1990

Section 382: Net Operating Loss Carryovers in Corporate Acquisitions

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Repository Citation
Faber, Peter L., "Section 382: Net Operating Loss Carryovers in Corporate Acquisitions" (1990). William & Mary Annual Tax Conference. 211.
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SECTION 382:
NET OPERATING LOSS CARRYOVERS IN CORPORATE ACQUISITIONS

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New York, New York

December 1, 1990
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1. Ordinarily, NOLs must be carried back three years and forward fifteen years. I.R.C. § 172(b)(1).
   a. Special rules are provided for certain industries.
   b. NOLs must generally be applied to the earliest years first.

2. The corporation can irrevocably elect to waive the carryback period for a NOL, in which case it will be carried forward only.

   Note: This election may be advisable if the tax rate applicable to the carryback years is lower than the tax rate applicable to carryforward years or if credits eliminate or reduce tax for the carryback years.

3. Unless otherwise provided by statute, NOLs are not affected by a change in L's shareholders.

B. Use of NOLs by taxpayers other than the corporation that sustains them.

1. Transfer of NOL carryover to another taxpayer. I.R.C. § 381.
   a. Before the 1954 Code, carryovers could generally only be used by L. They could not be transferred in a "C" reorganization. New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934). It was not clear whether they could be transferred in a statutory merger. Stanton Brewery, Inc. v. Commissioner, 176 F.2d 573 (2d Cir. 1949); Newmarket

b. NOL carryovers are transferred to the acquiring corporation in certain liquidations of subsidiaries and in "A", "C", "F", and, in some cases, "D" reorganizations. I.R.C. §§ 381(a) and (c)(1). If a transaction fails to qualify as a "reorganization" for technical reasons, the carryover does not move to the acquiring corporation. If L is liquidated, the carryover disappears.

c. The "acquiring corporation" that gets the carryover is the one that "pursuant to the plan of reorganization ultimately acquires, directly or indirectly, all of the assets transferred by the transferor corporation." Regs. § 1.381(a)-1(b)(2).

d. The date of transfer of the carryover is the date on which all transfers are complete, except that the date on which substantially all the assets are transferred can be used if all activities other than liquidating activities have been discontinued and the taxpayer elects or the I.R.S. concludes that the date of transfer has been "unreasonably postponed." Regs. § 1.381(b)-1(b)(2).

e. The carryover applies to the acquiring corporation’s first taxable year ending after the transfer. I.R.C. § 381(c)(1)(A). The acquiring corporation’s taxable income for that year to which the carryover can be applied is limited to the taxable income for the year pro-rated according to the number of days in the year before and after the transfer. I.R.C. § 381(c)(1)(B).

f. The transferor’s taxable year ends on the date of the transfer except in "F" reorganizations. I.R.C. § 381(b)(1). Even if its last year is a short year, it counts as a full year in computing the carryforward period under I.R.C. § 172(b)(1). Regs. § 1.381(c)(1)-1(e)(3).

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   b. Pre-consolidation losses or built-in deductions of a subsidiary can normally be used only against its own income in consolidated return years. Regs. §§ 1.1502-15, 21(c). (The separate return limitation year, or SRLY, rules).
   c. Pre-consolidation losses of the common parent can be used against income of all corporations in the group in consolidated return years unless it acquires a larger corporation in a "reverse acquisition" in which the shareholders of the acquired corporation end up controlling the parent. Regs. §§ 1.1502-1(f)(2) and (3). In this case, the larger corporation is treated as the common parent for purposes of the SRLY rules.

II. NOL carryovers can be lost in acquisitions motivated by tax avoidance: I.R.C. § 269.
   A. General rule: NOL carryover is lost if the principal purpose for an acquisition is to secure its benefit and in the transaction:
      1. Any person or persons acquire control (50% of voting power or value) of a corporation, or
      2. A corporation acquires property of another corporation and
         a. The property's basis carries over, and
         b. The transferor is not controlled by the acquiring corporation or its shareholders.
B. The carryover is lost even though the corporation later using it is the acquired corporation.Regs. § 1.269-3(a); Coastal Oil Storage Co. v. Commissioner, 242 F.2d 396 (4th Cir. 1957); Mill Ridge Coal Company v. Patterson, 264 F.2d 713 (5th Cir. 1959), cert. denied, 361 U.S. 816 (1959); James Realty Company v. United States, 280 F.2d 394 (8th Cir. 1960).


D. Nature of tax avoidance purpose.

1. Tax avoidance need not be a "but for not" cause of the transaction as long as it is the most important purpose. Regs. § 1.269-3(a). The regulations suggest a plurality test but a majority standard was required in Bobsee Corporation v. United States, 411 F.2d 231 (5th Cir. 1969).

2. The purpose at the time of acquisition is controlling. The carryover is not lost if the desire to use it arises later. Hawaiian Trust Company, Limited v. United States, 291 F.2d 761 (9th Cir. 1961); Capri, Inc. v. Commissioner, 65 T.C. 162 (1975) (step transaction argument by I.R.S. rejected).

E. Indicators of tax avoidance purpose.

1. A transfer of profitable assets to loss corporation after acquisition. Regs § 1.269-3(b); J.G. Dudley Company, Incorporated v. Commissioner, 298 F.2d 750 (4th Cir. 1962); Scroll Inc. v. Commissioner, 447 F.2d 612 (5th Cir. 1971). This technique is often used to try to avoid the impact of the SRLY rules.


3. There is no investigation of the business of the acquired corporation. Hart Metal Products Corporation v. Commissioner, 437 F.2d 946 (7th Cir. 1971).
4. A decision is made to have the loss corporation survive the merger that is not justified by business considerations. Meridan Corporation v. United States, supra.


F. The I.R.S. and some courts say that post-acquisition NOLs can be disallowed. R.P. Collins & Co., Inc. v. United States, 303 F.2d 142 (1st Cir. 1962); Luke v. Commissioner, 351 F.2d 568 (7th Cir. 1965). Other courts disagree. Zanesville Investment Company v. Commissioner, 335 F.2d 507 (6th Cir. 1964); Herculite Protective Fabrics Corp. v. Commissioner, 387 F.2d 475 (3d Cir. 1968).


A. Taxable acquisitions. Old I.R.C. § 382(a).

1. General rule: L's NOL carryovers were eliminated if there was a 50% change of ownership in certain transactions and L failed to continue the same business.

2. Required change of ownership.

   a. The shareholders whose ownership must change were the 10 largest shareholders by fair market value.

   b. There must have been an increase in the holdings of the 10 largest shareholders by at least 50 percentage points (not by 50%).

   c. The ownership of the shareholders was compared with their ownership at the start of the taxable year and at the start of the prior taxable year.

3. Transactions to which Old § 382(a) applied.

   a. A "purchase" of L stock by one or more of the 10 largest shareholders.

      (1) A "purchase" was generally defined in Old § 382(a)(4)(A) as an acquisition:
(a) From a person whose stock would not be attributed to the buyer under § 318 (with §§ 318(a)(2)(C) and (a)(3)(C) applied without regard to the 50% limitation).

(b) In which the buyer’s basis for the stock was determined solely by reference to its cost.

(2) Indirect purchases by buying an interest in a corporation, partnership, or trust that owned L stock were taken into account. Regs. § 1.382(a)-1(f).

b. A reduction in L’s outstanding stock.

(1) This was generally accomplished by a redemption of stock from other shareholders.

(2) A redemption to pay death taxes and estate administration expenses to which § 303 applied was not taken into account.

4. L must fail to continue "substantially the same" trade or business that it conducted before the change of stock ownership.

a. The change of business had to occur after the first change of stock ownership that was included in the 50% change.

b. The discontinuance of a significant business operation was treated as a change of business, especially if it was the operation that generated the losses. Regs. § 1.382(a)-1(h)(7).

c. Change of location.

(1) A change in location was considered a change in business if it substantially altered the business, taking into account employees, customers, geographical market area, nature of property used, and similar items. Regs. § 1.382(a)-1(h)(9).
(2) A relocation was not treated as a change of business when there was a substantial continuity of products, personnel, brand name, and customers. Wallace Corp. v. Commissioner, T.C. Memo. 1964-10.

d. Cessation of business.

(1) A cessation of business activities was treated as a termination of a business, even if the business was later resumed. Regs. § 1.382(a)-1(h)(6).

(2) A temporary cessation of business because of fire or similar catastrophe was not treated as a business termination. Regs. § 1.382(a)-1(h)(6). The courts held that a cessation while L attempted to restore its financial health was considered temporary. H.F. Ramsey Co. v. Commissioner, 43 T.C. 500 (1965), nonacq. on this issue, 1965-2 C.B. 7; Clarksdale Rubber Co. v. Commissioner, 45 T.C. 234 (1965).

e. The addition of a new business was not treated as a change of business as long as the old business was continued. Regs. § 1.382(a)-1(h)(8).


1. General rule of old § 382(b).

a. This provision applied to "A", "C", "F", and, in some cases, "D" reorganizations, but a "B" reorganization followed by a liquidation was treated as a "C". Regs. § 1.382(b)-1(a)(6); Rev. Rul. 67-274, 1967-2 C.B. 141; Resorts International, Inc. v. Commissioner, 60 T.C. 778 (1973), aff'd in part and rev'd in part, 511 F.2d 107 (5th Cir. 1975).

b. If the L shareholders ended up with less than 20% of the value of the acquiring corporation's stock (not counting certain preferred stock), the NOL carryover was reduced by 5% for each percentage point
less than 20. The earliest NOLs were lost first. Old I.R.C. § 382(b)(4).

c. Stock ownership was the only test. Continuation of business was immaterial. Nevertheless, the transaction would not qualify as a reorganization (and, hence, L's NOL carryover would not pass to the acquiring corporation) if the continuity of business enterprise test generally applicable to reorganizations was not met. Regs. § 1.368-1(d). This was not a problem if L was the acquiring corporation.

2. Who are the "loss corporation shareholders?"

a. The people who must meet the 20% test were those persons owning L stock "immediately before the reorganization." When does the "reorganization" begin? See Reeves v. Commissioner, 71 T.C. 727 (1979), vacated sub nom., Chapman v. Commissioner, 618 F.2d 856 (1st Cir. 1980), rev'd sub nom., Heverly v. Commissioner, 621 F.2d 1227 (3d Cir. 1980).

b. An acquisition of L stock by acquiring corporation shareholders for the purpose of avoiding the § 382 limits was ignored. Regs. § 1.382(b)-1(c). Reducing the value of the acquiring corporation's common stock by a preferred stock dividend to increase the L shareholders' share of the acquiring corporation worked. Rev. Rul. 77-227, 1977-2 C.B. 120.

3. Determination of L shareholders' ownership of acquired corporation stock.

a. Only stock received as a result of owning stock of L before the reorganization was counted. No credit was given for prior ownership. Regs. § 1.382(b)-1(a)(2).

b. Acquiring corporation stock owned "immediately after" the reorganization was counted.

(1) The effect of later sales was unclear. What if they were pursuant to a pre-arranged plan?
(2) The effect of contingent stock or escrowed stock subject to contingencies was unclear.

c. The I.R.S. said that acquiring corporation stock received by L in a "C" reorganization but not distributed to its shareholders was not counted. Regs. § 1.382(b)-1(a)(2). Contra, World Service Life Insurance Company v. United States, 471 F.2d 247 (8th Cir. 1973).

4. If stock of the acquiring corporation's parent was the consideration for the acquisition, L shareholders had to end up with parent stock equal to 20% of the subsidiary acquiring corporation's value. Old I.R.C. § 382(b)(6).

a. This enabled complete avoidance of § 382(b).

b. L's NOL carryover ended up in the subsidiary. The parent then had to get profits into the subsidiary or the SRLY rules would limit the post-acquisition use of the carryover. A transfer of profitable assets to the subsidiary could indicate a tax avoidance motive for purposes of § 269. Regs. § 1.269-3(b).

5. There was an exception if both corporations were owned by substantially the same persons in the same proportions. Old I.R.C. § 382(b)(3). Constructive ownership rules did not apply. Rev. Rul. 76-36, 1976-1 C.B. 105; Kern's Bakery of Virginia, Inc. v. Commissioner, 68 T.C. 517 (1977); Commonwealth Container Corp. v. Commissioner, 48 T.C. 483 (1967), aff'd, 393 F.2d 269 (3d Cir. 1968).

6. Successive reorganizations designed to avoid old § 382(b) were tested after the last one. Regs § 1.382(b)-1(c). An integrated plan would probably produce the same result even in the absence of tax avoidance intent. See Rev. Rul. 67-274, 1967-2 C.B. 141.

A. General approach of the new rules.

1. The 1986 Tax Reform Act rules changed the focus of § 382.
   a. Under prior law, the general approach was to eliminate or reduce the amount of L's NOL carryovers in certain acquisitions.
   b. Under the new law, the NOL carryovers remain intact but the post-acquisition income against which they can be applied is limited.
   c. The theory of the new law is that the buyer's ("P") use of L's NOL carryovers should be limited to the use that L could have made of them if the acquisition had not occurred. It is assumed that L could have earned income each year equal to a reasonable return on its value, and the post-acquisition income against which L's NOL carryovers can be applied is therefore limited each year to a percentage of L's value on the acquisition date deemed to represent a reasonable rate of return. The purpose of the provision is to remove the incentive for a buyer to pay more for L's stock because of L's NOL carryovers. This has been referred to as the "neutrality principle."
   d. The Revenue Act of 1987 added § 384 to the Code, which prevents L from using old NOL carryovers against built-in gains of an acquired corporation.

2. General operation of the statute.
   a. If there is a more-than-50% change in the ownership of L's stock, then
   b. L's use of its NOL carryovers is limited in each year to a specified return on the value of L at the time of the change.

3. Unlike prior law, taxable and tax-free acquisitions are generally subject to the same rules.
B. Corporations subject to the limitations.

1. The limits apply to the use of NOL carryovers by a "new loss corporation." I.R.C. § 382(a).

2. A "loss corporation" is any corporation that is:
   a. Entitled to use a NOL carryover or that has a net operating loss for the year in which an ownership change occurs, or
   b. That has a net unrealized built-in loss (except as regulations provide otherwise). I.R.C. § 382(k)(1).

3. An "old loss corporation" is a corporation that incurs an "ownership change" and that before the ownership change was a loss corporation. I.R.C. § 382(k)(2).

4. A "new loss corporation" is a corporation that after an ownership change is a loss corporation. The same corporation can be both an old loss corporation and a new loss corporation. I.R.C. § 382(k)(3).

Example. Corporation L has a NOL carryover. Individual A owns all of its stock. Individual B buys all of L's stock from A. L is both an old loss corporation and a new loss corporation and the § 382 limitations apply to its use of its NOL carryovers.

Example. Corporation L has a NOL carryover. L merges into corporation P in a reorganization under I.R.C. § 368(a)(1)(A). L's NOL carryover passes to P under I.R.C. § 381(a)(2). P is a new loss corporation and the § 382 limitations apply to its use of L's NOL carryovers.

C. Tax attributes the use of which is subject to the limitations.

1. NOL carryovers.
   a. The use of "pre-change losses" by a new loss corporation is limited by § 382 in any "post-change year." I.R.C. § 382(a).

   b. A "pre-change loss" is:
(1) A NOL carryforward of the old loss corporation to the taxable year ending with the ownership change or in which the change date occurs, and

(2) The NOL of the old loss corporation for the taxable year in which the ownership change occurs to the extent allocable to the period on or before the change date. The NOL is allocated to days within the year ratably except as provided by regulations. I.R.C. § 382(d)(1).

(3) A new loss corporation must separately account for NOLs acquired from each old loss corporation in a § 381 transaction. Regs. § 1.382-2T(f)(1)(iii).

c. A "post-change year" is any taxable year ending after the change date. I.R.C. § 382(d)(2).

Example. L, a calendar year taxpayer, has a NOL carryover as of December 31, 1989 of $5,000,000. In 1990, it incurs a NOL of $2,000,000, $1,000,000 of which is allocable to the period from January 1 to June 30. On June 30, 1990, all of its stock is purchased by a new shareholder. L has a $6,000,000 pre-change loss. Of its $7,000,000 NOL carryforward to 1991, a post-change year, $6,000,000 will be subject to the § 382 limits.

2. Built-in losses.

a. If L has a "net unrealized built-in loss" ("NUBIL"), the "recognized built-in loss" ("REBIL") for any "recognition period taxable year" is limited as if it were a pre-change loss. I.R.C. § 382(h)(1)(B).

b. Definition of NUBIL.

(1) a NUBIL is the excess of the aggregate adjusted basis of the assets of the old loss corporation immediately before an ownership change over their fair market value on that date. I.R.C. § 382(h)(3)(A).
(2) If a redemption is made in connection with an ownership change, the amount of the NUBIL is determined after taking the redemption into account.

(3) De minimis rule.

(a) A NUBIL that is not greater than the lesser of 15% of the value of the old loss corporation's assets immediately before the ownership change or $10,000,000 is ignored. I.R.C. § 382(h)(3)(B)(I). (For ownership changes and acquisitions occurring before October 3, 1989, the de minimis test was 25% of the value of the corporation's assets.)

(b) In determining applicability of the de minimis rule (but not in calculating the amount of the NUBIL if the de minimis rule does not apply), cash, cash items, and any marketable security with a value that does not differ substantially from its basis are disregarded. I.R.C. § 382(h)(3)(B)(ii).

(4) Treasury regulations may treat other items that accrue on or before the change date but that are recognized after the change date as NUBILs. I.R.C. § 382(h)(6).

(a) The Conference Report indicates that these items may include items the deduction of which was deferred under I.R.C. § 267 or 465 (Page II-191).

(b) Section 621(d) of the Act required the Treasury Department to report to the Congress by January 1, 1989 with respect to the treatment of depreciation, amortization, depletion, "and other built-in deductions" as NUBILs. The Revenue Act of 1987 amended § 382(h)(2) to treat
depreciation, amortization, and depletion attributable to a NUBIL as subject to the § 382 rules, without regard to the de minimis rule.


(1) A REBIL is any loss recognized during the "recognition period" on the disposition of any asset, except to the extent that the new loss corporation establishes that:

(a) The asset was not held by the old loss corporation immediately before the change date, or

(b) The loss exceeds the excess of the adjusted basis of the asset on the change date over its fair market value on that date. The Conference Report suggests that the exemption applies only to the excess of the loss over the amount of the depreciation in value on the change date. (Page II-191-92).

d. A "recognition period taxable year" is any taxable year any portion of which falls within the "recognition period" (the five years beginning on the change date). I.R.C. § 382(h)(7).


a. The use of unused general business credits (I.R.C. § 39) and minimum-tax credits (I.R.C. § 53) of a corporation undergoing an ownership change shall be limited under regulations to the tax liability attributable to so much of the taxable income as does not exceed the § 382 limitations, after the application of § 382 and those provisions of § 383 applicable to capital losses and foreign tax credits. I.R.C. § 383(a).

b. The amount of excess foreign taxes under I.R.C. § 904(c) for any taxable year before
the first post-change year shall be limited under regulations for any corporation undergoing an ownership change in a manner consistent with § 382. I.R.C. § 383(c).

   a. If an ownership change occurs, the amount of any net capital loss for any taxable year before the first post-change year that can be used in any post-change year shall be limited by regulations in a manner consistent with § 382.
   b. The regulations shall provide that any such capital loss that is used in a post-change year shall reduce the § 382 limitation applicable to pre-change NOL carryovers for such year.

D. Acquisitions subject to § 382.

1. The limits apply to the use of NOL carryovers in a "post-change year." I.R.C. § 382(a).

2. A "post-change year" is a taxable year ending after the "change date." I.R.C. § 382(d)(2).

3. The "change date" is the date on which an "ownership change" occurs and:
   a. If the last component of the ownership change is an "owner shift involving a 5-percent shareholder," the date on which such shift occurs, or
   b. If the last component of the ownership change is an equity structure shift, the date of the reorganization. I.R.C. § 382(j).

Comment. The meaning of "date of the reorganization" is unclear in a staged transaction in which P acquires L's assets or stock over a period of time.

4. Definition of "ownership change." I.R.C. § 382(g).
   a. An ownership change occurs if, as a result of an "owner shift involving a 5-percent shareholder" ("OSIFPS") or an "equity
structure shift" ("ESS"), the percentage of stock of the new loss corporation owned by one or more 5-percent shareholders has increased by more than 50 percentage points (not by 50%) over the lowest percentage of stock of the old loss corporation (or any predecessor corporation) owned by them any time during the "testing period." I.R.C. § 382(g)(1).

(1) Definition of "testing period."
I.R.C. § 382(i).

(a) Generally, the testing period is the 3-year period ending on the day of the OSIFPS or ESS.

(b) If an ownership change occurs, the testing period for determining whether a second ownership change has occurred shall not start before the first day after the change date for the first ownership change.

(c) The testing period shall not begin before the start of the first taxable year from which there is a carryforward of a loss or excess credit to the first post-change year. (Under the statute, this will not apply to a corporation that has a NUBIL, except as provided by regulations. The regulations indicate that the short period will apply if the corporation can show when the NUBIL first accrued, in which case the testing period cannot begin before the first day of the taxable year in which that occurred. Regs. § 1.382-2T(d)(3)(ii)).

(d) The testing period is not extended even if some shareholders intend to acquire stock after the testing period. Regs. § 1.382-2T(d)(5)(ii).
(2) A "5-percent shareholder" is any person owning at least 5% of the corporation's stock at any time during the testing period. I.R.C. § 382(k)(7).

b. Operating rules: statutory.

(1) In general, all stock owned by shareholders of a corporation who are not 5-percent shareholders shall be treated as stock owned by one 5-percent shareholder. I.R.C. § 382(g)(4)(A). Except as provided by regulations, the less-than-5-percent shareholders of each corporation that is a party to a reorganization will be treated as a separate 5-percent shareholder.

(2) Determinations of the percentage ownership of stock are based on value. I.R.C. § 382(k)(6)(C). The word "value" means "fair market value." I.R.C. § 382(k)(5).

(3) Changes in percentage ownership resulting from fluctuations in relative values of different classes of stock will be disregarded. I.R.C. § 382(1)(3)(C).

(4) Preferred stock described in I.R.C. § 1504(a)(4) shall not be taken into account. I.R.C. § 382(k)(6)(A). This includes stock that:

(a) Is not entitled to vote.

(b) Is limited and preferred as to dividends.

(c) Does not participate in corporate growth to any significant extent.

(d) Has redemption and liquidation rights that do not exceed the paid in capital or par value that it represents (except for a reasonable redemption premium).
(e) Is not convertible into another class of stock.

(5) The Treasury shall adopt regulations treating warrants, options, contracts to acquire stock, convertible debt, and similar interests as stock and, under some circumstances, treating stock as if it were not stock. I.R.C. § 382(k)(6)(B).

(a) The Conference Report indicates that voting preferred or common stock might be disregarded where its likely percentage participation in future growth is disproportionately small compared to its percentage of value at issuance. (Page II-173)

(b) The Conference Report indicates that preferred stock described in § 1504(a)(4) should not be treated as stock merely because its holders acquire voting rights because dividends are in arrears. (Pages II-173-74)


(a) The constructive ownership rules of § 318 shall apply in determining stock ownership.

(b) Exceptions.

(i) An individual and all members of his family within the meaning of § 318(a)(1) shall be treated as one shareholder.

(ii) Stock owned by a corporation will be attributed proportionately to all its shareholders, even those owning less than 50% of its stock.

(iii) Stock attributed under the entity attribution rules of
§ 318(a)(2) shall be treated as no longer owned by the entity, except as provided by regulations.

(iv) The option attribution rules of § 318(a)(4) shall apply if this results in an ownership change, except as provided in regulations. Similar rules shall apply to any contingent purchase, warrant, convertible debt, put, stock subject to a risk of forfeiture, contract to acquire stock, or similar interest.

(c) Exceptions may be provided by regulations in cases of foreign ownership, where information on the ownership of higher-tier entities may not be available. There is no such exception under present regulations. see, e.g., PLRs 8922080 and 9005029.

(7) Stock transferred by inheritance, gift, to a spouse, or to a former spouse incident to a divorce is treated as if it is still owned by the transferor. I.R.C. § 382(1)(3)(B).

c. Operating rules: regulations.


(a) Ordinary preferred stock described in § 1504(a)(4) does not become "stock" when it acquires voting rights because of dividend arrearages.

(b) Disregarding of stock whose participation in growth is disproportionately small.

(i) Circumstances in which such stock will be disregarded.
(A) The determination of whether the stock's participation would be disproportionately small is made when the stock is issued or transferred to or by a 5% shareholder ("FPS").

(B) Treating the interest as not stock will not occur unless it would result in an ownership change (i.e., L cannot disregard stock in order to avoid an ownership change).

(C) In a de minimis rule, stock will not be disregarded unless the pre-change loss (including NUBILs) is more than twice the product of the value of L on the testing date times the long-term tax exempt bond rate for that date.

(ii) No guidance is provided as to the meaning of "likely participation . . . in future corporate growth."

(iii) There is no requirement that the three parts of the test must be applied at the same time.

(iv) Despite the legislative history, this provision will not prevent the result in Maxwell Hardware Co. v. Commissioner, 343 F.2d 713 (9th Cir. 1965) (new shareholders contributed cash for preferred stock comprising 40% of the corporation's value keyed to value of new division). The provision disregards only
the stock that has a disproportionately small interest in corporate growth when it is issued or transferred.

(v) It is unclear whether a determination to disregard stock will be given retroactive effect throughout the testing period.

(c) Convertible preferred stock that would be described in I.R.C. §1504(a)(4) but for the convertibility feature and its right to participate in corporate growth will be treated as an "interest that is similar to an option" and not as stock. Notice 88-67, 1988-1 C.B. 555.

(d) Treating non-stock interests as stock.

(i) Circumstances in which non-stock interests will be treated as stock.

(A) At the time of its issuance or transfer to a FPS, the interest offers a "potential significant participation" in corporate growth.

(B) Treating the interest as stock would result in an ownership change.

(C) The pre-charge loss (including NUBILs) is more than twice the product of the value of L on the testing date times the long-term tax exempt bond rate for that date.
(ii) Options and other instruments that are subject to the option attribution rule are excluded from this provision.

(iii) The rule applies only to "ownership interests." Nevertheless, the preamble states that it could apply to participating debt.

(iv) It is unclear whether a determination to treat an interest as stock will be given retroactive effect throughout the testing period.

(v) No guidance is provided as to the meaning of "potential significant participation" in corporate growth.

(2) Determination of stock ownership.

(a) General concepts.

(i) The statute literally requires a tracing of ownership all the way up through a chain of entities to the ultimate individual owners, without any exceptions for owners of de minimis interests. This would create an impossible burden on compliance and enforcement.

(ii) The regulations generally allow the ownership of less than 5% of an entity to be ignored in determining stock ownership.

(iii) All persons owning less than 5% of L's stock are treated as a single FPS (the "aggregation rules").
(iv) Under some circumstances, groups of public shareholders are treated as separate FPSs (the "segregation rules").

(b) Rules of administrative convenience.

(i) L can generally disregard interests of people and entities of less than 5% of its stock. Regs. § 1.382-2T(g)(2).

Example. Individual A owns 2% of L's stock. Corporation X owns 8% of L's stock. A owns 50% of X's stock. L need not consider A a FPS. It can disregard A's direct ownership because it is less than 5% of L's stock, and A's ownership of X's stock makes him indirectly only a 4% owner of L.

(ii) L cannot disregard ownership interests of less than 5% if:

(A) L has actual knowledge of the ownership by an individual of a less-than-5% interest in a higher-tier entity. Regs. § 1.382-2T(k)(2). (It is not clear whose knowledge will be imputed to L.), or

(B) Interests (direct and indirect) in L are structured to avoid treating a person as a FPS. Regs. § 1.382-2T(k)(4).

(iii) If a person first becomes a FPS on a testing date, L can
treat stock he owned during the testing period but before he became a FPS as being owned by the public. If a FPS's ownership falls below 5%, L can assume that no further changes in his or her ownership occur. Regs. § 1.382-2T(g)(5).

(c) Family attribution. Regs. § 1.382-2T(h)(6).

(i) The normal family attribution rules of § 318(a)(1) do not apply.

(ii) An individual and all members of his or her family are treated as one individual. This does not apply to family members who, without regard to this rule, would not be FPSs. (This spares L the need to investigate family relationships of small shareholders.)

(iii) If under these rules a person would be treated as a member of more than one family, the family used will be that which results in the smallest increase in the holdings of FPSs on the testing date.

(d) Attribution from entities. Regs. § 1.382-2T(h)(2).

(i) Stock owned by a corporation, partnership, estate, or trust is generally attributed to its owners in accordance with § 318 and is not treated as owned by the entity.

Example. Individual A owns all of L's stock. She transfers it to a new
holding company, HC, in exchange for all of HC’s stock. A is deemed to be the owner of all of the L stock owned by HC and is still treated as L’s sole shareholder.

(ii) The 50% stock ownership limit that normally applies to attribution from a corporation to its shareholders under § 318(a)(2)(C) does not apply.

(iii) The owner of an interest in an entity will not be deemed to own stock owned by the entity to the extent that his or her interest in the entity consists of:

(A) Preferred stock described in § 1504(a)(4).

(B) An ownership interest that, although nominally stock, is treated as not stock under the § 382 regulations.

(C) Similar interests in an unincorporated entity.

Example. X Corporation owns 30% of the stock of L. Individual A owns all of X’s ordinary preferred stock (which is described in § 1504(a)(4)), comprising 90% of X’s value. Individual B owns all of X’s common stock, comprising 10% of X’s value. A is not a FPS of L because his preferred stock in X is ignored. Although the regulations are unclear, B would apparently be treated
as the owner of all of X's L stock and would be a FPS of
L, even though his interest
would only be worth 3% of
L's value.

(iv) The following entities will
be treated as individuals
and L stock owned by them
will not be attributed to
their owners:

(A) An entity that owns
less than 5% of L or of
the next entity down
the chain.

(B) A qualified retirement
plan trust under
§ 401(a).

(C) A government.

(D) Any other person named
by the I.R.S. in the
Internal Revenue
Bulletin.

(e) Option attribution. Regs.
§ 1.382-2T(h)(4).

(i) The statute,
§ 382(1)(3)(A)(iv), provides
that the option attribution
rules of § 318(a)(4) apply
if such application would
result in an ownership
change, except to the extent
provided by regulations.

(ii) General rule: for the
purpose of determining
whether there is an
ownership change on any
testing date, L stock
subject to an option shall
be deemed to be acquired on
that date pursuant to
exercise of the option if
such exercise would result
in an ownership change.
(iii) The option rule apparently applies to options to buy stock in higher-tier entities. Regs. § 1.382-2T(f)(18)(iv).

(iv) The option attribution rule applies separately to:

(A) Each class of options (i.e., identical terms, same issues, issued on same date) owned by each FPS.

(B) Each FPS.

Example. A owns 20 shares of L’s stock. B owns the remaining 80 shares. B gives A an option to buy all 80 of his shares, subject to the requirement that, if A exercises the option, he must give B an option to buy 40 of his newly acquired shares back for the same price. An ownership change has occurred. A’s option is deemed to be independent of B’s and its presumed exercise is viewed separately.

(v) Even though the deemed exercise of an option on its issuance does not result in an ownership change, it may be deemed to be exercised on a later testing date (e.g., the date of a later sale) so as to result in an ownership change. Regs. § 1.382-2T(h)(4)(ii), Example (1).

(vi) Options are deemed to be exercised even if they are contingent or not currently exercisable or if the option price exceeds the stock’s value. Regs. § 1.382-2T(h)(4)(iii).
An exception is made for options held by an entity or another owner of an interest in the entity to buy an interest in the entity on the owner’s death, complete disability, or mental incompetency. Regs. § 1.382-2T(h)(4)(x)(D).

(vii) The option rule applies to interests that are similar to options, including warrants, convertible stock, convertible debt, stock subject to a risk of forfeiture, and a contract to buy or sell stock.

Example. The owners of L agree to merge L into P, another corporation. Closing of the transaction is subject to the normal contingencies and is to take place 60 days after the agreement is signed. An ownership change occurs when the agreement is adopted by the parties. The date of adoption may be unclear. See PLRs 8847067 (approval by both boards of directors, although agreement not yet signed) and 8903043 (signing of agreement although not yet approved by board of directors).

(viii) Effect of exercise of option.

(A) The exercise of an option in existence immediately before or after an ownership change (regardless of whether it was treated as exercised in connection with the change) is ignored if
it is exercised by the same FP who held it at the time of the change. Regs. § 1.382-2T(h)(4)(vi)(A).

(B) Except as provided above, the exercise of an option shall be treated as a purchase of stock. Regs. § 1.382-2T(h)(4)(xii).

(C) If an option is exercised within 120 days after it is deemed exercised, L may elect to treat the sale as occurring on the exercise date. This rule cannot prevent an ownership change from occurring but can only defer the change date. Regs. § 1.382-2T(h)(4)(vi)(B).

(I) The long-term tax-exempt bond rate may have changed.

(II) The value of L may have changed.

(ix) Effect of deemed exercise of option on § 382. Regs. § 1.382-2T(h)(4)(vii).

(A) The deemed exercise of a right to sell stock to or buy stock from L shall change the number of shares deemed to be outstanding in determining whether an ownership change has occurred.

(B) The value of L will not be affected.
Lapse or forfeiture. Regs. § 1.382-2T(h)(4)(viii).

(A) If an option that was treated as having been exercised lapses or is forfeited, L can treat it as if it never existed.

(I) A refund claim can be filed, subject to the statute of limitations.

(II) Consider filing protective refund claims if there is a possibility that an option that caused an ownership change will lapse.

(B) The treatment of an option that is sold back to the corporation is unclear. It should be treated as a lapsed option.

(xi) De minimis exception. Regs. § 1.382-2T(h)(4)(ix).

(A) The option rule will not apply on a testing date if the pre-change NOL on that date (including NUBILs) is less than twice the product of the value of L on that date times the long-term tax-exempt bond rate for that date.

(B) An option that is deemed not to be exercised on a change date because of the de minimis rule may be treated as exercised
on a later testing date if the conditions for the de minimis exception are no longer met.

(xii) Options not subject to attribution. Regs. § 1.382-2T(h)(4)(x).

(A) Long-held options on actively-traded stock.
   (I) The stock must be publicly traded.
   (II) The option must be continuously owned by the same FPS for at least 3 years, but only until the earlier of (a) the transfer of the option by or to a FPS, or (b) the day on which the stock's value exceeds the option price.

(B) A right to receive, or obligation to issue, stock pursuant to the terms of a debt instrument that is economically equivalent to nonconvertible debt because the right is with respect to a fixed dollar amount of stock determined when the stock is transferred.

(C) A right or obligation of L to redeem stock at the time the stock is issued, but only to the extent that the stock is issued to persons who are not FPSs
immediately before issuance.

(I) The exception apparently continues to apply to a person who becomes a FPS after redeemable stock is first issued to him.

(II) The exception is not limited to the original holders of the stock. It applies to stock held by purchasers, including FPSs.

(D) Options under certain shareholders buy-sell agreements.

(I) Options between owners of the same entity or between an entity and an owner of the entity that is exercisable only upon the owner's death, complete disability, or mental incompetency. (This would not apply to an option that is also exercisable when a shareholder terminates employment or otherwise wants to sell his or her stock.)

(II) Options between noncorporate owners of the same entity or between
a noncorporate owner and the entity, but only if each owner actively participates in the entity’s trade or business, the option is issued when the corporation is not a loss corporation, and the option is exercisable solely on the owner’s “retirement.” (This would not apply if one or more shareholders were passive investors or to agreements signed in the early years if the corporation has start-up losses.)

(III) These rules are narrowly drawn and will not apply to many common buy-sell agreements.

(E) Right to receive or issue stock in payment of dividends or interest.

(F) An option in existence immediately before or after an ownership change, whether or not it was treated as exercised in connection with the change, as long as it continues to be owned by the same FPS who owned it immediately before or after the change.
(G) A right to acquire stock by a bank, insurance company, or a qualified employee retirement trust solely as a result of a loan agreement entered into in the ordinary course of such entity's trade or business.

(I) Finance companies and investment banks do not appear to be covered.

(II) The option does not seem required to have been included in the original loan agreement.

(III) The reference to the ordinary course of a qualified retirement plan's trade or business is unclear. Must the loan have been made in connection with an unrelated business within the meaning of § 513?

(f) Aggregation of public shareholders into public groups. Regs § 1.382-2T(j)(1).

(i) The public shareholders (i.e., all those who are not FPSs) are treated as a single individual that is a FPS, even if the group owns less than 5% of L's stock.

(ii) The members of any public group are presumed not to be
members of any other public group, subject to rebuttal.

(iii) The analysis of public groups begins with the highest tier entity (i.e., the entity at the top level of the ownership chain).

(A) Any owner of more than five percent of the highest tier entity who, through his or her ownership of entities down the chain would be considered a FPS of L, is treated as a separate FPS.

(B) Any other owner of the highest tier entity is a member of the public group of that entity.

(I) If that public group, tracing ownership down the chain, owns more than 5% of L’s stock, it is treated as a separate FPS.

(II) If that public group does not qualify as a separate FPS, it is treated as a member of the public group of the next lower tier entity.

(C) This process is repeated down the chain until every public shareholder is a member of an entity public group that is a FPS or is a member of L’s public group.
(g) Segregation of public groups.
Regs. § 1.382-2T(j)(2).

(i) The segregation rules generally apply to tax-free reorganizations and issuances of L stock by L.

(ii) In general, each public group that existed immediately before the transaction is treated as a separate group from each public group that acquires L stock in the transaction (even though all members of each group could be said to comprise one single public group).

Example. L is owned by the public. P merges into L in a reorganization under § 368(a)(1)(A). After the transaction, the old P shareholders own 60% of L. The old P shareholders are treated as a separate FPS whose ownership of L has increased from 0% to 60%.

Example. L is owned entirely by the public. L sells stock to the public and the stock so sold comprises 60% of L's outstanding stock. The public shareholders who bought L stock in the offering are treated as a separate public group and a new FPS whose ownership of L has increased from 0% to 60%.

(iii) It is presumed that each segregated public group has no common shareholders with each other public group. This presumption can be rebutted. People in both groups may themselves be
treated as a separate group if the overlapping membership can be proved.

Example. P and L are each owned by 50 equal shareholders. 35 of those shareholders own 2% of each corporation. P merges into L and, after the transaction, the old P shareholders own 60% of L's stock. The group of common shareholders, who formerly owned 70% of L's stock, now still own 70% of L. The other P shareholders have only increased their ownership of L stock from 0% to 18%.

(iv) Other transactions to which similar segregation principles apply.

(A) Redemptions

(B) Options (e.g., a public issuance of convertible debentures).

(C) Transactions involving higher tier entities.

(D) Other transactions that are identified in the Internal Revenue Bulletin.

(v) L may combine separate public groups each of which owns less than 5% of its stock into a single public group.

(vi) The acquisition of L stock by a FPS of L from members of different public groups is presumed to be proportionately from each public group unless a different proportion is
established by L or by the I.R.S.


(h) Presumptions regarding stock ownership. Regs. § 1.382-2T(k)(1).

(i) L can rely on the existence or absence of 13D and 13G forms filed with the S.E.C.

(ii) L can rely on a statement signed under penalties of perjury by an officer or responsible person with respect to a higher tier entity relating to that entity's owners unless it knows that the statement is false or unless the entity owns 50% or more of L's stock.

5. Definition of "owner shift involving a 5-percent shareholder" ("OSIFPS"). I.R.C. § 382(g)(2).

a. An OSIFPS is any change in the stock ownership of L that affects the percentage of stock of the corporation owned by a person who is a FPS before or after the change.

b. The Conference Report (Pages II-174-76) indicates that the following transactions are included in those that will be treated as OSIFPSs.

(1) A taxable purchase of any amount of L stock by a person who is a FPS before the purchase.

(2) A disposition of L stock by a person who is a FPS before or after the disposition.
(3) A taxable purchase of L stock by a person who first becomes a FPS by reason of the purchase.

(4) A § 351 exchange that affects the percentage ownership in L of a FPS (even if the FPS is not a party to the exchange, if the stock issued to other shareholders reduces his proportionate interest).

(5) A decrease in L's outstanding stock resulting from a redemption of the stock of a FPS or of another shareholder.

(6) A conversion of debt or excluded preferred stock (under § 1504(a)(4)) into stock, regardless of whether the holder is a FPS.

(7) An issuance of stock by L, regardless of whether the holder is a FPS.

Example. A owns 300 of the 1000 shares of L. L issues one share to X for cash. The issuance of the share to X is an OSIFPS because it reduces A's ownership from 30% to 29.97%.

c. Illustrations of transactions in which an OSIFPS can result in an ownership change. Conference Report pages II-174-76.

Example. Trading of shares of a publicly-held corporation with no FPSs will not be an OSIFPS.

Example. L is publicly-held with no FPSs. A, an Individual who previously owned no L stock, buys all of L's stock. A is now a FPS and, since he has increased his ownership from 0% to 100%, an ownership change has occurred.


(1) On June 15, 1990, I sells 300 of his shares to unrelated individual A. This is an OSIFPS and both I and A are
FPSSs, but it is not an ownership change because A's interest has not increased by 50 percentage points.

(2) On June 15, 1991, L issues 100 new shares to each of B, C, and D. This is an OSIFPS because all parties are FPSSs and their relative interests are affected. It is not an ownership change, however, because the interests of the FPSSs that have increased (A, B, C, and D) have increased to only 46% (600/1300), which is less than 50%.

(3) On December 15, 1991, L redeems 200 of the shares owned by I. This is an OSIFPS because it affects the interests of everyone and they are all FPSSs. It results in an ownership change because it increases the interests of A, B, C, and D to 54.6%. It does not matter whether the three transactions were accomplished pursuant to an integrated plan.

Example. All of L's stock is owned by A. There is a public offering of L's stock as a result of which public shareholders, none of whom is an FPSS, acquire 80% of L's stock from the corporation. A acquires no new stock and does not sell any of her old stock. All of the public shareholders are treated as a single FPSS. Their combined ownership has increased by more than 50 percentage points (from 0% to 80%). The transaction is an OSIFPS and results in an ownership change.

Example. L's stock is owned by A (60%) and B (40%). LS is a wholly owned subsidiary of L. L distributes all of the LS stock to A in exchange for A's stock in L in a § 355 transaction.

(1) There has been an OSIFPS of L. A § 355 transaction can be an OSIFPS. The OSIFPS results in an ownership change because B's interest has increased by more than 50 percentage points (from 40% to 100%).
(2) There has been an OSIFPS of LS, but there has not been an ownership change. A was deemed to own LS's stock before (by attribution) and his interest has not increased by more than 50 percentage points (it has gone from 60% to 100%).


a. An ESS includes any reorganization under I.R.C. § 368 except divisive reorganizations (certain transactions under § 368(a)(1)(D)), bankruptcy reorganizations (§ 368(a)(1)(G)), and reorganizations involving a mere change in form (§ 368(a)(1)(F)). I.R.C. § 382(g)(3)(A). An ESS need not involve any FPS.

b. Treasury regulations may expand the definition to include "reorganization type transactions, public offerings, and similar transactions." I.R.C. § 382(g)(3)(B).

(1) The Conference Report (Page II-176) indicates that a purpose of the OSIFPS definition was to relieve publicly-held corporations from the need to trace the holdings of minority shareholders. The conferees felt that there would be cases in which changes involving such shareholders would occur in a single integrated transaction, in which case identification of changes would be "reasonably feasible." These transactions will be treated as ESSs under regulations.

(2) Transactions that may be treated as ESSs under the regulations include:

(a) Public offerings.

(b) Cash mergers that do not qualify as tax-free reorganizations.

(3) The Conference Report indicates (Page II-178) that the regulations will be effective prospectively only.
c. In determining whether an ESS results in an ownership change, the non-FPSs of each corporation are treated as a separate FPS. I.R.C. § 382(g)(4)(B)(i).

d. Illustrations of transactions in which an ESS can result in an ownership change. Conference Report pages II-177-78.

Example. L merges into P in a tax-free reorganization under § 368(a)(1)(A). Neither corporation has any FPSs. L shareholders receive 30% of P's stock.

(1) The transaction is an ESS because it is a tax-free reorganization.

(2) For purposes of determining whether an ownership change has occurred, the non-FPS P shareholders are treated as a separate FPS from the non-FPS former L shareholders.

(3) The old P shareholders now own 70% of P. This is more than 50 percentage points more than their ownership of L stock (0%) before the merger. Therefore, an ownership change has occurred.

Comment. The example assumes that the old P shareholders owned no L stock before the merger. If both corporations were publicly-held, this may be a questionable assumption. This could be critical if the old P shareholders end up owning only 50.001% of P after the merger.

Example. L is publicly-held and has no FPSs. 60% of its stock is exchanged for nonvoting preferred stock. There is an ESS but not an OSIFPS, because all the public shareholders are treated as a single FPS who owns 100% of the L stock before and after the transaction. Regulations will provide, however, that the shareholders who keep their common stock will be treated as a separate FPS and, since their ownership increases from 40% to 100%, an ownership change will be deemed to have occurred.
7. Illustrations of multiple transactions involving both OSIFPSs and ESSs. Conference Report pages II-178-80.

a. An ownership change can result from a series of transactions each of which is an OSIFPS or an ESS and none of which, taken by itself, results in an ownership change.

b. The change date is based on the last component of the ownership change. I.R.C. § 382(j).

Example. L is publicly-owned with no FPS. On January 1, 1990, A buys 40% of L's stock. On July 1, 1990, L merges into P and the L shareholders receive 60% of P's stock (A receiving 24%).

(1) A's purchase of L stock is an OSIFPS but not an ownership change because his interest increases by only 40 percentage points.

(2) The merger is an ESS and results in an ownership change because the combined interests of A (24%) and the old P shareholders (40%) in P after the merger exceed their interests in L before the transactions (0%) by more than 50 percentage points. [The explanation of this example (11) in the Conference Report speaks in terms of A's increase and may be incorrect in analysis if not in result.]

Example. L and G corporations are publicly-held with no FPSs. On January 1, 1990, G merges into L in a tax-free reorganization and the G shareholders receive 49% of L's stock. On July 1, 1990, A, an individual who previously owned no L stock, buys 5% of L's stock on a public stock exchange.

(1) The merger is not an ownership change because the old G shareholders, who are treated as a single FPS, have increased their ownership of L stock by less than 50 percentage points.
(2) The purchase of L stock by A is an OSIFPS because A ends up with 5% of L's stock.

(3) A's purchase is treated as having been made proportionately from the old G shareholders (2.45%) and the old L shareholders (2.55%). I.R.C. § 382(g)(4)(B)(ii).

(4) A's purchase results in an ownership change because the L stock owned by him (5%) and the old G shareholders (49% - 2.45% = 46.55%) is 51.55%, which exceeds their prior holdings (0%) by more than 50 percentage points.

E. Calculation of the § 382 limitation.

1. General pattern.

   a. The "§ 382 limitation" is the amount of the new loss corporation's taxable income in any post-change year that can be reduced by pre-change losses. I.R.C. § 382(a).

   b. The basic § 382 limitation is the "value of the old loss corporation" multiplied by the "long-term tax-exempt rate." I.R.C. § 382(b)(1).

   c. The basic § 382 limitation is increased by:

      (1) Recognized built-in gains. I.R.C. § 382(h)(1)(A). Although ordinarily this includes only gains recognized in the 5-year recognition period beginning on the change date, regulations will provide that it includes gains recognized afterward pursuant to installment sales made during the recognition period. Notice 90-27, I.R.B. 1990-15, 21.

      (2) Gains resulting from a § 338 election. I.R.C. § 382(h)(1)(C).
d. The basic § 382 limitation is reduced:

(1) To 0 (plus the amount of recognized built-in gains, § 338 gains, and carryforwards of unused § 382 limitation amounts) if the new loss corporation does not continue the old loss corporation's business enterprise for at least 2 years after the change date.

(2) Under regulations, the § 382 limitation will be reduced by net capital losses for years preceding the first post-change year that are used in any post-change year. I.R.C. § 383(b).

2. Determination of the "value of the old loss corporation."

a. Generally, the value of the old loss corporation is the value of its stock immediately before the ownership change. I.R.C. § 382(e)(1).

Note. The Conference Report indicates that arm's-length sale prices are evidence of value but are not necessarily controlling. An example is given of sales over a period of time at varying prices affected by the degree of control. (Page II-187)

b. All stock is included, including nonparticipating preferred stock described in § 1504(a)(4) that is not taken into account in determining whether there has been an ownership change.

c. "Value" means "fair market value." I.R.C. § 382(k)(5).

d. The value is reduced under the following circumstances:

(1) If a stock redemption occurs "in connection with an ownership change," the reduction in value resulting from the redemption is taken into account. I.R.C. § 382(e)(2).

Comment. The words "in connection with" suggest that the redemption must
be functionally related to the ownership change and not merely a transaction that occurs at around the same time.

(2) A capital contribution received by the old loss corporation as part of a plan "a" principal purpose of which is to avoid or increase any limit under § 382 will be disregarded. I.R.C. § 382(1)(1)(A).

(a) A capital contribution made within 2 years before the change date will be conclusively presumed to be part of such a plan, except as provided in regulations. I.R.C. § 382(1)(1)(B).

(i) The Conference Report (Page II-189) indicates that the regulations should except:

(A) Capital contributions received on the formation of the corporation.

(B) Capital contributions made before the NOL or other carryforward item arose.

(C) Capital contributions to continue current operations (e.g., to meet payroll costs).

(ii) Under the statute, the 2-year presumption is conclusive unless the regulations provide otherwise. The I.R.S. may provide a general exception in the regulations if the taxpayer can show the absence of a tax avoidance motive, but it is not required to do so.
(b) The Conference Report indicates (Page II-189) that the regulations may consider distributions to shareholders as offsets to capital contributions.

(c) The treatment of capital contributions of property that changes in value between the change date and the contribution date is unclear.

(3) The value is reduced if immediately after an ownership change the new loss corporation has "substantial nonbusiness assets." I.R.C. § 382(1)(4).

(a) The amount of the reduction is the excess of the fair market value of the nonbusiness assets of the old loss corporation over those assets' share of indebtedness for which the corporation is liable. I.R.C. § 382(1)(4)(A).

(i) The share of indebtedness allocated to nonbusiness assets is based on their relative fair market values. I.R.C. § 382(1)(4)(D).

(ii) Since only indebtedness for which the "corporation is liable" is considered, the status of nonrecourse debt is unclear.

(b) Nonbusiness assets means assets held for investment. I.R.C. § 382(1)(4)(C).

(i) Assets held to meet statutory or regulatory reserve requirements are not deemed to be held for investment. Conference Report, page II-190.
(ii) It is likely that reasonable contingency reserves and minority interests in suppliers held for business purposes will be treated as business assets.

(iii) Stock and securities of a subsidiary corporation of which the corporation owns at least 50% of the voting power and value will be disregarded and the parent will be treated as owning its ratable share of the subsidiary’s assets. I.R.C. § 382(1)(4)(E). No similar rule is provided for partnership interests.

(c) Nonbusiness assets are "substantial" if at least 1/3 of the value of the corporation’s assets are nonbusiness assets. I.R.C. § 382(1)(4)(B)(i).

Comment. The statutory language suggests that this test is applied by reference to gross assets without regard to liabilities.

(d) Regulated investment companies, real estate investment trusts, and real estate mortgage pools are exempt by statute from the nonbusiness asset rule. I.R.C. § 382(1)(4)(B)(ii).

3. Determination of the "long-term tax-exempt rate."

   a. The rate is the highest of the federal long-term rates under I.R.C. § 1274(d) for any month in the 3-calendar-month period ending with the calendar month in which the change date occurs, adjusted to reflect the rate differential between taxable and tax-exempt obligations. I.R.C. § 382(f).

   b. The Treasury Department publishes the long-term tax-exempt rate monthly.
4. Increases in the basic § 382 limitation.

a. Recognized built-in gains ("REBIGs").

   (1) General rule: if the old loss corporation has a "net unrealized built-in gain" ("NUBIG"), the basic § 382 limitation will be increased by the amount of recognized built-in gains ("REBIGs") during any "recognition year." I.R.C. § 382(h)(1)(A)(i). The increase cannot exceed the amount of the NUBIG reduced by REBIGs in prior recognition years. I.R.C. § 382(h)(1)(A)(ii).

   (2) Definition of NUBIG.

      (a) A NUBIG is the excess of the aggregate value of the loss corporation's assets immediately before the ownership change over their aggregate adjusted bases. I.R.C. § 382(h)(3)(A)(i).

      (b) If a redemption occurs "in connection with an ownership change," the determination of the existence of a NUBIG will be made after taking the redemption into account. I.R.C. § 382(h)(3)(A)(ii).

      (c) De minimis rule.

         (i) There will be no NUBIG unless the appreciation is at least the lesser of 15% of the fair market value of the corporation's assets or $10,000,000. I.R.C. § 382(h)(3)(B)(i). (For ownership changes and acquisitions occurring before October 3, 1989, the de minimis test was 25% of the value of the corporation's assets.)

         (ii) In applying the de minimis rule, cash, cash items, and
any marketable security that has a value that does not substantially differ from its adjusted basis will be disregarded. I.R.C. § 382(h)(3)(B)(ii).

(3) Definition of REBIG.

(a) A REBIG is any gain recognized during a "recognition period taxable year" if the new loss corporation shows that:

(i) The asset was held by the old loss corporation immediately before the change date, and

(ii) The gain does not exceed the excess of the asset's value on the change date over its adjusted basis on that date. I.R.C. § 382(h)(2)(A).

Comment. The statute literally indicates that there is no REBIG if the gain recognized on the sale exceeds the appreciation in value of the asset on the change date. It should be interpreted to exclude from REBIG treatment only the excess of recognized gain over the amount of such appreciation.

(iii) The Treasury Department will adopt regulations governing the treatment of assets transferred in wholly or partly tax-free transactions. I.R.C. § 382(h)(9). These regulations will presumably treat assets acquired in such transactions in exchange for assets held on the change date as if they had been held on the change date.
(iv) A "recognition period taxable year" is a taxable year any portion of which falls within the five years starting on the change date. I.R.C. § 382(h)(7).

b. Section 338 gains.

(1) The basic § 382 limitation in any taxable year is increased by the amount of the excess of any "gain" recognized by reason of an election under I.R.C. § 338 over the amount of such gain taken into account in computing REBIGs for that year. I.R.C. § 382(h)(1)(C).

(2) Not all of the income recognized because of a § 338 election is "gain." Recoveries of bad debt reserves and previously deducted expenses are included in income under these circumstances. Neither the statute nor the Conference Report indicates how such income should be treated.

5. Reductions in the basic § 382 limitation.

a. Continuity of business enterprise.

(1) The basic § 382 limitation is reduced to 0 (but not less than REBIGs, § 338 gains, and unused § 382 limitation amounts carried forward under § 382(b)(2)) if the new loss corporation does not continue the business enterprise of the old loss corporation at all times during the 2-year period beginning on the change date.

(2) The Conference Report indicates (Page II-189) that this rule is the same as the continuity of business enterprise rule applicable to corporate reorganizations under I.R.C. § 368.

(a) The regulations require that the acquiring corporation in a reorganization continue the target’s historic business or use

(b) The continuation of one of three equal businesses satisfies the § 368 requirement and will apparently satisfy the § 382 requirement as well. Conference Report, Page II-189.

(c) The Conference Report makes clear (Page II-189) that changes in the location of a loss corporation business or of its key employees will not result in a failure to satisfy the business continuity test even though they might have caused a failure to satisfy the business continuity requirement of old § 382(a).

(d) The application of the step transaction doctrine is unclear. A sale of a business more than 2 years after a reorganization could disqualify the reorganization under § 368 if it had been planned at the outset. Will it be protected under § 382 by the 2-year rule?

Comment. The business continuity test introduces an unfortunate element of uncertainty into the law.


(1) If an ownership change occurs, the amount of any net capital loss for any taxable year before the first post-change year that can be used in any post-change year will be limited by regulations based on the principles of § 382.
(2) Any such net capital loss that is used in a post-change year shall reduce the § 382 limitation that is applied to any pre-change losses for such year.

F. Application of the § 382 limitation.

1. The taxable income of the new loss corporation for any post-change year that can be offset by pre-change losses cannot exceed the § 382 limitation for such year. I.R.C. § 382(a).

2. For the post-change year that includes the change date:
   a. The § 382 limitation does not apply to the taxable income for the year allocable to that part of the year on or before the change date. I.R.C. § 382(b)(3)(A).
      (1) Taxable income is allocated to days in the year on a ratable basis, except as shall be provided in regulations.
      (2) Taxable income shall be computed for this purpose by disregarding REBIGs and § 338 gains. I.R.C. § 382(h)(5).
   b. In applying the § 382 limitation to that part of the taxable year after the change date, the limitation shall be a fraction of the limitation computed in the normal way, the numerator of which is the number of days in the year after the change date and the denominator of which is the number of days in the year. I.R.C. § 382(b)(3)(B).
   c. The regulations will allow L to elect to allocate income based on a closing of the books on the change date. Income realized after the change date may be allowed to be allocated to the period before the change date in "appropriate circumstances" (e.g., discharge of indebtedness income that is "integrally related" to a transaction resulting in an ownership change). Notice 87-79, 1987-2 C.B. 387.
      (1) Until regulations are adopted reflecting Notice 87-79, taxpayers must get a private letter ruling to use the closing-of-the-books method.
See, e.g., PLRs 9005049, 9006065, and 9034052.

(2) The Service has ruled that, if L has taxable income for the taxable year including the change date, the amount allocated to the pre-change period will be the lesser of the taxable income for the pre-change period and the taxable income for the taxable year. Thus, pre-change taxable income must be reduced by post-change losses. PLRs 9017020 and 9030023.

3. If the § 382 limitation for a taxable year exceeds the new loss corporation's taxable income for the year that is offset by pre-change losses, the excess is carried forward and increases the § 382 limitation for the next year. I.R.C. § 382(b)(2).

4. Ordering rules.
   a. NOL carryovers in excess of the § 382 limitation for any taxable year are carried forward to the next year in full, even though the taxable income of the year exceeds the § 382 limitation. I.R.C. § 382(1)(2)(A).
   b. If in any year a corporation has income that can be offset by both a pre-change loss (i.e., one the use of which is subject to § 382) and an NOL that is not subject to § 382, the income will be deemed to be offset first by the NOL subject to the § 382 limitation. This rule reduces the effect of the limitation. I.R.C. § 382(1)(2)(B).

G. Effect of the Tax Reform Act of 1986 on other limitations on the use of NOL carryovers.

1. The statute does not refer to § 269 and the SRLY and CRCO rules. The Conference Report (Page II-194) confirms that these rules remain in effect. The Libson Shops doctrine will not apply.

Comment. The § 382 limits should effectively remove the incentives for buyers to attempt to buy NOL carryovers and it should have been possible to repeal these other limitations.
2. The statute gives the Treasury Department regulatory authority to prevent the avoidance of §§ 382 and 383 by multiple transactions, taxable year changes, and the use of related persons, pass-through entities, and other intermediaries. I.R.C. § 382(m).

a. The Conference Report indicates (Pages II-194-95) that the regulations should address the use of so-called tax-loss partnerships to make special allocations of losses of a partnership to partners with taxable income.

b. The Conference Report states (Page II-195) that the application of these regulations to partnerships should be effective as of the date of enactment of the Act (October 22, 1986).

H. Bankruptcy situations.

1. The § 382 limits do not apply to a corporation if:

   a. Immediately before the ownership change the old loss corporation is under court jurisdiction in a Title 11 or similar case (i.e., a receivership, foreclosure, or similar proceeding in a federal or state court), and

   b. The shareholders and creditors of the old loss corporation determined immediately before the ownership change own immediately after the change stock of the new loss corporation (or of a controlling corporation if that corporation is in bankruptcy) equal to at least 50% of the voting power and 50% of the value. I.R.C. § 382(1)(5)(A).

   (1) The stock ownership requirement is effected by a cross reference to I.R.C. § 1504(a)(2). It is not clear whether stock described in § 1504(a)(4) is excluded. A literal reading of § 382(k)(6)(A) would indicate that it is because that provision excludes § 1504(a)(4) stock
from the term "stock" "[f]or purposes of this section."

(2) Stock transferred to a creditor in satisfaction of indebtedness is treated as owned by the creditor for this purpose only if the indebtedness:

(a) Was owned by the creditor at least 18 months before the filing of the Title 11 or similar case, or

(b) Is held by the person who at all times held the beneficial interest in the indebtedness and arose in the ordinary course of the old loss corporation's trade or business. I.R.C. § 382(1)(5)(E).

(3) In applying these rules, options will be deemed to have been exercised if this would cause a failure to meet the § 382(1)(5) requirements. Prop. Regs. § 1.382-3(c) (applicable to ownership changes occurring after September 4, 1990).

2. Special rules if § 382(a) does not apply because of the exception in § 382(1)(5)(A).

a. The NOL deduction under § 172(a) for any post-change year is determined as if no deduction was allowable for interest on debt converted into stock pursuant to the court proceeding during any taxable year ending within 3 years preceding the taxable year in which the ownership change occurs and that part of the year of the change on or before the change date. I.R.C. § 382(1)(5)(B).

b. The pre-change losses and excess credits that may be carried to a post-change year are reduced by 50% of the amount that would have been included in gross income but for the application of the Title 11 and insolvency exception of I.R.C. § 108(e)(10)(B) to the normal rule that cancellation of indebtedness income results from the satisfaction of debt with stock
with a value less than the debt's face amount. I.R.C. § 382(1)(5)(C).

c. If a second ownership change occurs within 2 years after the first ownership change, the Title 11 exception will not apply to the second change and, in applying § 382 to that change, the § 382 limitation shall be 0. Thus, pre-change losses will no longer be available. I.R.C. § 382(1)(5)(D).

d. Proposed regulations indicate that § 269 may present major problems in bankruptcy reorganizations.

(1) The continuity of business requirement of § 382(c) does not apply to § 382(1)(5) transactions. Prop. Regs. § 1.382-3(b).

(2) An acquisition of control or property in a § 382(1)(5) transaction will normally be considered to be made for the principal purpose of tax avoidance unless the corporation "carries on more than an insignificant amount of an active trade or business" during and after the Title 11 or similar case. Prop. Regs. § 1.269-3(d).

(3) An acquisition of control of the corporation will be deemed to occur for purposes of § 269 no earlier than the date on which the bankruptcy court confirms the reorganization. Prop. Regs. § 1.269-5(b).

(4) A finding by a bankruptcy court that the principal purpose of the plan was not the avoidance of taxes for purposes of § 1129(d) of the Bankruptcy Code is not controlling for purposes of § 269 (the burden of proof is on the government under § 1129(d) and on the taxpayer under § 269). Prop. Regs. § 1.269-3(e).


a. In determining the application of the general Title 11 exception, the
shareholders and creditors of the old loss corporation need only end up owning 20% of the corporation's voting power and value.

b. Treatment of deposits.

(1) A depositor in the old loss corporation is treated as a stockholder.

(2) Deposits that after the ownership change became deposits in the new loss corporation are treated as stock of the new loss corporation.

(3) Such deposits are included in the value of the new loss corporation.

c. Transactions subject to the special rules for thrift institutions.

(1) An equity structure shift that is a reorganization described in I.R.C. § 368(a)(3)(D)(ii). This includes:

(a) A reorganization under § 368(a)(1)(G) involving a mutual savings bank or other organization described in I.R.C. § 593, if

(b) The federal or state agency having jurisdiction over the proceeding certifies as to the corporation's financial difficulties.

(2) Any other ESS or § 351 exchange that is an integral part of a § 368(a)(3)(D)(ii) transaction.

d. The special rules for thrift institutions will not apply to ESSs or transactions occurring after December 31, 1988.

4. General rules relating to the Title 11 exception.

a. A new loss corporation may elect to be subject to the general § 382(a) rules rather than the Title 11 rules. I.R.C. § 382(1)(5)(H). Corporations often make
this election because of the reductions of NOLs resulting from the special rules described above.

b. If the Title 11 rules do not apply to a reorganization under § 368(a)(1)(G) or to a debt-stock exchange in a Title 11 or similar case, the value of the old loss corporation in applying the regular § 382 rules will be the value of the new loss corporation immediately after the ownership change (i.e., taking conversions of debt into stock into account). I.R.C. § 382(1)(6).

c. The special rules do not apply to debt-stock exchanges in informal workouts, but the Treasury Department was instructed to submit a report to Congress on informal workouts before January 1, 1988. Tax Reform Act § 621(d)(2).


A. Introduction.

1. Section 382 limits the use of L’s NOLs if there is a change in L’s shareholders, but it does not affect L’s use of its NOLs under other circumstances.

2. Section 384 prevents the use of L’s NOLs against built-in gains of a corporation that L acquires.

B. Transactions subject to § 384.

1. Stock acquisitions.

a. General rule.

(1) If a corporation acquires "control" of another corporation and either corporation ("G") has built-in gains (defined as NUBIGs, including the de minimis rule).

(2) Then, the income of G during any recognition period taxable year (defined as under § 382 but by reference to the acquisition date) to the extent attributable to a REBIG
shall not be offset by any pre-acquisition loss of any corporation other than G.

Note: The rule applies regardless of which corporation is the acquiror.

Note: L's NOL cannot be used at all against G's NUBIG. Its use is not merely limited by the § 382 rules.

b. "Control" generally means at least 80% of the voting power and value of the corporation.

2. Asset acquisitions.

a. General rule.

(1) If the assets of a corporation are acquired by another corporation in a tax-free reorganization under §§ 368(a)(1)(A), (C), or (D), and either corporation has built-in gains (defined in the same manner as for stock acquisitions) ("G")

(2) Then, the income of G during any recognition period taxable year to the extent attributable to a REBIG shall not be offset by the pre-acquisition loss of any corporation other than G.

C. Exception for common control situations. I.R.C. § 384(b).

1. General rule. Section 384 does not apply if L and G were members of the same controlled group of corporations (defined in terms of § 1563(a) but using a 50% test) throughout the 5-year period ending on the acquisition date.

D. Income subject to § 384. I.R.C. § 384(c)(1).

1. Gain on any asset disposed of that is recognized during the recognition period except to the extent that G can show that it was not owned by G on the acquisition date or that the gain exceeds the excess of the property’s value over its basis on that date. Regulations will provide that § 384 will apply to gains recognized after the recognition period pursuant

Comment. An inventory and appraisal of property should be made on the acquisition date.

2. Other items of income that are taken into account for a recognition year but that are attributable to periods before the acquisition date are considered in determining the amount of the NUBIG.

E. Acquisition date. I.R.C. § 384(c)(2).

1. Stock transfer: the date on which control was acquired.

2. Asset transfer: the date of the transfer.

F. Pre-acquisition losses. I.R.C. § 384(c)(3).

1. Pre-acquisition losses include:

a. Any NOL carried forward to the taxable year in which the acquisition date occurs.

b. Any NOL for the taxable year in which the acquisition date occurs. The loss is allocated ratably to each day in the year except to the extent provided in regulations.

2. REBILs are treated as pre-acquisition losses.

G. Similar rules will apply to excess credits (as defined in § 383(a)(2)) and net capital losses. I.R.C. § 384(d).