the context of many consolidated groups, it may be difficult to determine whether a creditor of a subsidiary, in substance, funded losses incurred elsewhere in the group, in light of the prevalence of intercompany distributions, intercompany contributions and intercompany loans.

However, this also can be true of the creditors of a standalone corporation. Those creditors might hold claims with limited recourse and, thus, hold a proprietary interest in less than all of the corporation's business. Alternatively, a creditor of a standalone corporation might be adequately secured, or might hold the debt of a solvent business entity that is disregarded as separate from the corporation for U.S. federal tax purposes, and thus might not stand in the position of a proprietor. But in neither case would the corporation be barred from the relief provided by the Section 382 Bankruptcy Provisions or limited in its ability to take into account the full value of its gross assets and the full extent of its debt relief, and neither should a group the Tested Entity of which is a debtor in a title 11 case. Further, we note that Treas. Reg. § 1.382-9(a) limits relief under the Section 382 Bankruptcy Provisions to situations in which "the transaction resulting in the ownership change is ordered by the court or is pursuant to a plan approved by the court." This regulatory requirement – which we would leave intact – would continue to apply to ensure that the transactions giving rise to the ownership change bear an appropriately close relationship to the resolution of the relevant group's distress.

2. Administrability Considerations Support a Single-Entity Approach

Administrability considerations also weigh strongly in favor of a single-entity approach to the Section 382 Bankruptcy Provisions.

A separate-entity approach to Section 382(l)(5) or Section 382(l)(6) would introduce serious administrative burdens which, for the reasons discussed above, would not be justified by underlying policy considerations. A consolidated group's CNOL is determined on a group-wide basis,[82] as is a loss group's NUBIG and, to a lesser degree, its NUBIL.[83] If the Section 382 Bankruptcy Provisions were applied (or determined to be partially inapplicable) to the group on a separate-entity basis, the CNOL would need to be disaggregated, and NUBIGs, NUBILs and Section 382 limitations separately calculated, and then tracked separately for an indefinite period. While separate tracking is contemplated by existing regulations in the context of certain anti-avoidance provisions,[84] a separate-entity approach to the Section 382 Bankruptcy Provisions would represent a significant and burdensome expansion.[85] Moreover, anti-duplication rules (*i.e.*,

[82] *See* Treas. Reg. § 1.1502-21(e).

[83] *See* Treas. Reg. §§ 1.1502-91(g)(2), 1.1502-91(g)(6), 1.1502-92(b)(3), 1.1502-96.

[84] *See* Treas. Reg. § 1.1502-96(b), discussed at note 52, *supra*. The rules for loss subgroups and new loss members also require separate tracking of a member's attributes but are focused on losses that arose before the loss subgroup or new loss member joined the group. To the extent a collection of members leaves a group as part of title 11 or similar case but remain affiliated with each other thereafter, our proposals similarly would provide for a separate accounting of losses allocable to those members.

[85] Commentators have noted some of the issues separate tracking creates:

> Treating a member as having a separate ownership change introduces conceptual issues that are not addressed in the regulations (and are one of the rationales for adoption of the more general single-entity approach to groups and subgroups). In addition to the difficulties of separately tracking each member's owner shifts, taking into account a variety of minority shareholder transactions (even beyond that required by the supplemental method of Treas. Reg. § 1.1502-92(c)), the potential for duplication of IRC Section 382 limitations arises.

(….continued)

rules to prevent double counting of equity value) and new ordering rules for usage would need to be specified. Further, because intragroup transactions could affect (and potentially could be manipulated to affect) the resulting Section 382 limitations and the future utilization of pre-change attributes,[86] it would be necessary to consider whether (and the extent to which) anti-avoidance rules should be adopted. Even if all of these complicated new mechanisms were put in place, a separate-entity approach could still render anomalous results: for example, if Section 382(l)(5) were to apply to one member of the group, while Section 382(l)(6) or the general rules of Section 382 were to apply to another, the second member presumably would have unlimited use of the first's pre-change losses, which would seem potentially contrary to the rationale for applying a separate-entity approach in the first instance.[87]

On the other hand, a single-entity approach would not require a plethora of separate calculations and extended separate tracking of attributes and Section 382 limitations. Nor would it introduce the potential for manipulation through intercompany transactions that would need to be policed via anti-avoidance rules, which themselves create uncertainty and require enforcement resources.

C. Group to Which Single-Entity Approach Applies

In Part IV.B we addressed the Application Question and proposed that the Section 382 Bankruptcy Provisions, if determined to be applicable, generally should apply on a single-entity basis to the consolidated attributes of a consolidated group (or to those of a subset of its members, if that subset departs the group pursuant to an order of the court or the title 11 plan of reorganization). In the sections that follow, we propose rules for doing so. In developing these proposals, we have sought to offer rules that are workable from an administrative perspective and are consistent with the policies underlying Section 382, the Section 382 Bankruptcy Provisions and the broader consolidated return regulations.

We begin by addressing the Qualification Question – that is, to which collection or collections of group members might the Section 382 Bankruptcy Provisions apply and in what circumstances? The first part of that inquiry is straightforward in a case where there are no separately tracked loss members or loss subgroups and the consolidated group remains fully intact following the title 11 plan of reorganization: the Post-Change Group (to which the Section 382 Bankruptcy Provisions, if applicable, should apply) should be the entire consolidated group and the Tested Entity (to which the qualification requirements of the Section 382 Bankruptcy Provisions would be applied, as discussed below in Part IV.D (with respect to Section 382(l)(5)) and Part IV.K

Blanchard et al., *supra* note 60, § 42.05[3][c][ii].

[86] That intercompany obligations and other intercompany transactions easily could affect the group's total tax liability if a separate-entity approach were adopted is itself contrary to the general thrust of their treatment under Treas. Reg. § 1.1502-13, which is to achieve the result which would obtain if the members were separate divisions of a single corporation.

[87] *Cf.* Blanchard et al., *supra* note 60, § 42.05[3][c][ii].

(with respect to Section 382(l)(6))) should be the common parent of the emerged consolidated group.[88]

Where one or more members depart the consolidated group pursuant to an order of the court or the group's confirmed title 11 plan, however, we believe that the applicability and effect of the Section 382 Bankruptcy Provisions should be determined separately for the departing member(s) and the remaining group, consistent with the general approach of Treas. Reg. § 1.1502-95(b)(1) to the Section 382 limitation of a departing member. In that case, the CNOL and other group attributes would be allocated between the departing member(s) and the remaining group, applying the principles of Treas. Reg. § 1.1502-21(b),[89] and then the Section 382 Bankruptcy Provisions would be tested and applied separately to the remaining consolidated group and each departing member or collection of departing members. In the case of a departing member that does not remain affiliated with any other member of the Pre-Change Tested Group, that member should itself be the Tested Entity. In the case of departing members that remain consolidated with each other following their departure, we believe the Tested Entity for determining the applicability of the Section 382 Bankruptcy Provisions generally should be the parent of the new consolidated group or, if the departing members join another existing consolidated group,[90] the parent of the new loss subgroup. In this regard, different members may be taken into account in determining the membership of a loss subgroup for NOL and NUBIL purposes.[91] Nonetheless, we believe that each entity's eligibility for relief under Section 382(l)(5) should be tested only once with respect to consolidated attributes (rather than separately with respect to an NOL

[88] Where an ownership change occurs with respect to both (i) the broader group and (ii) an existing loss member or loss subgroup that is subject to separate tracking in respect of its SRLY losses, it would be difficult to characterize creditors of members of the broader group as having funded the SRLY losses, and those other group members generally would not have access to those SRLY losses prior to the ownership change. Accordingly, we would propose to separately test the existing loss member or loss subgroup for purposes of determining the Section 382 limitation to be applied to those SRLY losses (with the loss member or the parent of the loss subgroup, as applicable, being the Tested Entity for that purpose). In that case, appropriate adjustments would be made under Treas. Reg. § 1.1502-93(b)(2)(ii) to prevent any duplication of value of the stock of a member. We would not, however, propose a special rule where the loss group experiences an ownership change but a new loss member or loss subgroup does not. We expect this to be uncommon and assume that separate tracking of the new loss member or loss subgroup would continue in that case.

[89] Under Treas. Reg. § 1.1502-21(b)(2)(ii)(A), the NOL carryovers attributable to a departing corporation are first carried to the consolidated return year and then subject to reduction under Section 108 and Treas. Reg. §§ 1.1502-28 and 1.1502-36 before being carried to the first separate return year of the departing corporation.

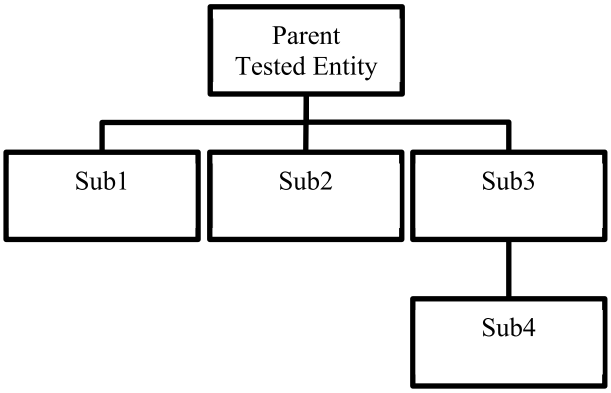
[90] If Section 382(l)(5) applies when a loss subgroup joins a new consolidated group and, as a result, no Section 382 limitation is imposed on the use of the joining members' pre-change NOL carryovers or built-in losses, the SRLY overlap rule (which renders the SRLY rules inapplicable when both a Section 382 limitation and a SRLY limitation would be imposed) would not be implicated, and the ordinary SRLY limitations would apply to the utilization of subgroup losses to offset income of the broader group. *See* Treas. Reg. § 1.1502-21(g)(ii)(2)(A) ("An overlap . . . occurs if a corporation becomes a member of a consolidated group (the SRLY event) within six months of the change date of an ownership change giving rise to a section 382(a) limitation with respect to that carryover (the section 382 event)."); Treas. Reg. § 1.1502-15(g)(ii)(2)(A) (similarly requiring an "ownership change giving rise to a section 382(a) limitation" within six months to trigger the overlap rule).

[91] *See* Treas. Reg. § 1.1502-91(d).

carryover and again with respect to a NUBIL).[92] However, if a subset of those departing members constituted an existing loss subgroup of the old consolidated group, that subset would be tested separately to determine the applicability of Section 382(l)(5) to the existing loss subgroup's SRLY losses (and its parent would be a Tested Entity for that purpose).[93]

The examples below illustrate the Tested Entity concept.

> **Example 1.** Parent owns three direct subsidiaries, Sub1, Sub2 and Sub3. Sub3 owns Sub4. Parent, Sub1, Sub2, Sub3 and Sub4 are a consolidated group (the "**Parent Group**"). Parent Group undergoes reorganization in a title 11 case and experiences an ownership change. Following the title 11 plan of reorganization, all members remain consolidated with each other (with Parent remaining the group parent).



> Parent is the Tested Entity.
>
> **Example 2.** Parent Group is organized as in Example 1 and members of Parent Group undergo reorganization in a title 11 case. Following the title 11 plan of reorganization, Sub2 is no longer consolidated with Parent Group, while Sub1,

[92] When members leave one consolidated group and join another, we believe the Post-Change Group should consist of the following:

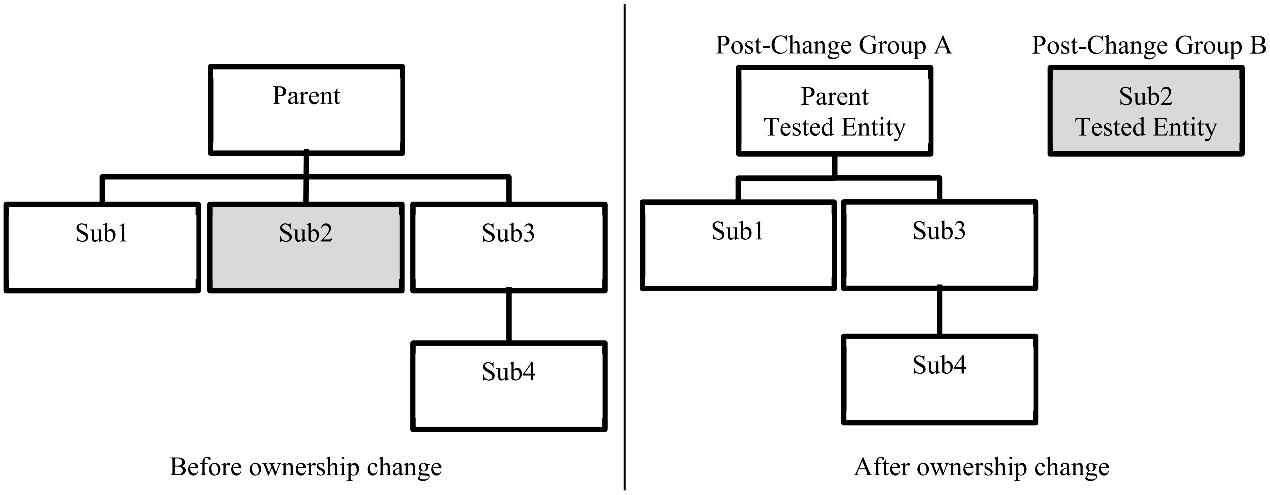
1. If there is a new NOL loss subgroup described in Treas. Reg. § 1.1502-91(d)(1), we would treat that loss subgroup as the Post-Change Group and its parent as the Tested Entity.

2. If there is no NOL subgroup (because no member carries over a net operating loss described in Treas. Reg. § 1.1502-91(d)(1)(iii)), we would treat any NUBIL loss subgroup described in Treas. Reg. § 1.1502-91(d)(2) as a Post-Change Group and the parent of such Post-Change Group as the Tested Entity with respect to that Post-Change Group.

There may be multiple NUBIL loss subgroups or there may be a new loss member with a NUBIL that is not part of a loss subgroup; if there is no NOL loss subgroup, we would test each NUBIL loss subgroup or NUBIL new loss member separately. If an election were made under Treas. Reg. § 1.1502-91(d)(4), then each member treated as a loss subgroup parent should be treated as a Tested Entity (and Section 382(l)(5) would apply to a Post-Change Group only if all of its Tested Entities qualified for its applicability).

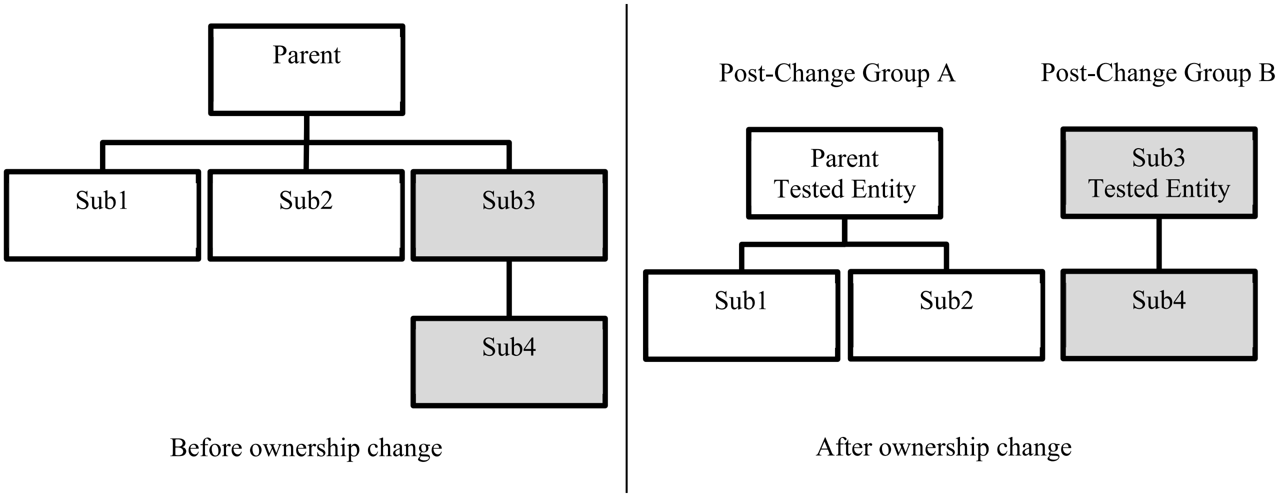
[93] Again, in this circumstance, appropriate adjustments would be made under Treas. Reg. § 1.1502-93(b)(2)(ii) to prevent any duplication of value of the stock of a member.

Sub3 and Sub4 remain consolidated subsidiaries of Parent (with Sub4 owned by Sub3). Both Parent and Sub2 experience ownership changes.


Parent
Sub1
Sub2
Sub3
Sub4
Before ownership change
Post-Change Group A
Post-Change Group B
Parent
Tested Entity
Sub2
Tested Entity
Sub1
Sub3
Sub4
After ownership change

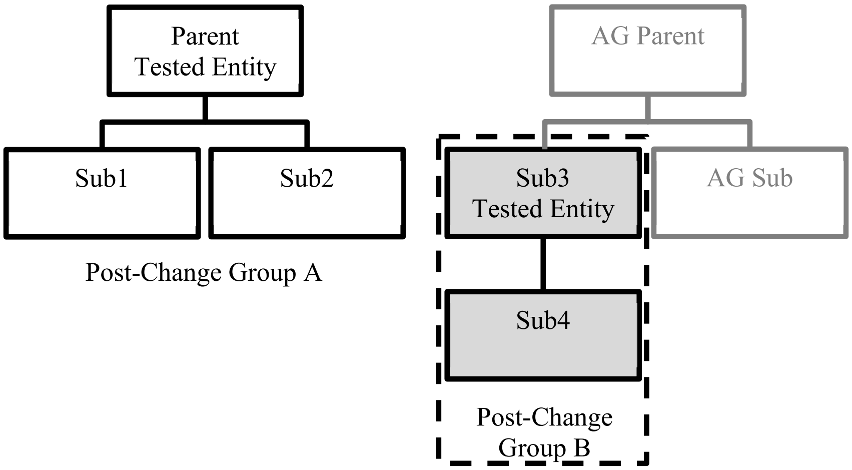
With respect to Sub2's ownership change, Sub2 is the Tested Entity. With respect to the ownership change of the remaining Parent Group, Parent is the Tested Entity.

Example 3. Parent Group is organized as in Example 1. Members of Parent Group undergo reorganization in a title 11 case. Following the title 11 plan of reorganization, Sub3 and Sub4 are no longer consolidated with Parent Group but remain consolidated with each other, while Sub1 and Sub2 remain consolidated subsidiaries of Parent. Both Parent and Sub3 experience ownership changes.


Parent
Sub1
Sub2
Sub3
Sub4
Before ownership change
Post-Change Group A
Post-Change Group B
Parent
Tested Entity
Sub3
Tested Entity
Sub1
Sub2
Sub4
After ownership change

With respect to the ownership change of the new consolidated group parented by Sub3, Sub3 is the Tested Entity. With respect to the ownership change of the remaining Parent Group, Parent is the Tested Entity.

Example 4. Parent Group is organized as in Example 1. Members of Parent Group undergo reorganization in a title 11 case. Following the title 11 plan of reorganization, Sub3 and Sub4 are no longer consolidated with Parent Group but remain consolidated with each other and join Acquiring Group (consisting of AG Parent and AG Sub) with Sub3 as a subsidiary of AG Parent. Sub3 and Sub4 comprise a new loss subgroup described in Treas. Reg. § 1.1502-91(d)(1) within Acquiring Group. Sub1 and Sub2 remain consolidated subsidiaries of Parent. Both Parent and Sub3 experience ownership changes as a result of the title 11 plan.



After ownership change

With respect to the ownership change of the new loss subgroup parented by Sub3, Sub3 is the Tested Entity. Sub3's ownership change terminates separate tracking of the loss subgroup within Acquiring Group; however, if no Section 382 limitation is imposed on the use of Sub3 and Sub4's pre-change losses in Acquiring Group due to the application of Section 382(l)(5) to its ownership change, then the SRLY limitation will apply with respect to those carryovers.[94] With respect to the ownership change of the remaining Parent Group, Parent is the Tested Entity.

D. Proposed Criteria for Qualifying Under Section 382(l)(5)

Section 382(l)(5)(A) sets forth a pair of criteria for the application of Section 382(l)(5) to a loss corporation. Below, we propose rules adapting these criteria to the consolidated-group context.

1. Tested Entity Must Be a Debtor in the Title 11 Case

The first criterion in Section 382(l)(5)(A) is that the old loss corporation be "under the jurisdiction of the court in a title 11 or similar case."[95] Where pre-change shareholders and creditors will receive stock of a "controlling corporation" rather than the loss corporation, that

[94] *See supra* note 90.

[95] Section 382(l)(5)(A)(i).

section requires that the controlling corporation "also [be] in bankruptcy."[96] When one member of a consolidated group undergoes reorganization in a title 11 case, it is possible that not every other member of the group will join that case as a title 11 debtor. It is therefore necessary to determine whether Section 382(l)(5) may apply when not all members are debtors in the title 11 case and, if so, which members must be title 11 debtors in order for Section 382(l)(5) to apply. We believe that the best answer is that the Tested Entity or its qualifying predecessor[97] must be a debtor in a title 11 case,[98] but we would not require any other member to be a title 11 debtor.[99]

Requiring the Tested Entity to be a debtor in the title 11 case is most consistent with the policies underlying Section 382(l)(5).[100] Section 382(l)(5) is intended to provide relief from the Section 382 limitation where due to a corporation's financial difficulties, its creditors have come to hold a proprietary interest in the corporation's business, and bankruptcy filing is an objective indicator

[96] Section 382(l)(5)(A)(ii).

[97] Existing guidance under the Section 382 Bankruptcy Provisions does not expressly indicate whether those provisions may apply if a qualifying successor was not a debtor in the associated title 11 or similar case. However, in general, if a loss corporation is acquired in a transaction to which Section 381(a) applies, the target corporation is treated as remaining in existence for so long as pre-change losses, NUBILs or credits (determined as if such Section 381(a) transaction were the change date) persist, the acquiring corporation is also considered as a loss corporation and the acquiring corporation's stock is treated as the target corporation's stock for purposes of determining whether an ownership change occurs. *See* Treas. Reg. §§ 1.382-2(a)(1)(i)-(ii), 1.382-2(a)(5). Moreover, the text of Section 382(l)(6), which applies to "any reorganization described in [Section 368(a)(1)(G)]" to which Section 382(l)(5) does not, strongly suggests that either section may apply where a Section 381(a) predecessor, but not its successor, was a title 11 debtor. We believe it is appropriate to treat, for purposes of the Section 382 Bankruptcy Provisions, a qualifying successor as though it had been a debtor in the associated title 11 or similar case and, therefore, recommend that Treasury and the IRS issue guidance to that effect. In the remainder of this Report, we assume that a corporation's qualifying successor will succeed to such corporation's status as a title 11 debtor for purposes of applying the Section 382 Bankruptcy Provisions and this Report's proposals for guidance thereunder.

[98] The requirement in Section 382(l)(5) that the loss corporation be "under the jurisdiction of the court in a title 11 or similar case" arguably does not require that a standalone loss corporation be a title 11 debtor, and we previously proposed a more expansive interpretation of the phrase "under the jurisdiction of the court" in the context of Section 108. *See* New York State Bar Association Tax Section, Report No. 1289, *Report Addressing Proposed Treasury Regulation § 1.108-9*, at 19-25 (June 25, 2013). However, Treasury did not adopt this proposal, *see* T.D. 9771, Guidance Under Section 108(a) Concerning the Exclusion of Section 61(a)(12) Discharge of Indebtedness Income of a Grantor Trust or a Disregarded Entity, 81 Fed. Reg. 37504, 37505 (June 10, 2016). Moreover, we read the subsequent text of Section 382(l)(5)(A)(ii), which requires that any parent corporation of which stock is issued "*also* [be] in bankruptcy" (emphasis added), to indicate that such a loss corporation must be a title 11 debtor if Section 382(l)(5) is to apply. *See also* Treas. Reg. § 1.108-9(a)(2) (providing that Section 108(a)(1)(A) – which applies when a taxpayer who has a discharge of indebtedness "is under the jurisdiction of the court in a [title 11] case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court" – applies to a grantor trust or disregarded entity only if the owner of the trust or disregarded entity is "under the jurisdiction of the court in a title 11 case *as the title 11 debtor*") (emphasis added).

[99] As described in Part IV.D.2, *infra*, however, in certain cases we would treat a Pre-Change Tested Group member's pre-change creditors as owners of qualified indebtedness of the Tested Entity only if that member is a title 11 debtor.

[100] It is also consistent with the consolidated return regulations' focus on the group parent in determining, for example, whether an ownership change has occurred. *See* Treas. Reg. § 1.1502-92(b).

that this has occurred.[101] We believe that a title 11 filing by a Tested Entity provides an adequate signal that the enterprise it heads has reached this point, while the bankruptcy filing of a subsidiary alone may not.[102] This approach is also consistent with the text of Section 382(l)(5)(A)(ii) (requiring a parent corporation whose stock is received by qualifying creditors to be in bankruptcy itself), the prior ruling practice of the IRS[103] and the existing regulations' focus on the group parent in determining whether an ownership change has occurred.[104]

However, we do not believe it necessary for any other group member to be a debtor in the title 11 case in order to meet the requirement under Section 382(l)(5)(A)(i). Our view is consistent with prior IRS ruling practice[105] and a single-entity approach that, properly in our view, treats the Tested Entity as a bankrupt title 11 debtor the subsidiaries of which constitute divisions of a single corporation (potentially with limited recourse liabilities).

2. Tested Entity's Stock Must Be 50% Owned by Group's Pre-Change Shareholders and Holders of Qualified Indebtedness

In the context of a standalone corporation, Section 382(l)(5)(A)(ii) requires that at least 50% of the "stock of the new loss corporation (or stock of a controlling corporation if also in bankruptcy)"[106] must be held after the ownership change by pre-change shareholders and certain

[101] *See supra* note 41.

[102] In arriving at this proposal, we have considered arguments against requiring the Tested Entity to be a debtor in the title 11 case. In particular, this requirement may disadvantage holding company structures where assets and liabilities generally are located below the parent (such that the parent might not, absent tax considerations, be a debtor in the title 11 case). However, we believe the benefits of clear and administrable criteria outweigh this concern.

[103] *See* PLR 8849061 (ruling that Section 382(l)(5) was not applicable where subsidiaries of a consolidated group were in bankruptcy but the parent was not).

[104] *See* Treas. Reg. § 1.1502-92(b). Other provisions of the consolidated return regulations also give the group parent special status. *See, e.g.,* Treas. Reg. § 1.1502-77(c) (generally providing that the common parent is the agent for the group); Treas. Reg. § 1.1502-21(b)(2)(ii)(B) (providing that the CNOL attributable to a continuously affiliated member of a consolidated group may be carried back to a separate return year of the common parent if the group did not file a consolidated return for the carryback year and the common parent was not a member of another consolidated group).

[105] *See* PLR 201328027 (ruling, where the loss group parent was a debtor in a title 11 case but its principal operating subsidiary was not, and creditors of the parent received parent stock, that no Section 382 limitation would be imposed on the group following an ownership change due to the application of Section 382(l)(5)); PLR 201306003 (same); PLR 201051019 (ruling that Section 382(l)(5) could apply where common parent was in bankruptcy but other members of the group were not).

[106] In this regard, we note that "control" for purposes of Section 382 has the meaning given to the term in Section 368(c). Although we are explicit in suggesting that subsidiary members of the group not be required to file as debtors in the title 11 case, implicit in our proposals is also that any requirement under Section 382(l)(5) that a Tested Entity be in "control" of a subsidiary member whose creditors receive Tested Entity stock in the title 11 case be abrogated by implementing regulations. Because "control" requires direct ownership of stock, second- or lower-tier subsidiaries could not qualify for Section 382(l)(5) on a separate-entity basis, unless the group were "busted up" pursuant to the title 11 plan of reorganization.

pre-change creditors.[107] In the consolidated return context, we believe this test should be applied to the post-change stock of the Tested Entity. Treas. Reg. § 1.1502-92 looks to the group parent to determine whether an ownership change of the loss group has occurred, and separate entity principles apply in determining whether a departing member and its subsidiaries experience an ownership change.[108] We believe it appropriate to look to the same entity to determine whether – notwithstanding that an ownership change has occurred – a Section 382 limitation should not be imposed because 50% of the post-change stock is owned by pre-change holders of proprietary interests in the business.

It is also necessary to determine which members' shareholders and creditors may qualify as pre-change shareholders and qualified creditors for purposes of Section 382(l)(5). We believe that the shareholders of all members of the Pre-Change Tested Group[109] should be counted as pre-change shareholders, and that holders of otherwise qualified indebtedness issued by Qualified Obligors[110] of the Pre-Change Tested Group should be treated as qualified creditors.[111] For this purpose, we generally include within the Pre-Change Tested Group all members of the pre-change consolidated group, because each member of that group had an interest in the losses of members of the Post-Change Group that arose during consolidation. However, in the context of an existing separately tracked loss member or loss subgroup, we limit the Pre-Change Tested Group to the entities that have an interest in the SRLY losses that are subject to separate tracking and the creditors of which could be viewed as funding those losses – namely the other members (if any) of that separately tracked group.

Section 382(l)(5) should apply with respect to an ownership change if 50% or more of the post-change stock of the Tested Entity is held by those holders by reason of their pre-change holdings (pursuant to a title 11 plan approved by the court or a transaction ordered by the court), even if

[107] Under Section 382(l)(5)(E) and Treas. Reg. § 1.382-9(d)(2) only stock transferred in satisfaction of qualified indebtedness counts toward (l)(5) qualification. Qualified indebtedness includes (i) indebtedness that has been owned by the same beneficial owner since the date 18 months before the bankruptcy filing, and (ii) indebtedness that arose in the ordinary course of business and has been held continuously by the same owner.

[108] Treas. Reg. § 1.1502-95(b).

[109] As used herein, the Pre-Change Tested Group is (i) with respect to a Tested Entity that is an existing loss member, the parent of an existing loss subgroup or a qualifying successor to such member or parent, such loss member or such loss subgroup, and (ii) with respect to any other Tested Entity, the U.S. federal consolidated group of which the Tested Entity or its qualifying predecessor was a member before giving effect to the transaction or series of related transactions that resulted in the ownership change of the Tested Entity.

[110] As used herein, a Qualified Obligor is (i) where the Tested Entity or its qualifying predecessor is the common parent of a consolidated group, any member of that consolidated group, (ii) where the Tested Entity or its qualifying predecessor is an existing loss member, that existing loss member, (iii) where the Tested Entity or its qualifying predecessor is the parent of an existing loss subgroup, any member of that existing loss subgroup and (iv) otherwise, (x) the Tested Entity or its qualifying predecessor and (y) any member of the Pre-Change Tested Group that is a title 11 debtor.

[111] For clarity, we believe that, at least in the context of a surviving consolidated group, a holder of otherwise qualifying indebtedness of a pre-change consolidated subsidiary of the Tested Entity that is not a title 11 debtor should qualify as a holder of qualified indebtedness, although as a practical matter it likely will be uncommon for such a holder to receive Tested Entity stock in the title 11 case.

holders of pre-change stock and debt of no single entity meet that threshold.[112] This approach is generally consistent with the one taken by the IRS in the private ruling context.[113]

As discussed above in Part IV.B, where a shareholder's or creditor's interest is at the level of a subsidiary, we acknowledge that the pre-change interest may not extend to the entire enterprise. More to the point, where a subsidiary member is not a debtor in the title 11 case, an otherwise qualifying creditor may not stand in the position of a proprietor with respect to *any* portion of the enterprise. Thus, where a subsidiary member is not a title 11 debtor, we acknowledge that the policy rationale underlying the Section 382 Bankruptcy Provisions – to provide relief where creditors hold what is economically a proprietary interest in the loss corporation and may have funded its losses – may not be served by treating the subsidiary as a Qualifying Obligor and, absent other safeguards, doing so could facilitate loss trafficking.

Nonetheless, at least in the context of a consolidated group or existing loss subgroup that persists through the ownership change, we believe that creditors of any member of the pre-change consolidated group or loss subgroup should be eligible to qualify as pre-change creditors of the group or subgroup, even if the member is not itself a title 11 debtor. Creditors of a subsidiary are economically similar to holders of limited recourse debt issued by a standalone loss corporation and, in the separate-return context, holders of nonrecourse debt may be qualified creditors of a loss corporation. On the other hand, that fact pattern is distinguishable because the corporate issuer of the limited recourse debt is itself a title 11 debtor and, therefore, squarely within the scope of the language of Section 382(l)(5).

It might historically have been the case that all instruments (and all holders of instruments) treated for U.S. federal income tax purposes as indebtedness of a title 11 debtor would at least be subject to the jurisdiction of the court in the title 11 case. However, after the check-the-box regulations were adopted this is no longer true: under current law, debt of a disregarded subsidiary of a standalone corporation that is a debtor in a title 11 case can constitute qualified indebtedness of the corporate debtor without regard to whether the disregarded subsidiary is also a debtor in that case. For the reasons noted above, this result may not be consistent with the policy rationale for the Section 382 Bankruptcy Provisions. Nonetheless, this is the result under current law, and we do not believe that an entity treated as a corporate subsidiary in a group filing a consolidated return should be subject to a more restrictive treatment than if it was treated as a disregarded entity of a corporate debtor in a title 11 case. Further, any exchange of a

[112] The fact that creditors and shareholders of group members might collectively hold 50% or more of the Tested Entity's stock after an ownership change in a title 11 case – without creditors and shareholders of a single member holding 50% of such stock – also weighs against applying a separate-entity approach to Section 382(l)(5) in the consolidated context, as doing so would render many title 11 reorganizations ineligible for Section 382(l)(5) in a manner inconsistent with the neutrality principle.

[113] *See* PLR 201435003 ("In determining whether section 382(l)(5) applies to the Ownership Change, the Taxpayer Group will be treated on a consolidated basis as though the Taxpayer Group were a single entity under the jurisdiction of the court in a title 11 or similar case. Accordingly, whether section 382(l)(5) applies to the Ownership Change will depend not on whether the qualified creditors of any single Debtor member receive stock of reorganized Parent meeting the requirements of section 1504(a)(2) (determined by substituting '50 percent' for '80 percent' each place it appears), but on whether the shareholders and qualified creditors of the entire Taxpayer Group receive such stock.").

nondebtor subsidiary's debt for stock of the Tested Entity must occur pursuant to an order of the court or a confirmed title 11 reorganization plan in order to count favorably towards the qualification of the ownership change for the application of Section 382(l)(5), and our experience suggests that it would be very uncommon for historic creditors of a solvent subsidiary corporation to voluntarily exchange their creditor claims for the stock of a recently troubled parent corporation.[114] Thus, both procedural and practical hurdles to loss trafficking would exist under our proposal. For these reasons, in the case of a continuing consolidated group, we include subsidiary members of the loss group or loss subgroup as Qualified Obligors without regard to their status as title 11 debtors.

However, where a subset of the pre-change consolidated group members leave the group as part of the resolution of the title 11 case (and that subset did not itself constitute a pre-change existing loss subgroup), this comparison to a standalone loss corporation is not so apt. Creditors of sibling or parent members of the Pre-Change Tested Group are not similar to nonrecourse creditors of the Tested Entity, and a bankruptcy filing by the Tested Entity may give no indication of the financial health of the broader group. In that case, requiring a member to be a title 11 debtor in order to be a Qualified Obligor provides the necessary indication that its creditors stand in the position of proprietors of the broader group. Moreover, while the Tested Entity may be a shareholder in other members of the Pre-Change Tested Group, such that the analogy to a standalone loss corporation could be made, there is no requirement that the Tested Entity hold, directly or indirectly, any minimum percentage of those other members' stock (as there is in the case of a common parent of an affiliated group) and, even if there were, that relationship could be manipulated in a manner not available to the common parent of the group. However, all members of the Pre-Change Tested Group had unrestricted access to all of the group's losses, including those attributable to the Tested Entity.[115] Accordingly, where the Tested Entity becomes a post-change standalone corporation (or a new loss corporation) or the parent of a new post-change consolidated group (or of a new loss subgroup), we would include as Qualified Obligors only the Tested Entity and each other member of the Pre-Change Tested Group that is a title 11 debtor.

Notwithstanding our proposed general rule that Section 382(l)(5) could apply if, immediately after an ownership change, 50% or more of the stock of the Tested Entity is owned by pre-change shareholders of the Pre-Change Tested Group and pre-change holders of otherwise qualified indebtedness issued by Qualified Obligors (in each case, by reason of their qualified pre-change holdings), there are circumstances in which this result may not be appropriate. In particular, a title 11 restructuring could be arranged to exploit the fact that minority shareholdings in Post-Change Group members would not be taken into account in determining the applicability of Section 382(l)(5) by providing for a disproportionate issuance of subsidiary

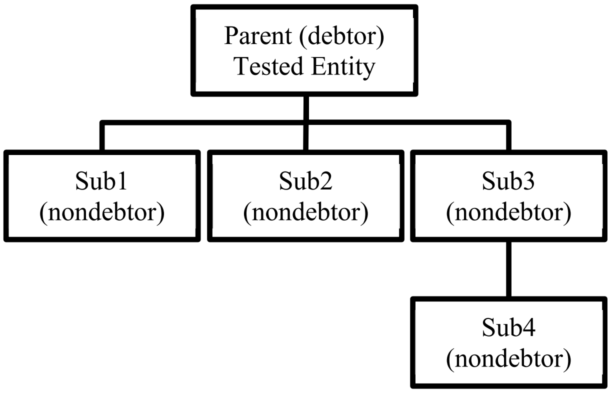
[114] There may be non-tax reasons why an insolvent subsidiary may not join a title 11 case. For example, certain entities, like insurance companies, are not permitted to be debtors in title 11 cases. *See* 11 U.S.C. § 109(b), (d). While an alternative proceeding may be available to such an entity—for example, "rehabilitation" under a state insurance regulator—it is not always clear that the alternative proceeding is a "similar" case.

[115] We also believe that whether the creditors or shareholders of any particular member of the group should be viewed as having funded the group's losses likely would be a fact intensive inquiry and one rendered unnecessary by the neutrality principle as applied to consolidated groups.

stock in exchange for nonqualified consideration in connection with the title 11 restructuring. To prevent this occurrence, we propose an anti-avoidance rule, which would disqualify an ownership change from the application of Section 382(l)(5) if (x) 50% or more of the stock of the Tested Entity would not be owned by qualifying stakeholders (by reason of their surrender of qualifying consideration) if the Tested Entity were treated as also having issued, in exchange for nonqualifying consideration, an amount of its own stock having a value equal to the value of subsidiary stock actually issued in exchange for nonqualifying consideration and (y) a principal purpose of the issuance of subsidiary stock was to allow the Post-Change Group to qualify for the application of Section 382(l)(5) in respect of the ownership change.[116]

We illustrate these proposed rules in the following examples.

> **Example 5.** Parent Group is organized as in Example 1, with three direct subsidiaries (Sub1, Sub2 and Sub3) and one indirect subsidiary (Sub4, owned by Sub3). Parent files for bankruptcy but none of its subsidiaries do. Parent Group undergoes reorganization in the title 11 case and experiences an ownership change. Pursuant to an order of the court or an approved title 11 plan of reorganization, 100% of the stock of Parent is transferred to holders of qualified indebtedness issued by Sub3. All members remain consolidated with each other (with Parent remaining the group parent).

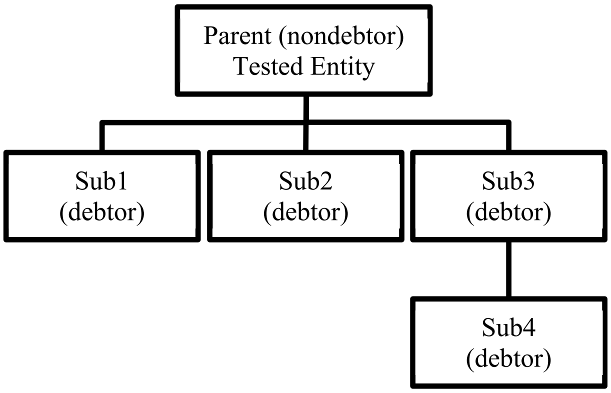


> Parent is the Tested Entity. The ownership change qualifies for the application of Section 382(l)(5) because the Tested Entity is a title 11 debtor and at least 50% of the stock of the Tested Entity is transferred to pre-change holders of qualified indebtedness issued by members of the Pre-Change Tested Group that are Qualified Obligors.

> **Example 6.** Parent Group is organized as in Example 1. Sub1, Sub2, Sub3 and Sub4 file for bankruptcy, but Parent does not. Members of Parent Group undergo reorganization in the title 11 case, and Parent Group experiences an ownership change. Pursuant to an order of the court or an approved title 11 plan of reorganization, 100% of the stock of Parent is transferred to a holder of ordinary-

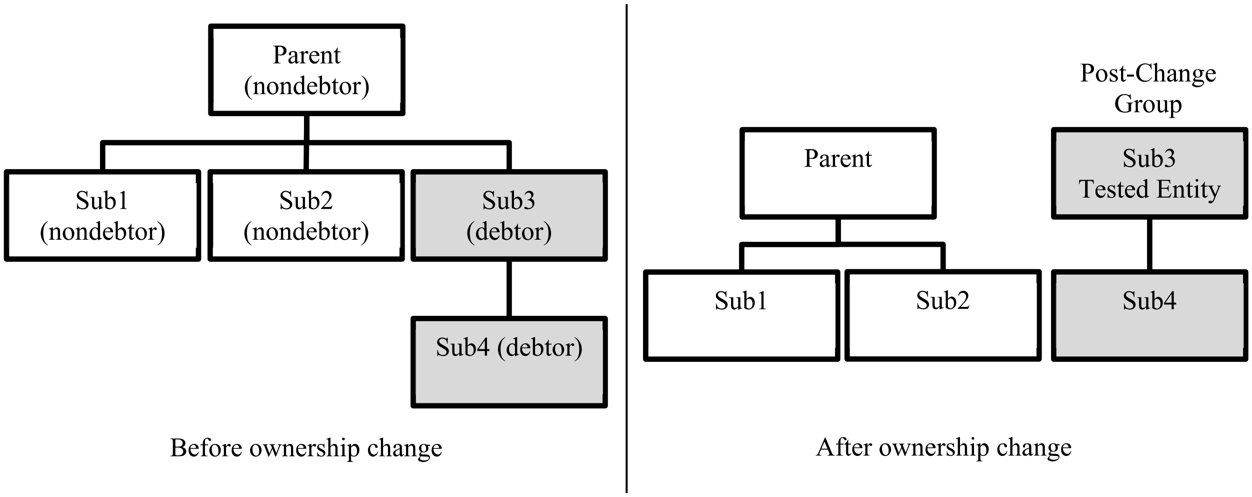
[116] This anti-abuse proposal is modeled in large part on the supplemental ownership change rules of Treas. Reg. § 1.1502-92(c). *See supra* note 53.

course indebtedness issued by Sub3. The holder of Sub3's indebtedness has held the indebtedness continuously since it was issued. All members remain consolidated with each other (with Parent remaining the group parent).


Parent (nondebtor)
Tested Entity
Sub1
(debtor)
Sub2
(debtor)
Sub3
(debtor)
Sub4
(debtor)

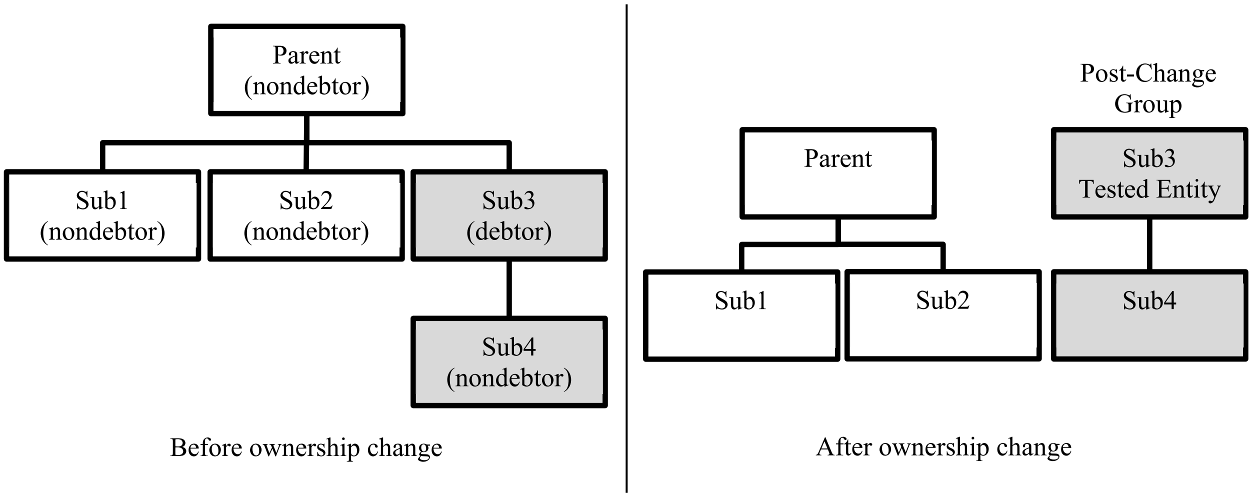
Parent is the Tested Entity. The ownership change does not qualify for the application of Section 382(l)(5) because the Tested Entity is not a title 11 debtor.

Example 7. Parent Group is organized as in Example 1. Sub3 and Sub4 file for bankruptcy, but no other member does. Pursuant to an order of the court or an approved title 11 plan of reorganization, 100% of the stock of Sub3 is transferred to holders of qualified indebtedness issued by Sub4; Sub3 and Sub4 depart Parent Group but remain consolidated with each other (with Sub3 the parent of Sub4). No owner shifts occur with respect to the stock of Parent, and Parent Group does not experience an ownership change.


Parent
(nondebtor)
Sub1
(nondebtor)
Sub2
(nondebtor)
Sub3
(debtor)
Sub4 (debtor)
Before ownership change
Post-Change
Group
Parent
Sub3
Tested Entity
Sub1
Sub2
Sub4
After ownership change

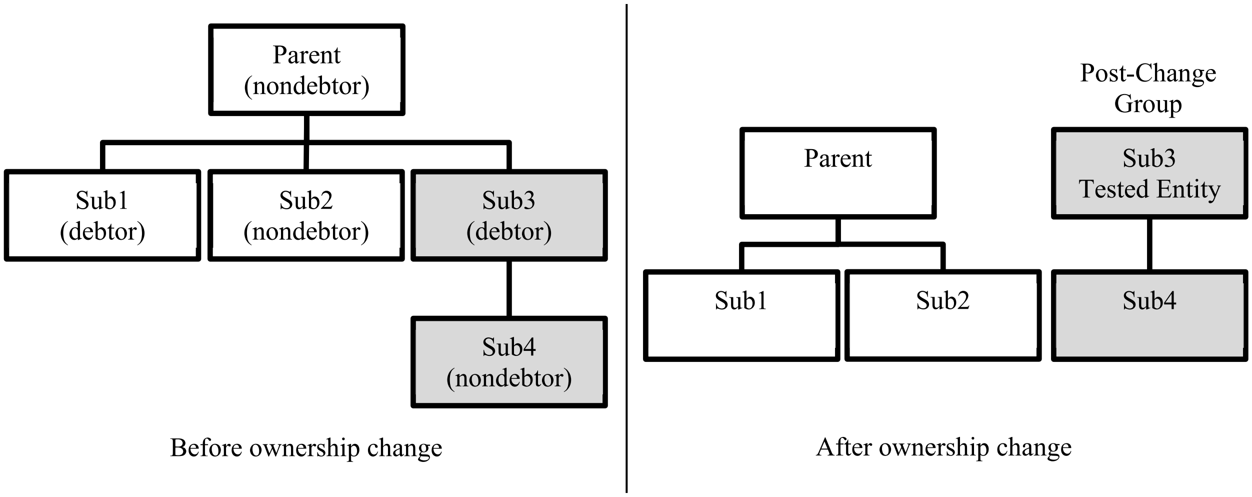
Sub3 is the Tested Entity with respect to the ownership change of the new consolidated group headed by Sub3; the ownership change qualifies for the application of Section 382(l)(5) because the Tested Entity is a title 11 debtor and at least 50% of the stock of the Tested Entity is transferred to pre-change holders of qualified indebtedness issued by a Qualified Obligor.

Example 8. Parent Group is organized as in Example 1. Sub3 files for bankruptcy, but no other member does. Pursuant to an order of the court or an approved title 11 plan of reorganization, (i) 40% of the stock of Sub3 is transferred to holders of qualified indebtedness issued by Sub3, (ii) 40% of the stock of Sub3 is transferred to a holder of ordinary-course indebtedness of Sub1 (who has held such indebtedness continuously since issuance) and (iii) 20% of the stock of Sub3 is transferred to non-ordinary-course creditors of Sub3 who have held Sub3's indebtedness for one month. Sub3 and Sub4 depart Parent Group but remain consolidated with each other (with Sub3 the parent of Sub4). No owner shifts occur with respect to the stock of Parent, and Parent Group does not experience an ownership change.



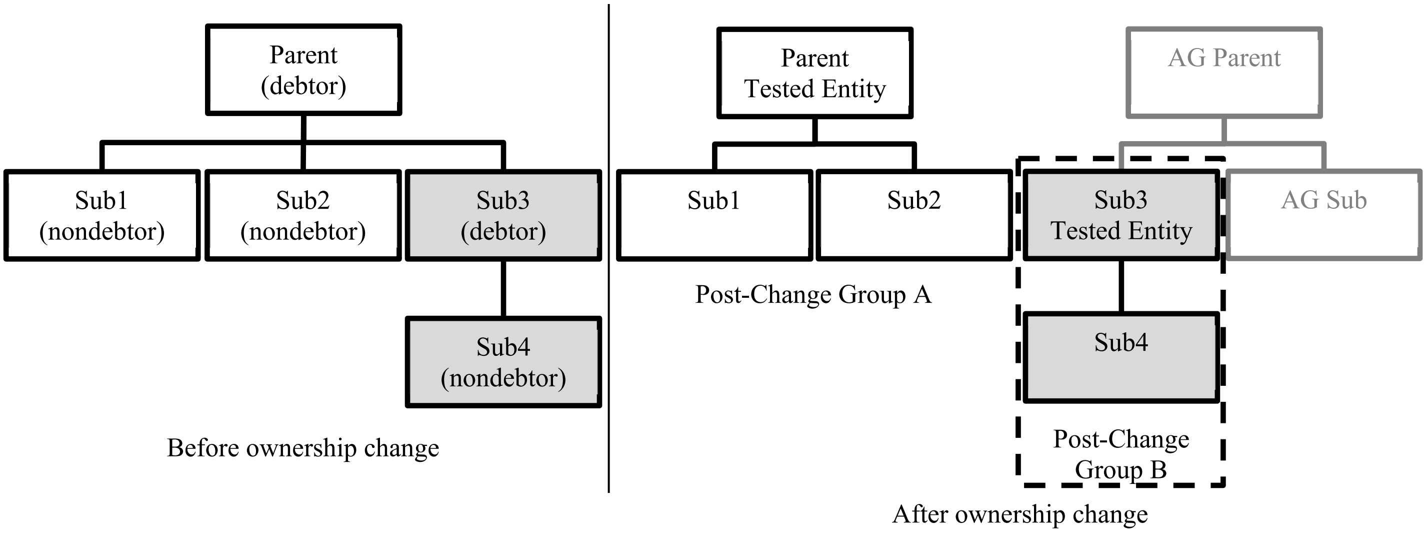
Sub3 is the Tested Entity with respect to the ownership change of the new consolidated group parented by Sub3; the ownership change does not qualify for the application of Section 382(l)(5) because only 40% of the stock of the Tested Entity is transferred to pre-change holders of qualified indebtedness issued by Qualified Obligors. The stock transferred to the holder of Sub1's ordinary-course indebtedness does not count because Sub1 is not a title 11 debtor.

Example 9. Parent Group is organized as in Example 1. Sub1 and Sub3 file for bankruptcy, but no other members do. Pursuant to an order of the court or an approved title 11 plan of reorganization, (i) 40% of the stock of Sub3 is transferred to holders of qualified indebtedness issued by Sub3, (ii) 40% of the stock of Sub3 is transferred to holders of qualified indebtedness issued by Sub1 and (iii) 20% of the stock of Sub3 is transferred to non-ordinary-course creditors of Sub3 who have held Sub3's indebtedness for one month. Sub3 and Sub4 depart Parent Group but remain consolidated with each other (with Sub3 the parent of Sub4). No owner shifts occur with respect to the stock of Parent, and Parent Group does not experience an ownership change.


Parent
(nondebtor)
Sub1
(debtor)
Sub2
(nondebtor)
Sub3
(debtor)
Sub4
(nondebtor)
Before ownership change
Post-Change
Group
Parent
Sub3
Tested Entity
Sub1
Sub2
Sub4
After ownership change

Sub3 is the Tested Entity with respect to the ownership change of the new consolidated group parented by Sub3. The ownership change qualifies for the application of Section 382(l)(5) because the Tested Entity is a title 11 debtor and at least 50% of the stock of the Tested Entity is transferred to pre-change holders of qualified indebtedness (40% to holders of indebtedness issued by the Tested Entity and 40% to holders of indebtedness issued by a member of the Pre-Change Tested Group that is a title 11 debtor).

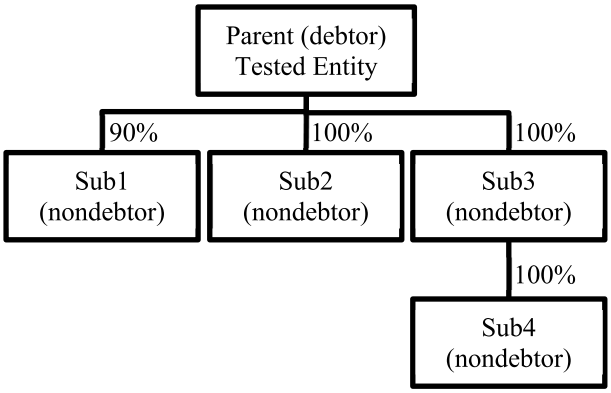
Example 10. Parent Group is organized as in Example 1. Parent and Sub3 file for bankruptcy, but no other members do. Parent Group undergoes reorganization in a title 11 case. Pursuant to an order of the court or an approved title 11 plan of reorganization, (i) 100% of the stock of Sub3 is transferred to AG Parent, a holder of qualified indebtedness issued by Sub3, and (ii) 100% of the stock of Parent is transferred to holders of qualified indebtedness of Parent. Parent and Sub3 experience ownership changes. AG Parent is the parent of Acquiring Group, a consolidated group that, prior to the ownership change of Sub3, consisted of AG Parent and its subsidiary AG Sub. Following the ownership change of Sub3, Sub3 and Sub4 are no longer consolidated with Parent Group but remain consolidated with each other and join Acquiring Group. Sub3 and Sub4 comprise a loss subgroup described in Treas. Reg. § 1.1502-91(d)(1) within Acquiring Group. Sub1 and Sub2 remain consolidated subsidiaries of Parent.


Parent
(debtor)
Sub1
(nondebtor)
Sub2
(nondebtor)
Sub3
(debtor)
Sub4
(nondebtor)
Before ownership change
Parent
Tested Entity
AG Parent
Sub1
Sub2
Sub3
Tested Entity
AG Sub
Post-Change Group A
Sub4
Post-Change
Group B
After ownership change

Parent is the Tested Entity with respect to the ownership change of Parent Group; this ownership change qualifies for the application of Section 382(l)(5) because the Tested Entity is a title 11 debtor and at least 50% of the stock of the Tested Entity is transferred to pre-change holders of qualified indebtedness of the Tested Entity. Sub3 is the Tested Entity with respect to the ownership change of the new loss subgroup within Acquiring Group parented by Sub3; this ownership change qualifies for the application of Section 382(l)(5) because the Tested Entity is a title 11 debtor and at least 50% of the stock of the Tested Entity is transferred to a pre-change holder of qualified indebtedness of the Tested Entity. As a result of the ownership change of Sub3, separate tracking of the loss subgroup parented by Sub3 within Acquiring Group terminates; however, assuming that no election is made to remove the ownership change from the application of Section 382(l)(5), the pre-change losses of Sub3 and Sub4 are subject to SRLY limitation within Acquiring Group.[117]

Example 11. Parent Group is organized as in Example 1, except that a minority shareholder (who is not a shareholder of Parent) holds 10% of the outstanding stock of Sub1. Parent files for bankruptcy, but none of its subsidiaries do. Parent Group undergoes reorganization in the title 11 case and experiences an ownership change. Pursuant to an order of the court or an approved title 11 plan of reorganization, (i) 30% of the stock of Parent is transferred to holders of qualified indebtedness issued by Sub1, (ii) 10% of the stock of Parent is transferred to the minority shareholder of Sub1, (iii) 10% of the stock of Parent is transferred to holders of qualified indebtedness issued by Sub2 and (iv) 50% of the stock of Parent is transferred to holders of non-ordinary-course indebtedness issued by Parent one month ago. All members remain consolidated with each other (with Parent remaining the group parent).

[117] *See supra* note 90.



Parent is the Tested Entity. The ownership change qualifies for the application of Section 382(l)(5) because the Tested Entity is a title 11 debtor and at least 50% of the stock of the Tested Entity is transferred to pre-change shareholders of the Pre-Change Tested Group and holders of qualified indebtedness issued by members of the Pre-Change Tested Group that are Qualified Obligors.

E. Effect of Intra-Group Exchanges and Assumptions

In the separate-return context, if a loss corporation satisfies or is deemed to satisfy its indebtedness with new indebtedness, the owner of the new indebtedness is treated as having owned the new indebtedness for the period it owned the prior indebtedness, and the new indebtedness is treated as having arisen in the ordinary course if the prior indebtedness did.[118] A debt-for-debt exchange therefore will not cause qualified indebtedness to cease being qualified indebtedness under Section 382(l)(5).

We believe that an analogous rule is appropriate in the consolidated-return context under a single-entity approach. We therefore propose that, consistent with prior IRS ruling practice,[119] if a member[120] issues or is deemed to issue indebtedness to a nonmember in exchange for another member's indebtedness, the holder should be treated as having owned the new indebtedness for the period the holder owned the prior indebtedness, and the new indebtedness should be treated as having arisen in the ordinary course of business if the prior indebtedness so arose.

F. Treatment of Indebtedness Originally Incurred by a Nonmember

Notwithstanding that a member of a Pre-Change Tested Group may, in general, be a Qualified Obligor the creditors of which may constitute qualified creditors of a Tested Entity, we believe that indebtedness of a Qualified Obligor that was originally incurred[121] at a time when the

[118] Treas. Reg. § 1.382-9(d)(5)(iv).

[119] *See* PLR 201435003.

[120] For clarity, for the purpose of this proposed rule, "member" includes any DREs of the member.

[121] For this purpose, we would treat the indebtedness, the holding period for which would tack under the proposal described in the preceding Part IV.E, as having been originally incurred when its predecessor indebtedness was originally incurred.

regarded obligor under that indebtedness (or any predecessor indebtedness) was not a member of the Pre-Change Tested Group should constitute qualified indebtedness only if indebtedness of a standalone corporation would be so treated in an analogous situation. We believe that the appropriate standalone corporate analogy is to indebtedness of a Section 381(a) predecessor of the standalone corporation that was assumed by the standalone corporation in the Section 381(a) transaction. As in those circumstances, the Pre-Change Tested Group generally would effectively succeed to the NOLs, NUBILs, credits and Section 163(j) carryforwards of the new member, and the obligor's entry into the Pre-Change Tested Group would not be likely, in and of itself, to give rise to a deemed exchange of the debt under Treas. Reg. §1.1001-3.[122] The extent to which indebtedness of a Section 381(a) predecessor of a standalone corporation could be qualified indebtedness of that standalone corporation in a subsequent ownership change is not entirely clear,[123] but in any event we believe that indebtedness of a Qualified Obligor that was originally incurred outside of a loss group (or subgroup) should be qualified indebtedness of the loss group (or loss subgroup) to that same extent.

G. Determination of Whether Indebtedness Arose in the Ordinary Course

Indebtedness that arose in the ordinary course of a loss corporation's trade or business and that has been continuously owned by the same beneficial owner is qualified indebtedness for the purpose of Section 382(l)(5) and the regulations thereunder.[124] Indebtedness arises in the ordinary course only if it is incurred "in connection with the normal, usual, or customary conduct of business, determined without regard to whether the indebtedness funds ordinary or capital expenditures of the loss corporation."[125] Treas. Reg. § 1.382-9(d)(2)(iv) offers examples of indebtedness arising in the ordinary course, including trade debt; tax liabilities; liabilities arising from employment relationships and relationships with suppliers, customers or competitors; liabilities arising from torts and breaches of warranties or statutory duties; and indebtedness incurred to pay deductible expenses or included in the cost of goods sold.

We believe that whether indebtedness incurred by a member of a consolidated group constitutes ordinary-course indebtedness should be determined taking into account the normal, usual and customary business activities of the entire Pre-Change Tested Group (and not just the member that issued the indebtedness). This is a natural consequence of a single-entity approach to Section

[122] *See* Treas. Reg. § 1.1001-3(e)(4)(B).

[123] We are not aware of any authority directly addressing this question, although a plain reading of the text of Section 382(l)(5)(E)(i) would suggest that, if the indebtedness was incurred more than 18 months prior to the filing of the subsequent title 11 or similar case, it could be qualified indebtedness under that provision, without regard to when the Section 381(a) transaction occurred. The text of Section 382(l)(5)(E)(ii), which requires the debt to have been incurred in the ordinary course of business "of the old loss corporation," is more ambiguous. Treas. Reg. § 1.382-2(a)(1)(i), which provides that any Section 381(a) predecessor of a loss corporation is also a loss corporation, might be read to suggest that indebtedness of a predecessor also could be described in Section 382(l)(5)(E)(ii).

[124] Treas. Reg. § 1.382-9(d)(2)(i)(B).

[125] Treas. Reg. § 1.382-9(d)(2)(iv).

382(l)(5), which would treat the group as a single corporation engaged in all of the lines of business of its members.[126]

H. Recomputation of Pre-Change Losses and Excess Credits

Section 382(l)(5)(B) provides that, if Section 382(l)(5) applies to an ownership change, the corporation must calculate its pre-change losses and excess credits that may be carried to a post-change year as if no deduction was allowable for the interest paid or accrued, in the year of the ownership change or the prior three taxable years, on indebtedness exchanged for stock pursuant to the title 11 case. In the consolidated group context, we believe that this recomputation should take into account the identity of the member which paid or accrued the interest. Regulations provide that the 163(j) limitation is applied[127] and CNOLs are used[128] at the consolidated-group level, and we expect that this rule would be relevant primarily where a member leaves the group.[129]

I. Departure of a Member Within Two Years Following an Ownership Change to Which Section 382(l)(5) Applies

Section 382(l)(5)(D) imposes a zero-dollar Section 382 limitation on a loss corporation that experiences a second ownership change within two years following an ownership change to which Section 382(l)(5) applied. If the Tested Entity experiences such a second ownership change, the application of Section 382(l)(5)(D) is straightforward. If a subsidiary of the Tested Entity experiences such a change on its departure from the Tested Entity's consolidated group, we would propose that the departing member be subject to a zero-dollar Section 382 limitation in respect of pre-change losses of the group to which Section 382(l)(5) applied and that are attributable to the departing member under Treas. Reg. § 1.1502-21(b). However, we would not propose to limit the remaining members of the group in their utilization of such losses in the consolidated return year of such departure.

Existing regulations governing the application of Section 382 in the consolidated group context provide rules for the situation where a subsidiary leaves the group following a prior ownership change of the group. Under Treas. Reg. § 1.1502-95, when the member departs, the portion of

[126] The single-entity approach also applies for purposes of the general 382 COBE requirement. *See* Treas. Reg. § 1.1502-93(d). While this requirement does not apply to ownership changes to which Section 382(l)(5) applies, we propose that a single-entity approach apply for purposes of the presumption in Treas. Reg. § 1.269-3(d), *see* Part IV.J, *infra*, and we believe it is appropriate that the entities considered in determining whether a business is continued should also be considered in determining whether indebtedness was issued in the ordinary course of a business.

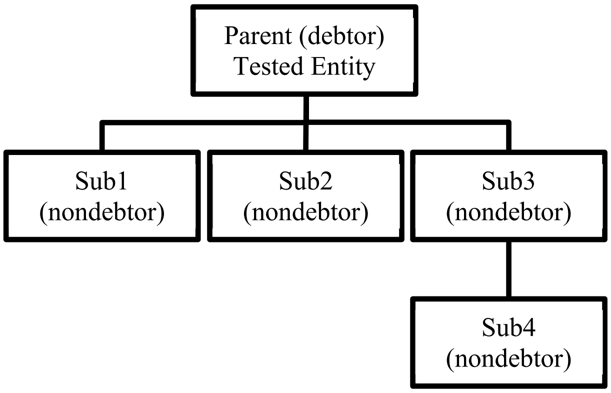
[127] Treas. Reg. § 1.163(j)-4(d)(2)(i).

[128] Treas. Reg. § 1.1502-21(a)(1).

[129] When a member departs, it is necessary to disaggregate the 163(j) carryforwards and losses attributable to the member. *See* Treas. Reg. § 1.163(j)-5(b)(3)(ii); Treas. Reg. § 1.1502-21(b). Where applicable, we would reduce the group's CNOL in respect of interest paid to creditors becoming shareholders before allocating the CNOL under Treas. Reg. § 1.1502-21(b), and we would determine the member's attributable portion as if no deduction was allowable for the interest.

the CNOL attributable to the departing member will be allocated to it under Treas. Reg. § 1.1502-21(b)(2).[130] This occurs after the CNOL is carried to the consolidated return year, and only the attributable portion of the CNOL not absorbed in the consolidated return in the year of departure is allocated to the departing member.[131] While the group would not have a Section 382 limitation in connection with the ownership change to which Section 382(l)(5) applied, if the group had a Section 382 limitation from an even earlier ownership change, the group parent would have the option to apportion some of that limitation to the departing member.[132] However, under our proposed approach, the departing member's Section 382 limitation following the second ownership change would be zero, regardless of any Section 382 limitation apportioned to it by the group. We illustrate this proposal in the following example.

> **Example 12.** Parent Group is organized as in Example 1. As in Example 5, Parent files for bankruptcy, but no other members do, and Parent Group undergoes reorganization in a title 11 case. As in Example 5, pursuant to an order of the court or an approved title 11 plan of reorganization, 100% of the stock of Parent is transferred to holders of qualified indebtedness of Sub3. As described in Example 5, the ownership change of Parent qualifies for the application of Section 382(l)(5). One year later, Parent sells 100% of the stock of Sub3 to an unrelated third party, resulting in an ownership change of both Sub3 and Sub4.



The subsequent ownership change is a second ownership change described in Section 382(l)(5)(D) with respect to Sub3 and Sub4. The portion of the Parent Group CNOL attributable to them under Treas. Reg. § 1.1502-21(b) becomes subject to a zero dollar ($0) Section 382 limitation. Parent Group's ability to use its CNOL (including, during the taxable year of the Parent Group that includes the second ownership change, the portion attributable to Sub3 and Sub4) is not affected.

[130] Treas. Reg. § 1.1502-95(b).

[131] Treas. Reg. § 1.1502-21(b)(2)(ii)(A).

[132] Treas. Reg. § 1.1502-95(c). Presumably the group would not apportion any of this limitation to the departing member if our proposal regarding the consequence of the ownership change that occurs on the member's departure from the group were adopted.

J. Treas. Reg. § 1.269-3(d) Continuity-of-Business Test

While the general 382 COBE requirement does not apply to ownership changes to which Section 382(l)(5) applies,[133] Treas. Reg. § 1.269-3(d) imposes a different continuity-of-business requirement on an acquisition of a corporation (or of property by a corporation) in connection with an ownership change governed by Section 382(l)(5). Unless the corporation "carries on more than an insignificant amount of an active trade or business during and subsequent to the title 11 or similar case," the acquisition is presumed made for the principal purpose of evading income tax, resulting in the denial of the tax benefits secured by the acquisition.[134] The determination is made based on all the facts and circumstances, and the trade or business may "not necessarily [be] the historic trade or business."[135]

We believe that, in the consolidated group context, the activities of the Tested Entity and all of its post-change consolidated subsidiaries should be taken into account for this purpose. This result follows from our broader proposal to adopt a single-entity approach and is consistent with a prior private letter ruling issued by the IRS.[136] It is also consistent with the approach to continuity-of-business tests elsewhere. Following an ownership change to which (l)(5) does not apply, a loss corporation's Section 382 limitation will be zero if it does not meet the general 382 COBE requirement. Regulations treat a consolidated group as a single entity for the purpose of this test.[137] Similarly, the continuity-of-business requirement for several types of tax-free reorganizations under Treas. Reg. § 1.368-1(d) treats the acquiror (who must continue the target's historic business or use a significant portion of its historic assets in a business) as undertaking all of the activities, and holding all of the assets, of a wider "qualified group."[138]

K. Section 382(l)(6) Should Apply on a Single-Entity Basis if the Tested Entity is a Debtor in the Title 11 Case

As we explain in Part IV.B, we believe that Section 382(l)(6) should apply to a consolidated group (or, in the case where some members leave the group pursuant to a confirmed plan or an order of the court in the title 11 or similar case, to the departing members which remain consolidated with each other) on a single-entity basis. Similar to our recommendation in Part IV.D with respect to Section 382(l)(5), we believe that Section 382(l)(6) should apply to an ownership change when the Tested Entity or its qualifying predecessor is a debtor in the title 11 case and any transfer of Tested Entity stock occurs pursuant to an order of the court or an

[133] Treas. Reg. § 1.382-9(m)(1).

[134] Treas. Reg. § 1.269-3(a), (d).

[135] Treas. Reg. § 1.269-3(d).

[136] *See* PLR 201306003.

[137] Treas. Reg. § 1.1502-93(d)(1).

[138] We note, however, that the determination under Treas. Reg. § 1.269-3(d) is "made without regard to the continuity of business enterprise requirement set forth in section 1.368-1(d)."

approved title 11 plan of reorganization.[139] We similarly would not require that subsidiaries be debtors in the title 11 case.

Much of the reasoning in support of this proposal is similar to that described in Part IV.D above.[140] The Section 382 Bankruptcy Provisions treat a bankruptcy filing as an objective indication that a corporation's creditors hold a proprietary interest in its business such that relief from the general application of Section 382 is appropriate. We believe that a filing by the Tested Entity or its qualifying predecessor is adequate indication that the enterprise it heads is sufficiently distressed to warrant the application of Section 382(l)(6).[141] And we further believe that requiring any of a Tested Entity's subsidiaries to be debtors in the title 11 case would be inconsistent with the neutrality principle animating the existing regulations' treatment of consolidated groups under Section 382.[142]

L. Loss Group Treated as Single Entity To Determine Value Under Section 382(l)(6)

If Section 382(l)(6) applies to an ownership change of a loss group, rules are necessary to determine how the resulting Section 382 limitation should "reflect the increase (if any) in value of the [loss group] resulting from any surrender or cancellation of creditors' claims." Consistent with the general single-entity approach we propose for Section 382(l)(6), we would adapt the form-neutral[143] test under Treas. Reg. § 1.382-9(j) to the group setting as follows:

1. Stock value for the purpose of Treas. Reg. § 1.382-9(j)(1) should include the value of the stock of the Tested Entity (subject to appropriate adjustments in the case of a Tested Entity that is a qualifying successor), *plus* the value of any stock of subsidiary members of the Post-Change Group not held by members of the Post-Change Group.

[139] For Section 382(l)(5) or Section 382(l)(6) to apply, Treas. Reg. § 1.382-9(a) requires that "the transaction resulting in the ownership change [be] ordered by the court or [be] pursuant to a plan approved by the court."

[140] *See* Part IV.D.1, *supra*.

[141] Although the textual basis for requiring the Tested Entity to be a debtor in the title 11 case to qualify for Section 382(l)(6) is less clear than for Section 382(l)(5) (which explicitly contemplates that a "controlling corporation" would "also [be] in bankruptcy"), we believe that a bankruptcy filing by the Tested Entity provides the best signal that creditors hold a proprietary interest in its business.

[142] As in the case of Section 382(l)(5), as a practical matter we expect that the exchange of indebtedness of a subsidiary that is not a title 11 debtor for stock of the Tested Entity would be a rare occurrence.

[143] The test under Treas. Reg. § 1.382-9(j), which treats the value of the old loss corporation as the lesser of the value of its post-change stock and its pre-change gross assets, acknowledges that (i) transferring X shares of stock in cancellation of $Y of indebtedness is economically equivalent to (ii) issuing X shares of stock for cash and transferring the cash in cancellation of the $Y of indebtedness and does not distinguish between these situations. *See* Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change; Special Rule for Value of a Loss Corporation Under the Jurisdiction of a Court in a Title 11 Case, 57 Fed. Reg. 34736, 34737 (Aug. 6, 1992) ("In either case, the economic result to the loss corporation is the same: debt is converted into stock. Accordingly, the proposed regulations make the benefits of section 382(1)(6) of the Code available to a loss corporation in either case.") The value under the test is capped by the loss corporation's pre-change gross asset value because value in excess of this amount must represent the infusion of fresh capital. *Id*. We believe the form neutrality of this test to be a significant advantage.

2. Gross asset value for the purpose of Treas. Reg. § 1.382-9(j)(2) should be the combined pre-change gross value of all of the assets of the members of the Post-Change Group and their qualifying predecessors, excluding the stock of those members' subsidiaries and any intercompany obligations of those entities and appropriately adjusted to take into account any disposition of assets (including stock of pre-change group members) by Post-Change Group members or their qualifying predecessors as part of the resolution of the title 11 or similar case.

This approach reflects the treatment of the loss group as a single corporation which has issued all members' stock that is held by external parties and which holds all of the assets held by group members. It also preserves the form neutrality of the test applied to standalone corporations. In a letter ruling addressing the application of Section 382(l)(6) to a consolidated group where the parent and some but not all subsidiaries were debtors in the title 11 case, the IRS adopted this approach for the stock-value test but not the asset-value test.[144] In that ruling, the IRS determined that, if Section 382(l)(6) applied, gross asset value for the purpose of Treas. Reg. § 1.382-9(j)(2) would be the gross value of the assets held by the parent (including stock of subsidiary members), *plus* the gross value of a subsidiary's assets to the extent parent stock was issued to the subsidiary's creditors in satisfaction of their claims.[145] Commentators have noted that this approach is form based and can be planned around,[146] and we believe that a stricter adherence to single-entity principles is more appropriate, both conceptually and practically.

We illustrate our proposal in the following examples.

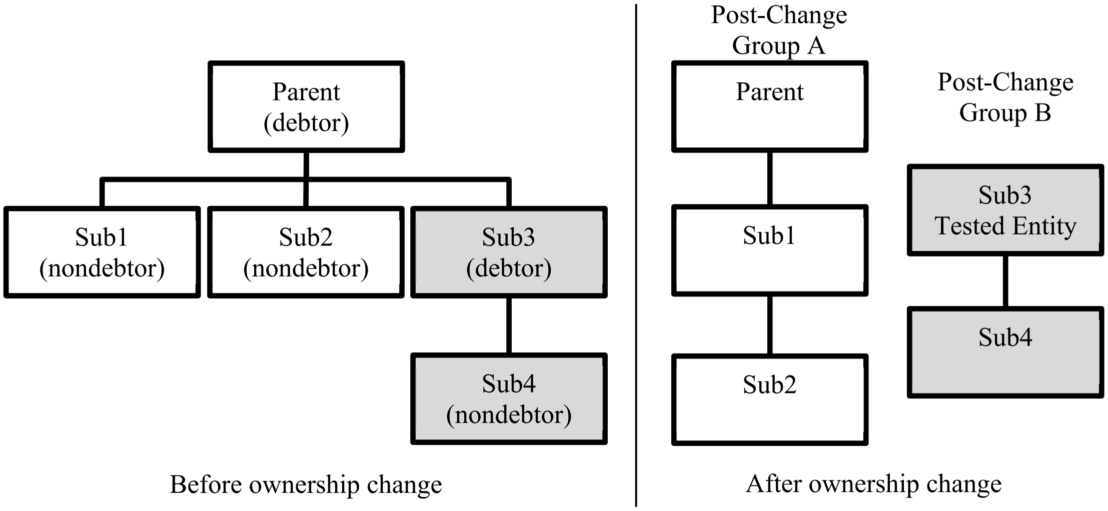
> **Example 13.** Parent Group is organized as in Example 1. Parent and Sub3 file for bankruptcy, but no other members do. Pursuant to an order of the court or an approved title 11 plan of reorganization, (i) the stock of Parent is transferred to

[144] PLR 201435003.

[145] Prior to the ruling in PLR 201435003, IRS officials publicly contemplated an alternative approach to calculating gross asset value, which would treat the parent as owning (i) the stock of direct subsidiaries not in bankruptcy and (ii) the gross assets (but not the stock) of direct subsidiaries in bankruptcy (including, down the chain, the stock of lower-tier subsidiaries that are not title 11 debtors and the gross assets of lower-tier subsidiaries that are title 11 debtors). *See* Amy S. Elliott, "Entity Look-Through Limited for Bankruptcy Ownership Changes," 131 *Tax Notes* 697 (May 16, 2011), https://www.taxnotes.com/tax-notes-today-federal/bankruptcy-and-insolvency/single-entity-look-through-limited-bankruptcy-ownership-changes-irs-official-says/2011/05/09/vvby; Amy S. Elliott, "IRS Rules on Ownership Change for Loss Corporations," 131 *Tax Notes* 136 (Apr. 11, 2011), https://www.taxnotes.com/tax-notes-federal/bankruptcy-and-insolvency/irs-rules-ownership-change-loss-corporations/2011/04/11/qmyt. We believe this approach is similarly inconsistent with a single-entity approach and should not be adopted. We also believe that its focus on whether a subsidiary is a title 11 debtor is misplaced. As long as the subsidiary was a member of the consolidated group prior to the ownership change, whether the subsidiary is individually in bankruptcy has no bearing on whether its assets represent an infusion of fresh capital. Value attributable to new capital is instead excluded by limiting the value of the old loss corporation to the value of its pre-change gross assets. *See supra* note 143. In applying this limitation, Treas. Reg. § 1.382-9(l)(4) incorporates (and broadens) the anti-stuffing rule in Section 382(l)(1).

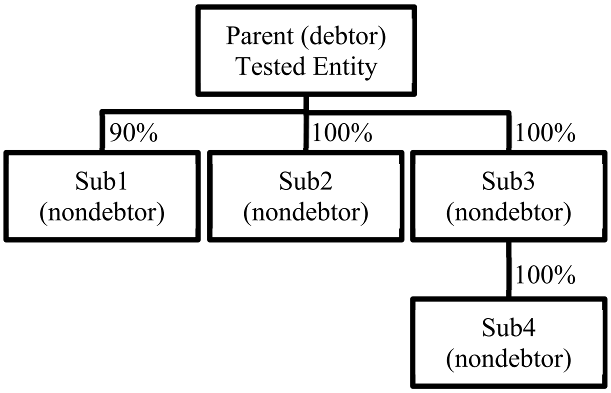
[146] *See* Gordon D. Henderson & Stuart J. Goldring, *Tax Planning for Troubled Corporations* (2023) § 508.7 ("[I]f cash distributions to a subsidiary debtor's creditors would normally be funded through a new stock investment by a third party pursuant to the Chapter 11 plan, it would be prudent (given the IRS's position in this ruling) to first issue the parent stock to the creditors, and for the creditors to sell the stock to the new investor.").

creditors of Sub2 and (ii) the stock of Sub3 is transferred to creditors of Sub3. Both Parent and Sub3 experience ownership changes, and both elect out of (or otherwise do not qualify for) the application of Section 382(l)(5). Sub3 and Sub4 depart Parent Group but remain consolidated with each other. There are no minority shareholders of Sub1, Sub2 or Sub4.


Parent
(debtor)
Sub1
(nondebtor)
Sub2
(nondebtor)
Sub3
(debtor)
Sub4
(nondebtor)
Before ownership change
Post-Change
Group A
Parent
Sub1
Sub2
Post-Change
Group B
Sub3
Tested Entity
Sub4
After ownership change

Section 382(l)(6) applies to both ownership changes because (i) in both cases the Tested Entity (Parent and Sub3) is a title 11 debtor, (ii) Section 382(l)(5) does not apply to either ownership change and (iii) in both cases the ownership change results from an exchange of debt for stock pursuant to an order of the court or an approved title 11 plan. The value of Parent Group, as increased under Section 382(l)(6), is the lesser of (i) the post-change stock value of Parent and (ii) the pre-change value of the gross assets of Parent, Sub1 and Sub2 (excluding the value of member stock held by Parent). The value of the new consolidated group parented by Sub3, as increased under Section 382(l)(6), is the lesser of (i) the post-change stock value of Sub3 and (ii) the pre-change value of the gross assets of Sub3 and Sub4 (excluding the value of member stock held by Sub3).

Example 14. Parent Group is organized as in Example 1, except that a minority shareholder holds 10% of the outstanding common stock of Sub1. Parent files for bankruptcy but none of its subsidiaries do. Parent Group undergoes reorganization in the title 11 case and experiences an ownership change. Pursuant to an order of the court or an approved title 11 plan of reorganization, the stock of Parent is transferred to creditors of Parent. All members remain consolidated with each other (with Parent remaining the group parent). The ownership change does not qualify for Section 382(l)(5), or Parent elects out of its application.


Parent (debtor)
Tested Entity
90%
100%
100%
Sub1
(nondebtor)
Sub2
(nondebtor)
Sub3
(nondebtor)
100%
Sub4
(nondebtor)

Parent is the Tested Entity. Section 382(l)(6) applies to the ownership change because (i) the Tested Entity is a title 11 debtor, (ii) Section 382(l)(5) does not apply to the ownership change and (iii) the ownership change results from an exchange of debt for stock pursuant to an order of the court or an approved title 11 plan. The value of Parent Group, as increased under Section 382(l)(6), is the lesser of (a) the sum of (x) the post-change stock value of Parent *plus* (y) the post-change value of the 10% minority stake in Sub1 and (b) the pre-change value of the gross assets of Parent, Sub1, Sub2, Sub3 and Sub4 (excluding the value of member stock held by members).