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A REVIEW OF THE PROVISIONS OF THE TAX REFORM ACT OF 1986 RELATING TO CORPORATE ACQUISITIONS

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I. Scope

ments on June 24, 1986. The Conference Committee reached agreement on the bill on August 16, 1986, and the Conference Report on the Tax Reform Act of 1986 was released on September 18, 1986 (H. Rept. No. 99-841, 99th Cong. 2d Sess. 1986) (the "Conference Report"). The House passed H.R. 3838 on September 25, 1986, and the Senate passed it on September 27, 1986. The President signed the bill on Wednesday, October 22, 1986. Also, on September 25, 1986 the House passed House Concurrent Resolution 395, which contains technical corrections to and transitional rules under H.R. 3838. The Senate passed its version of this concurrent resolution on October 16, 1986, however, the House and Senate were not able to agree on the terms of the resolution before adjournment on October 18, 1986.

Section 2 of the Tax Reform Act of 1986 (the "Act") redesignates the Internal Revenue Code of 1954 (the "1954 Code") as the Internal Revenue Code of 1986 (the "1986 Code"), and section 2(b) provides that except where inappropriate (1) any reference to the 1954 Code shall include a reference to the 1986 Code, and (2) any reference to the 1986 Code shall include references to the 1954 Code.

Title VI of the Act contains substantive amendments to the corporate provisions of the 1986 Code and Title XVIII contains technical amendments to, inter alia, the corporate provisions.

This paper deals with the following corporate changes:

1. The repeal of the General Utilities doctrine (Section II);
2. The allocation of purchase price in certain asset sales (Section III);
3. The limitation on net operating losses and other carryforwards in acquisition transactions (Section IV);
4. The technical amendments to section 361, relating to the treatment of the target corporation in a reorganization (Section V).

This paper does not deal with the other corporate changes, which are:

1. Corporate Tax Rates
2. Corporate Dividends Paid Deduction
3. Corporate Dividends Received Deduction
4. Dividend Exclusion for Individuals
5. Extraordinary Dividends
6. Corporate Shareholder Redemptions
7. Stock Redemption Payments
8. Net Operating Loss Carrybacks—Tax Rate Limitation
9. Related Party Sales
10. Amortizable Bond Premium
11. Cooperative Housing Corporations
12. Real Estate Investment Trusts
13. Mortgage-Backed Securities

II. Repeal of General Utilities

A. Sections 336, 337, and 311

Act section 631(a) repeals section 336, which provides generally that a corporation does not recognize gain or loss on a liquidating distribution, and section 337, which provides generally that a corporation does not recognize gain or loss on the sale of assets followed by liquidation pursuant to a plan of liquidation occurring within a 12 month period.

Also, Act section 331(c) amends section 311, which governs the tax treatment to a corporation upon the distribution of appreciated property. The amendment eliminates the exceptions to recognition treatment in the case of nonliquidating distributions (e.g., nonrecognition for distributions which are partial liquidations or qualified dividends with respect to qualified stock, see Code section 311(d)(2)(A)).

B. New Section 336

Act section 631(a) adds a new section 336 (New section 336) to the 1986 Code. Under New section 336(a), gain or loss is recognized by a "liquidating corporation on the distribution of property in complete liquidation as if such property were sold to the distributee at its fair market value...." This recognition rule does not apply to distributions under New section 337 by a subsidiary corporation to a parent corporation in a transaction that qualifies under section 332, nor does it apply to any distribution of property to the extent there is nonrecognition of gain or loss with respect to the property by the recipient under the reorganization provisions. New section 336(c):

1. Liabilities in Excess of Basis. If any property distributed in a liquidation is subject to a liability or the distributee shareholder assumes a liability, the fair market value of the property is treated for purposes of both New section 336 and New section 337 as not less than the amount of the liability. New section 336(b).

If contributed disqualified property is exchanged in a like-kind exchange under section 1031 for other property, such other property is also disqualified property.

2. Limitation on Recognition of Loss. No loss is recognized by a liquidating corporation on the distribution of any property to a related person (within the meaning of section 267) if (1) the distribution is not pro rata, or (2) the property is disqualified property. New section 336(d) (1)(A). Disqualified property is any property that was acquired by the liquidating corporation within the five year period before the distribution in a transaction that qualified as a tax-free contribution to a corporation under section 351 or as a contribution to capital. New section 336(d)(1)(B). Also disqualified property includes any property the adjusted basis of which is determined (in whole or in part) by reference to the adjusted basis of other disqualified property. Id. Thus, if contributed disqualified property is exchanged in a like-kind exchange under section 1031 for other property, such other property is also disqualified property.

For purposes of determining the amount of loss recognized by a liquidating corporation on a sale, exchange, or distribution of certain carryover basis property (as described below), the adjusted basis of the property is reduced (but not below zero) by the excess of (1) the adjusted basis of the property immediately after its acquisition by the corporation, over (2) the fair market value
of the property at that time. New section 336(d)(2)(A). The carryover basis property is property acquired by the
liquidating corporation in a section 351 transaction or as a contribution to capital where the acquisition was part of
a plan a "principal purpose of which was to recognize
loss by the liquidating corporation with respect to such
property in connection with the liquidation." New section
336(d)(2)(B). Carryover basis property also includes any
property the basis of which is determined in whole or in
part by the basis of carryover basis property. Id. Any
property acquired by the corporation during the two year
period ending on the date of the adoption of the plan of
complete liquidation is treated as acquired as part of a
plan, a principal purpose of which is to recognize loss,
except to the extent provided in regulations. New section

In lieu of disallowing loss for a prior taxable year
pursuant to the above described basis reduction rules,
the Secretary may provide in regulations that the "gross
income of the liquidating corporation for the taxable year
in which the plan of complete liquidation is adopted...be
increased by the amount of the disallowed loss." New
section 336(d)(2)(C).

No loss is recognized by a liquidating corporation on
any distribution to which section 332 (relating to liquidations of subsidiaries) applies. New section 336(d)(3).

The Secretary is authorized to promulgate regulations that
will provide that where a parent corporation that
owns a subsidiary (within the 80 percent affiliation rules
of section 1504(a)(2)) sells, exchanges, or distributes all
of the stock of the subsidiary, then the parent may elect
to treat the transaction as a disposition of all of the assets
of the subsidiary and no gain or loss is recognized with
respect to the stock. New section 336(e).

C. New Section 337
Under New section 337, a liquidating corporation does
not recognize gain or loss on the distribution to a parent
corporation (i.e., an "80-percent distributee") of property
in a complete liquidation to which section 332 applies.
New section 337(a). A parent corporation does not recog-
nize gain on a liquidation of a subsidiary under section
332. The term 80 percent distributee means only the
parent corporation that qualifies for nonrecognition treat-
ment under section 332(b). New section 337(c). Thus,
there is gain or loss with respect to property distributed
to minority shareholders.

If a subsidiary that is liquidated under section 332 is
indebted to the parent, then for purposes of both New
section 336 and New section 337, any transfer of property
to the parent in satisfaction of such indebtedness is
treated as a distribution to the distributee in the liquida-
tion. New section 337(b). This is a carryover of the
present rule of section 332(c).

There is a special rule governing tax-exempt distri-
butees. New section 337(b)(2).

D. Regulatory Authority
Under New section 337(d), the Secretary is authorized
to promulgate regulations as "may be necessary or appro-
 priate to carry out the purposes" of the amendments
made by New section 336 and New section 337, including

(1) regulations to ensure that such purposes may
not be circumvented through the use of any provi-
sion of law or regulations (including the consoli-
dated return regulations, and part III of this sub-
chapter [i.e., the reorganization provisions]), and
(2) regulations providing for appropriate coor-
dination of the provisions of this section with the
provisions of this title relating to taxation of foreign
corporations and their shareholders.

1. Mirror Transactions. One question that the Treasury
may address under this regulatory authority is the use of
the so-called "mirror" transaction.

When an acquiring corporation plans to dispose of part
of a target's assets after an acquisition, a mirror transac-
tion can be used to permit the assets to be disposed of in
a tax-free transaction. A typical mirror transaction might
be structured as follows. Assume that a target corpo-
ration has two divisions each with a fair market value of $10
million and an adjusted basis of $1 million. Acquiror
plans to purchase the target's stock for $20 million. After
the acquisition, acquiror wants to keep Division #1, but
wants to dispose of Division #2. Acquiror is not planning
to make a section 338 election, and, therefore, if after the
acquisition the target were to sell Division #2, there
would be a $9 million taxable gain.

One question that the Treasury may address under
this regulatory authority is the use of the so-called 'mirror' transaction.

In order to avoid this gain and yet dispose of Division
#2, acquiror forms two subsidiaries, Sub 1 and Sub 2, and
capitalizes each with $10 million. Subs 1 and 2 then each
purchase $10 million of target's stock. Target is then
liquidated, distributing the assets of Division 1 to Sub 1
and the assets of Division 2 to Sub 2. Under the stock
aggregation rules of Treas. Reg. section 1.1504-34 of the
consolidated return regulations, the liquidation of target
qualifies as a liquidation under section 332, and, con-
sequently, neither Subs 1 and 2 nor target recognize gain
on the liquidation (note that in any case Subs 1 and 2
would not recognize gain because the basis of their
target shares equals the value of the assets distributed). Subs
1 and 2 take a carryover basis for the assets received.

After the liquidation acquiror could then sell for $10
million the stock of Sub 2, which contains the assets of
unwanted Division 2, and recognize no gain or loss
because the acquirer's basis for the stock of Sub 2 is $10
million. (This assumes that the Court Holding
doctrine, or a similar anti-abuse principle, does not apply to
treat the sale of stock as a sale of assets or otherwise to break
the section 332 liquidation.)

One possible attack on the mirror transaction is for the
Treasury to use the regulatory authority under New sec-
tion 337(d) (which specifically refers to the consolidated
return regulations) to repeal or limit the stock aggregation
rules of Treas. Reg. section 1.1504-34 in order to deny
section 332 liquidation treatment for the target in such
cases. Under the 1986 Code, if the transaction did not
qualify as a tax-free subsidiary liquidation under section
332, then the target would have recognition on the
liquidating distribution, because New section 337 would
not apply to give it nonrecognition treatment on the
liquidation. In this connection, it should also be noted
that in a footnote in the Conference Report the conferees say:

The conferees anticipate that in a consolidated context, the Treasury Department will consider whether aggregation of ownership rules similar to those in section 1.1502-34 of the regulations should be provided for purposes of determining status as an 80-percent distributee. Conf. Rep. at II-202 footnote 9.

The same footnote appears in the House Report (see House Rep. at 283, footnote 32); however, the House bill does not have a broad grant of regulatory authority similar to that contained in New section 337(d) above, which specifically refers to the consolidated return regulations. It can be expected that the Treasury will address this policy issue quickly. However, if a mirror transaction is completed before the effective date of the repeal of General Utilities (i.e., before January 1, 1987), the transaction should give rise to the desired results.

If a mirror transaction is completed before the effective date of the repeal of General Utilities (i.e., before January 1, 1987), the transaction should give rise to the desired results.

In his floor statement on the Conference Report on September 25, 1986, Congressman Rostenkowski made a clarifying statement concerning the Treasury’s authority to address the mirror transaction. He said that the purpose of the grant of regulatory authority was to give the Treasury “flexibility so that only transactions that use the consolidated return regulations to avoid the purposes of the Conference agreement are affected.” Cong. Rec. Sept. 25, 1986 at H8358. He went on to say that avoidance of the basic statutory rules “would most plainly occur when it is reasonable to infer that the disposition of an acquired business without paying the corporate level tax on the built-in appreciation was contemplated as a reasonable possibility at the time of an acquisition.” Id.

On the other hand, in a colloquy on the Senate floor between Senators Dole and Packwood during the consideration of the Act, Senator Dole said that “it would be unsound economic tax policy to prohibit [mirror transactions],” and that he “hoped” the Treasury would take no regulatory action on the subject, but rather would address the issue in the Treasury study of the corporate provisions (See Section K below). Cong. Rec. Sept. 27, 1986 at S13958. Senator Packwood responded that he shared Senator Dole’s view. Finally, in a statement by Congressman Rostenkowski on the House floor relating to Senate floor colloquies, the congressman said the Treasury is “expected fully to carry out the intent of Congress in repealing the General Utilities doctrine including preventing the circumvention thereof by allowing mirror subsidiary transactions to take place.” Cong. Reg. Oct. 2, 1986 at E3389.

E. Amendments to Section 338

Present section 338 is amended by deleting the words “to which section 337 applies” in section 338(a)(1). Act section 631(b)(1). Thus, there is complete recognition of gain and loss upon the making of a section 338 election. Section 338(c), which relates to the coordination with section 337 where the purchasing corporation holds less than 100 percent of the stock and to the treatment of certain redemptions, is deleted. Act section 631(b)(2).

Also section 338(h)(10), which allows a selling consolidated group to elect to treat the target as if it had sold its assets, is amended by Act section 631(b)(3) to add the following sentence at the end of the subsection:

To the extent provided in regulations, such term also includes any affiliated group of corporations which includes the target corporation (whether or not such group files a consolidated return).

F. Amendments to Section 311

New section 311(a) provides that except as provided in New section 311(b), no gain or loss is recognized by a corporation on the distribution, with respect to its stock, of (1) its stock (or stock rights), or (2) property.

Under New section 311(b), if a corporation distributes property (other than an obligation of the corporation) to a shareholder in a distribution to which sections 301 through 307 (relating to property and stock distributions) apply, and the fair market value of such property exceeds its adjusted basis, then gain is recognized by the distributing corporation as if the property were sold to the distributee at its fair market value. Where there are liabilities in excess of basis, rules similar to the rules discussed above under New section 336(b) apply. New section 311(b)(2).

Thus, there is, in essence, parity in the treatment of nonliquidating distributions under New section 311 with liquidating distributions under New section 336, except that no loss is recognized in a nonliquidating distribution.

There is, in essence, parity in the treatment of nonliquidating distributions under New section 311 with liquidating distributions under New section 336, except that no loss is recognized in a nonliquidating distribution.

G. Amendments to Section 367

Section 367(e) is amended to provide that (1) in a distribution under section 355 by a domestic corporation to a foreign person, gain is recognized to the extent provided in regulations, and (2) in a distribution under section 322 by a subsidiary to a foreign parent, the nonrecognition rules of New sections 337(a) and (b)(1) do not apply, except as provided in regulations. Act section 631(d).

H. Other Technical and Conforming Amendments

There are a host of other technical and conforming amendments, including: (1) an amendment to section 312(n) dealing with LIFO inventory adjustments (Act section 631(e)(1)); (2) the deletion of section 323(c) (Act section 631(e)(2)); (3) the repeal of section 333 and the associated basis provision in section 334(c) (Act section 631(e)(3) and (4)); (4) the repeal of section 338(h)(12)
(Act section 631(e)(5)); (5) amendments to section 341(e) (the collapsible corporation provision) (Act section 631(e)(6)); (6) the deletion of the reference to section 337 in section 346 (Act section 631(e)(7)); (7) amendments to section 453(h)(1) (relating to the use of installment sales in liquidating sale transactions) (Act section 631(e)(8)); and (8) amendments to section 453B (relating to the distribution of installment obligations to section 332 liquidations) (Act section 631(e)(9)).

I. Treatment of C Corporations That Elect Subchapter S Status

In order to prevent a C corporation from electing Subchapter S in order to avoid the double tax on a liquidating sale or distribution, section 1347 is amended to provide generally for a corporate level tax on any recognized gains that were built-in at the time the C corporation elected S status. The tax is imposed at the time the S corporation disposes of the property in a taxable transaction.

Section 1374 is amended to provide generally for a corporate level tax on any recognized gains that were built-in at the time the C corporation elected S status.

Under New section 1374(a) if a S corporation has Recognized Built-in Gain during any taxable year beginning in the Recognition Period, the tax under section 1374(b) is imposed.

The Recognition Period is the 10 year period beginning with the first day of the first taxable year for which the corporation is an S corporation. New section 1374(d)(3).

Recognized Built-in Gain is the gain recognized during the Recognition Period on the disposition of any asset, except to the extent that the corporation establishes that (1) the asset was not held by the S corporation as of the beginning of the first taxable year for which it was an S corporation, or (2) the gain exceeds the excess of (a) the fair market value of the asset as of the beginning of such first taxable year, over (b) the adjusted basis of the asset at such time. New section 1374(d)(2).

The tax imposed by New section 1374(a) is computed by multiplying (1) the lesser of (a) the Recognized Built-in Gains for the taxable year, or (b) the amount which would have been the taxable income of the corporation for such year if the corporation were not an S corporation, by (2) the highest corporate tax rate applicable under section 11(b). New section 1374(b)(1). Subject to certain limitations, net operating loss carryovers and business credit carryforwards from a period when the S corporation was a C corporation can be utilized to offset the tax liability. New sections 1374(b)(2) and (3).

The amount of the Recognized Built-in Gains for any taxable year cannot exceed the excess of (1) the Net Unrealized Built-in Gain over the Recognized Built-in Gains for prior taxable years beginning in the Recognition Period. New Section 1374(c)(2). The Net Unrealized Built-in Gains is the amount by which (1) the fair market value of the corporation’s assets as of the beginning of the first taxable year for which the S election is in effect, exceeds (2) the aggregate adjusted basis at such time. New section 1374(d)(1). Thus, the amount of Recognized Built-in Gains that is subject to the tax is limited by the Net Unrealized Built-in Gain at the time the S election first becomes effective.

This means, in effect, that any unrecognized gain in assets of a C corporation (including presumably inventory gains) that elects S status will be subject to corporate level tax if the gain is recognized during the Recognition Period.

J. Treatment of S Corporation In Liquidating Transaction

Section 1383(e) is amended to eliminate section 1363(e)(1), which provides that an S corporation does not recognize gain on the distribution of property in a complete liquidation. Act section 632(b).

K. Treasury Study of Corporate Provisions

Act section 634 requires the Treasury to conduct a study of proposals to reform Subchapter C and report to the Congress no later than January 1, 1988. This study will probably use as its starting point the Senate Finance Committee Staff’s Subchapter C Revision Bill of 1985.

In view of the repeal of General Utilities, it can be expected that the Treasury study will consider whether asset purchase transactions should be able to be completed with the acquiring corporation taking a carryover basis for the assets and the target not recognizing gain.

L. Effective Dates Generally

The amendments repealing the General Utilities doctrine, in general, apply to (1) any distribution in complete liquidation and any sale or exchange made after July 31, 1986, unless the corporation is completely liquidated before January 1, 1987, (2) any section 338 transaction for which the acquisition date occurs after December 31, 1986, and (3) any distribution (not in complete liquidation) made after December 31, 1986. Act section 633(a). Special effective date rules apply to built-in gains of S corporations (Act section 633(b)) and to liquidations pursuant to certain binding contracts (Act section 633(c)).

Also, a special transitional rule for small closely-held corporations (i.e., "qualified corporations") delays until January 1, 1989, the repeal of the General Utilities doctrine. Thus, the repeal of General Utilities does not apply to such corporations that completely liquidate before January 1, 1989. Act section 633(d)(1). These corporations are corporations with a value of no more than $5 million that are at least 50 percent owned by 10 or fewer individuals, estates and certain trusts. Act sections 633(d)(5) and (6); see also section 74 of House Concurrent Resolution No. 395 (which adds a five year ownership requirement). Partial nonrecognition treatment is granted to such closely-held corporations with a value between $5 million and $10 million. Act section 633(d)(3).

The exception to the repeal of General Utilities does not, however, apply to ordinary gain or loss, short-term capital gain or loss, or to any gain to the extent section 453(B) applies. Act section 633(d)(2).

As a consequence, qualifying corporations have until December 31, 1988, to take advantage of the current nonrecognition rules in sections 336, 337, and 338, with those corporations with a value of less than $5 million getting complete relief (except with respect to ordinary

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*Here and in the balance of this paper the italicized terms are statutorily defined terms.*

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income assets, short-term capital gains and losses and Code section 453B gains) and those with a value between $5 million and $10 million receiving partial relief. Also, the Conference Report says (but the Act does not) that the present nonrecognition rules in section 311(d) continue to apply to qualified corporations until December 31, 1988. Conf. Rep. at II-207 Section 75 of House Concurrent Resolution 395 clarifies that section 311(d) continues to apply for such corporations until December 31, 1988.

New section 1374 applies to taxable years beginning after December 31, 1986, but only where the first taxable year for which the corporation is an S corporation is pursuant to an election made after December 31, 1986. Act section 633(b). It is understood from conversations with a staff member of the Joint Committee on Taxation that for example, a calendar year corporation for which an S election is made between now and the end of 1986 will not be subject to New section 1374 even though the election does not become effective until January 1, 1987. Such corporations would, however, be subject to the present section 1374 (which imposes a corporate level tax on certain net capital gains realized during the three year period after a C corporation has become an S).

Also, in the case of a qualifying corporation that elects to become an S corporation for a taxable year before January 1, 1989, rules similar to the conversion rules of New section 1374 are to apply. Act section 633(d)(8). The Conference Report says that qualifying corporations will be subject to the present section 1374. Conf. Rep. at II-206.

III. Special Allocation Rules for Certain Asset Acquisitions

A. General Rules

Act section 641 adds New section 1060 to the Code. Under this provision, in the case of any asset acquisition, the consideration paid is to be allocated among the assets acquired in accordance with the allocation rules of section 338(b)(5). New section 1060(a). This allocation method is to apply for purposes of determining both the transferee's basis and the transferor's gain or loss. Id.

The regulations under section 338(b) basically apply the residual method for valuing good will, with a fair market value being determined for all other assets, and the residual value being assigned to good will.

The asset acquisitions covered by this rule are transfers (1) of assets which constitute a trade or business, and (2) with respect to which the transferee's basis in the assets is determined in whole or in part by reference to the consideration paid. New section 1060(c).

The Secretary is authorized to promulgate regulations requiring the parties to file certain information concerning the allocation of the purchase price. New section 1060(b). The purpose of this provision is to ensure that the two parties allocate the purchase price in the same way.

B. Effective Date

This provision applies to any acquisition of assets after May 6, 1986, unless the acquisition is pursuant to a binding contract which was in effect on May 6, 1986. Act section 641(c).

IV. NOL and Excess Credit Carryforwards

A. Introduction

Act section 621 amends section 382 and section 383. The amendments are similar to those contained in the Senate Finance Committee's Subchapter C Revisions Bill of 1985, which was based on suggested changes contained in The American Law Institute's 1982 study entitled Federal Income Tax Project: Subchapter C. Sections 382 and 383 apply to both taxable acquisitions and reorganizations. New section 382 applies to the carryover of net operating losses and to the treatment of built-in gains and losses, and New section 383 applies to certain excess credits, net capital losses and foreign tax credits.

The basic theory of New section 382...is known as the 'limitation on earnings' approach.

The basic theory of New section 382 is that after a change in control of a loss corporation the net operating losses should be available to the new owners only to the extent the losses would have been utilized if there had been no change of control. The theory is known as the "limitation on earnings" approach. This concept is effected by allowing the utilization of the loss corporation's net operating losses only to the extent of a specified percentage of the equity of the loss corporation. Further, losses are subject to complete disallowance if the loss corporation does not satisfy the continuity of business requirement applicable to reorganizations for the two-year period following the acquisition. Thus, if the loss corporation has $1 million in equity and the applicable rate of return is 10 percent, $100,000 of the losses could be utilized each year after the acquisition. Under the new statute, utilization of losses will be a function of the equity value of the loss corporation, and no one will buy a loss corporation simply to utilize its losses.

B. General Limitation Rule

Under New section 382(a), the amount of taxable income of the New Loss Corporation for any Post-Change Year which may be offset by Pre-Change Losses cannot exceed the Section 382 Limitation for the year. A New Loss Corporation for purposes of applying the limitation contained in New section 382(a) is defined by reference to two other definitions: Loss Corporation and Old Loss Corporation. Under section 382(k)(1), a Loss Corporation is "a corporation entitled to use a net operating loss carryover." While, except as provided in regulations to be issued, the term will include any corporation with a Net Unrealized Built-in Loss, built-in losses are beyond the scope of this paper.

New section 382(k)(2) defines an Old Loss Corporation as any corporation with respect to which there is an Ownership Change and (1) which before such change was a Loss Corporation, or (2) with respect to which there is a Pre-Change Loss.

Under New section 382(k)(3), the term New Loss Corporation means a corporation which after an ownership change is a Loss Corporation. The same corporation may be both the Old and the New Loss Corporation.

1. Ownership Change

Under New section 382(g)(1), an Ownership Change occurs if immediately after (1) any Owner Shift Involving a Five-Percent Shareholder, or (2) any Equity Structure Shift there has been an increase by more than 50 percentage points in (A) the percentage of stock of the New Loss Corporation owned by one or
more Five-Percent Shareholders, over (B) the lowest percentage of stock of the Old Loss Corporation (or any predecessor) owned by the Five-Percent Shareholders at any time during the Testing Period (generally three years). A Five-Percent Shareholder is defined in New section 382(k)(7) as any person holding five percent or more of the stock of the corporation at any time during the Testing Period.

In determining whether an Ownership Change has occurred under New section 382(g)(4), "all stock owned by shareholders of a corporation who are not five-percent shareholders of such corporation [is] treated as stock owned by one five-percent shareholder of such corporation." In this connection, for purposes of determining whether an Equity Structure Shift (or subsequent transaction) is an Ownership Change in the case of a reorganization, the aggregation rule for less than Five-Percent Shareholders is applied separately immediately before the Equity Structure Shift for the target corporation and the acquiring corporation. New section 382(g)(4)(B)(ii). Acquisitions of stock after such an Equity Structure Shift are treated as being made proportionately from all shareholders immediately before such acquisition, unless a different proportion is established. New section 382(g)(4)(B)(ii). The above two rules apply in determining whether there has been an Owner Shift Involving a Five-Percent Shareholder and whether such shift (or subsequent transaction) results in an Ownership Change. New section 382(g)(4)(C).

Under New section 382(g)(2), an Owner Shift Involving a Five-Percent Shareholder occurs if (A) there is any change in the respective ownership of stock of a corporation, and (B) such change affects the percentage of stock of such corporation owned by any person who is a Five-Percent Shareholder before or after such change. Thus, an Owner Shift Involving a Five-Percent Shareholder could result from, inter alia, a purchase of the stock of the Old Loss Corporation, a redemption of such stock, or a contribution of property for stock in a section 351 transaction.

Under New section 382(i)(1), the Testing Period is the three-year period ending on the day of any Owner Shift Involving a Five-Percent Shareholder or Equity Structure Shift.

An Equity Structure Shift means any reorganization under section 368, except that this term does not include (1) any section 368(a)(1)(D) (split-up) or (G) (bankruptcy) reorganization unless the requirements of section 354(b)(1) (relating to transfer of substantially all the assets) are met, and (2) any section 368(a)(1)(F) (mere change in form) reorganization. New section 382(g)(3)(A). The term also means, to the extent provided in regulations, any taxable reorganization-type transactions, public offerings, and similar transactions. New section 382(g)(3)(B).

Under New section 382(i)(1), the Testing Period is the three-year period ending on the day of any Owner Shift Involving a Five-Percent Shareholder or Equity Structure Shift. If an Ownership Change has occurred, the Testing Period for determining whether a second change has occurred does not begin before the first day following the Change Date for such earlier Ownership Change. New section 382(i)(2). The Testing Period does not, however, begin before the first day of the first taxable year from which there is a carryforward of a loss or of an excess credit to the 1st Post-Change Year. New section 382(i)(3). This rule does not apply to any Loss Corporation which has a Net Unrealized Built-in Loss (after application of the Threshold Requirement of Section 382(h)(3)(B)). Id.

The term Change Date means (1) in the case where the last component of an Ownership Change is an Owner Shift Involving a Five-Percent Shareholder, the date on which such shift occurs. and (2) in the case where the last component of an Ownership Change is an Equity Structure Shift, the date of the reorganization. New section 382(i).

With certain exceptions involving built-in gains and losses and as provided in regulations, the net operating loss for the taxable year in which a change occurs will be allocated ratably to each day in the year.

2. Pre-Change Loss and Post-Change Years. Under New section 382(d)(1), the term Pre-Change Loss means "(A) any net operating loss carryforward of the Old Loss Corporation to the taxable year ending with the Ownership Change or in which the Change Date occurs, and (B) the net operating loss of the Old Loss Corporation for the taxable year in which the Ownership Change occurs to the extent such loss is allocable to the period in such year or before the Change Date." With certain exceptions involving built-in gains and losses and as provided in regulations, the net operating loss for the taxable year in which a change occurs will be allocated ratably to each day in the year. New section 382(d)(1).

Under New section 382(d)(2), the Post-Change Year means "any taxable year ending after the Change Date."

3. Illustrations. The general limitation rule of section 382(a) can apply in two basic situations. First, the limitation applies where during the three-year Testing Period there has been a more than 50 percentage point increase in the stock ownership of a Loss Corporation by Five-Percent Shareholders, i.e., there has been an Owner Shift Involving a Five-Percent Shareholder that results in an Ownership Change. This type of Ownership Change could occur in its simplest form where an acquiring corporation purchases all of the stock of a Loss Corporation. Also, it could apply where, as a result of a redemption, a continuing shareholder of a Loss Corporation owning before the redemption, for example, four percent of a stock, ends up after the redemption owning 60 percent of the Loss Corporation stock. After the stock purchase or redemption that results in the Ownership Change the Loss Corporation is both (1) an Old Loss Corporation, because before the Ownership Change it was a Loss Corporation (New section 382(k)(2)), and (2) a New Loss Corporation (New section 382(k)(3)), because after the Ownership Change it con-
Our reports continue to be a Loss Corporation, i.e., the Ownership Change did not cause its net operating losses to disappear. As a result of this Ownership Change, under the general limitation rule of New section 382(a), the amount of the taxable income of the New Loss Corporation for any Post-Change Year that may be offset by any Pre-Change Losses cannot exceed the Section 382 Limitation for such year. This limitation is discussed under C below.

The following example of an Ownership Change resulting from an Owner Shift Involving Five-Percent Shareholders is given in the Conference Report:

Example 2.—On January 1, 1987, the stock of L corporation is publicly traded; no shareholder holds five percent or more of L stock. On September 1, 1987, individuals A, B, and C, who were not previously L shareholders and are unrelated to each other or any L shareholders, each acquires one-third of L stock. A, B, and C each have become five-percent shareholders of L and, in the aggregate, hold 100 percent of the L stock. Accordingly, an ownership change has occurred, because the percentage of L stock owned by the three five-percent shareholders after the owner shift (100 percent) has increased by more than 50 percentage points over the lowest percentage of L stock owned by A, B, and C at any time during the testing period (zero percent prior to September 1, 1987). Conf. Rep. at II-174.

The second situation in which the general limitation can come into effect is where there has been an Ownership Change resulting from an Equity Structure Shift. For example, if, as a result of an acquisitive reorganization under section 368(a)(1)(A) (merger), (B) (stock for stock), (C) (stock for assets), an acquiring corporation acquires either the assets in an (A) or (C) or stock in a (B) of a Loss Corporation, and as a result of the acquisition there has been a more than 50 percentage point increase in the stock ownership of the Loss Corporation by reason of the reorganization, an Ownership Change has occurred. In applying this test, the aggregation rules under New section 382(g)(4)(B)(i) for Less Than Five-Percent Shareholders apply. Thus, for example, if prior to the reorganization the acquiring corporation and its shareholders owned no stock in the target Loss Corporation and as a result of the reorganization the shareholders of the target owned 20 percent of the stock of the acquirer, there would be an Ownership Change because immediately after the Equity Structure Shift the percentage of the stock of the New Loss Corporation (either (1) the acquiring corporation in an (A) merger or (C) stock for asset reorganization, or the target in a (B) stock for stock reorganization) owned by the aggregate of the old shareholders of the acquiring corporation has increased by more than 50 percentage points over the lowest percentage of stock of the Old Loss Corporation (i.e., zero percent) owned by such shareholders at any time during the Testing Period. This principle is illustrated by the following example from the Conference Report:

Example 8.—On January 1, 1988, L corporation (a loss corporation) is merged (in a transaction described in section 368(a)(1)(A)) into P corporation (not a loss corporation), with P surviving. Both L and P are publicly traded corporations with no shareholder owning five percent or more of either corporation or the surviving corporation. In the merger, L shareholders receive 30 percent of the stock of P. There has been an ownership change of L, because the percentage of P stock owned by the former P shareholders (all of whom are less-than-five-percent shareholders who are treated as a separate, single five-percent shareholder after the equity structure shift (70 percent) has increased by more than 50 percentage points over the lowest percentage of L stock owned by such shareholders at any time during the testing period (zero percent prior to the merger). If, however, the former shareholders of L had received at least 50 percent of the stock of P in the merger, there would not have been an ownership change of L. Conf. Rep., at II-177.

C. Section 382 Limitation

Under New section 382(b)(1), the Section 382 Limitation for any Post-Change Year is generally an amount equal to (A) the Value of the Old Loss Corporation, multiplied by (B) the Long-Term Tax-Exempt Rate.

1. Value of Old Loss Corporation. The Value of the Old Loss Corporation is generally the fair market value of the stock of the corporation, including nonvoting limited preferred stock described in section 1504(a)(4), immediately before the Ownership Change. New section 382(e)(1) and section 382(k)(5). For other purposes of New section 382, the term “stock” does not include nonvoting limited preferred described in section 1504(a)(4). New section 382(k)(6)(A). However, the Secretary is authorized to prescribe regulations that treat (1) warrants, options, contracts to acquire stock, convertible debt interests, and other similar interests as stock, and (2) stock as not stock. New section 382(k)(6)(B).

The Value of the Old Loss Corporation is generally the fair market value of the stock of the corporation.

If a redemption occurs in connection with an Ownership Change, the Value is determined after taking the redemption into account. New section 382(e)(2). Thus, the Value on which the limitation is based will be lower.

2. Long-Term Tax-Exempt Rate. The Long-Term Tax-Exempt Rate is determined under New section 382(t). It is determined under principles similar to those in section 1274(d), (which governs, inter alia, the determination of the Federal long-term rate for the original issue discount provisions) except that it is determined by reference to long-term rates on tax-exempt obligations. The rate is the highest such rate in effect for any month in the three calendar-month period ending with the calendar month in which the Change Date occurs.

3. Illustration. If there has been an Ownership Change with respect to an Old Loss Corporation that has (1) a Pre-Change Loss of $10 million dollars, and (2) a Value (i.e., fair market value of the stock immediately before the Ownership Change) of $25 million, and the Long-Term Tax-Exempt Rate is 10 percent, then the Section 382 Limitation for any Post-Change Year is $2.5 million (i.e., $25 million Value multiplied by the Long-Term Tax-Exempt Rate). Thus, under the general limitations rule of New section 382(a), the amount of the taxable income of
the New Loss Corporation for any Post-Change Year that can be offset by Pre-Change Losses (i.e., $10 million) cannot exceed $2.5 million.

4. Carryforward of Unused Limitation. If the Section 382 Limitation for any Post-Change Year exceeds the taxable income of the New Loss Corporation for such year that is offset by Pre-Change Losses, then such excess is added to the amount of the Section 382 Limitation for the next year. New section 382(b)(2).

5. Special Rule. In the case of a Post-Change Year (i.e., taxable year ending after the Change Date), the general limitation does not apply to the portion of the taxable income for such year that is allocable to the period on or before the Change Date. New section 382(b)(3)(A). Thus, if the Loss Corporation has taxable income for the year in which the Change Date occurs, the taxable income arising prior to the Change Date will not be subject to the general limitation.

Except in the case of built-in gains and losses, and as provided in regulations, taxable income for the year of change is allocated ratably to each day in the year. New section 382(b)(3)(A). The Conference Report says that the regulations may provide the Loss Corporation with the option of determining Pre- and Post-Change income by closing its books. Conference Report at 11-186.

The limitation for the period of the year after the Change Date is determined by multiplying the Section 382 Limitation by the following fraction: (1) the number of days in such year after the Change Date, over (2) the total number of days in the year. New section 382(b)(3)(B). Thus, if the Section 382 Limitation is $2.5 million and the number of days after the Change Date is 182, then the Section 382 Limitation for each year would be approximately $1.25 million.

D. Continuity of Business Requirement

Except in situations involving recognized built-in gain, gain recognized by reason of a section 338 election, and certain carryforwards of unused limitations, if a New Loss Corporation fails to continue the business enterprise of the Old Loss Corporation at any time during the two year period beginning on the Change Date, the Section 382 Limitation for any Post-Change Year is zero. New section 382(c).

E. Certain Capital Contributions Not Taken Into Account

Capital contributions to the Old Loss Corporation that are part of a plan "the principal purpose of which is to avoid or increase any limitation' under New section 382 are not taken into account.

F. Reduction in Value for Substantial Nonbusiness Assets

If immediately after an Ownership Change, the New Loss Corporation has Substantial Nonbusiness Assets, then the Value of the Old Loss Corporation is reduced by the excess (if any) of (1) the fair market value of the Nonbusiness Assets of the Old Loss Corporation, over (2) the Nonbusiness Asset Share of Indebtedness for which the corporation is liable. New section 382(l)(4)(A).

1. Substantial Nonbusiness Assets. An Old Loss Corporation has Substantial Nonbusiness Assets if at least one-third of the fair market value of the corporation's total assets consist of Nonbusiness Assets, which are assets held for investment. New sections 382(l)(4)(B)(i) and (C). There are exceptions to this rule for regulated investment companies, real estate investment trusts, and real estate mortgage pools. New section 382(l)(4)(B)(ii).

2. Nonbusiness Asset Share of Indebtedness. The Nonbusiness Asset Share of the indebtedness of the Old Loss Corporation is an amount that bears the same ratio to the indebtedness as (1) the fair market value of the Nonbusiness Assets bears to (2) the fair market of the Total Assets. New section 382(l)(4)(D).

3. Illustration. Assume that a New Loss Corporation has total assets with a fair market value of $9 million, $3 million of which are Nonbusiness Assets. Therefore, the corporation has Substantial Nonbusiness Assets. Also, the corporation has $1 million of indebtedness. Therefore, the Nonbusiness Asset Share of that indebtedness is $333,333 (i.e., the amount that bears the same ratio to the indebtedness as (1) the fair market value of the Nonbusiness Assets ($3 million) bears to (2) the total value of the assets ($9 million)). Consequently, under the value reduction rule of New section 382(l)(4)(A), the Value of the New Loss Corporation is reduced by $2.6 million (i.e., the excess of (1) the fair market value of the Nonbusiness Assets ($3 million) over the Nonbusiness Asset Share of Indebtedness ($333,333).

Capital contributions to the Old Loss Corporation that are part of a plan 'the principal purpose of which is to avoid or increase any limitation' under New section 382 are not taken into account.

For purposes of this rule, a parent corporation is deemed to own a ratable share of its subsidiary's assets. New section 382(l)(4)(E). A subsidiary for this purpose is a corporation that is owned 50 percent or more in both vote and value. Id.

G. Miscellaneous Provisions

Operating rules are provided for (1) coordinating New section 382 with section 172(b) (New section 382(l)(2)(A)), and (2) ordering the losses carried from the same taxable year (New section 382(l)(2)(B)). Operating rules are also provided relating to (1) constructive ownership of stock (New section 382(l)(3)(A)); (2) treatment of stock acquired by reason of death, gift, divorce, etc. (New section 382(l)(3)(B)); (3) stock acquired by ESOPs (New section 382(l)(3)(C)); and (4) changes in percentage of ownership attributable to fluctuations in Value (New section 382(l)(3)(D)).

Also, special rules are provided for built-in gains and losses and section 338 gains. New section 382(h). Finally, special rules are provided for (1) Title II or similar cases (New section 382(l)(5)), (2) certain insolvency transactions (New section 382(l)(6)), and (3) coordination with the alternative minimum tax (New section 382(l)(7)).

H. Regulatory Authority

Under New section 382(m), the Secretary is given broad regulatory authority to deal with a variety of issues under New section 382. This regulatory authority includes regulations "providing for such adjustments to the appli-
cation of this section and section 383 as is necessary to prevent avoidance of the purposes of this section and section 383, including the avoidance of such purposes through the use of related persons, passthrough entities, or other intermediaries..." New section 382(m)(3).

The Conference Report makes it clear that the above regulatory authority extends to the use of NOL partnerships, where the income of an acquired business is allocated to a partner that has net operating losses:

In the case of partnerships, for example, the conferees expect the regulations to limit the tax benefits that may be derived from transactions in which allocations of partnership income are made to a loss partner or to a corporation that is a member of a consolidated group with NOL carryovers (a "loss corporation partner") under an arrangement that contemplates the diversion of any more than an insignificant portion of the economic benefit corresponding to such allocation (or any portion of the economic benefit of the loss corporation partners' NOL) to a higher tax bracket partner. Conf. Rep., at II-194.

I. Applicability of Prior Law

The Conference Report says that section 269, which deals with acquisitions made for the principal purpose of tax avoidance, and the CRCO and SRLY rules in the consolidated return regulations will continue to apply. However, the Libson Shops doctrine will not apply. Conf. Rep., at II-194.

J. Effective Dates

The amendments to sections 382 and 383 generally apply to an Owner Shift Involving a Five-Percent Shareholder occurring after December 31, 1986 and to an Equity Shift occurring pursuant to a plan of reorganization adopted after December 31, 1986. Act section 621(f)(1). The changes made by the Tax Reform Act of 1976 are generally repealed as of January 1, 1986. Act sections 621(e) and (f)(2). Consequently, the 1954 version of section 382 applies through December 31, 1986.

V. Technical Correction for Targets

A. General Rules

Act section 1804(g) amends section 361, which deals with the tax treatment to the target in a reorganization transaction. The amendments make it clear that old sections 336 and 337 do not apply with respect to any liquidation of the target pursuant to a plan of reorganization. New section 361(b)(1). Thus a target corporation that is engaged in a reorganization cannot take advantage of the liquidations provisions. This amendment overrides General Housewares Corp. v. United States, 1978-2 USTC 9693 (N.D. Ala. 1978), and adopts the view taken in FEC Liquidating Corp. v. United States, 548 F.2d 924 (Ct. Cl. 1977).

However, the amendment makes it clear that the target recognizes no gain or loss on the disposition (pursuant to the plan of reorganization) of stock or securities of another party to the reorganization that are received pursuant to the plan. New section 361(b)(3). The transfer of stock or securities to the creditors of the target is generally permissible. Id.

The amendment makes it clear that the target recognizes no gain or loss on the disposition...of stock or securities of another party to the reorganization that are received pursuant to the plan.

B. Effective Date

This amendment applies to plans of reorganizations adopted after the date of enactment. Act section 1804(g).

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