CHAPTER 13 – COMBINING TAX ATTRIBUTES: NET OPERATING LOSSES AND AFFILIATED CORPORATIONS

Problems, pages 472-474

13-1a. Section 382 does not limit L from diversifying into a profitable business and using the NOLs in the future to offset the profits resulting from the purchase of the P assets. Note that because L makes a cost-basis purchase of the P assets, §384 does not limit L's use of its losses after the purchase.

13-lb. L's taxable sale of its assets does not carry with it L's tax history since §381 does not apply. Accordingly, the result is the same as in problem 13-1a except that L Corp. will recognize gain or loss on the asset sale.

13-1c. On audit, the Commissioner might rely on §269 to deny the loss corporation the right to use L Corp.'s NOLs against profits generated by P's assets. See *Briarcliff Candy Corp.* , page 471. Section 269(b) targets this transaction, a qualified stock purchase for which no §338 election is made but which is followed by a prompt liquidation. That provision allows the Service to disallow a deduction if the principal purpose of the liquidation was to evade or avoid Federal income tax by securing the benefit of the deduction. *See also* §384.

13-2. This problem is based on example 4 found at page II-175 of the Conference Report accompanying the Tax Reform Act of 1986. Under §382(a), losses of a "new loss corporation" can be offset by pre-change losses only as limited in §382(b). Before even looking at the §382(b) limitation, the definition of a "new loss corporation" becomes important since that definition triggers §382. Under §382(k)(3), a "new loss corporation" is defined as a corporation which after an "ownership change" is a loss corporation. There is an "ownership change" under §382(g) if immediately after any "owner shift" involving a 5-percent shareholder or any "equity structure shift," 1 or more 5-percent shareholders have increased their stock interest by more than 50 percentage points.

An "owner shift" is defined in §382(g)(2) to be essentially any stock sale affecting the ownership of any 5-percent shareholder. Under §382(g)(4)(A), all less-than-5-percent shareholders are lumped together as a single 5-percent shareholder for purposes of applying these tests.

13-2a. In this problem, the new less-than-5-percent public shareholders are considered to be one 5-percent shareholder. Because that "shareholder" acquires 60 percent of the L stock, L has undergone an owner shift under §382(g)(2). That owner shift has increased the ownership of that new public group of less-than-5-percent shareholders from 0 percent in the old loss corporation (§382(k)(2)) to 60 percent in the new loss corporation, which constitutes an "ownership change" under §382(g)(1). As a result of the ownership change, §382(b) would limit the income of L Corp., which the losses of L Corp. could offset.

13-2b. At first blush, it may appear that there is no ownership change, because less-than-5 percent shareholders own 100 percent of L both before and after the offering. Although there is no ownership change, the analysis is more involved.

Generally, if a loss corporation issues its stock in a public offering, the group of non-5 percent shareholders that acquires stock in that offering is segregated from any public groups that owned loss corporation stock before the stock issuance. §1.382-2T(j)(2)(iii)(B). Thus, the public offering will result in a new public group treated as a 5-percent shareholder.

However, members of existing public groups may purchase stock in the public offering and their purchases should not be included in the stock held by the new public group. Often, it may be extraordinarily difficult to determine when a member of an existing public group actually purchases stock in a public offering, but the regulations offer a convenient solution. Under the "cash issuance" exception, if a loss corporation issues its stock to the public for cash, any existing public group is deemed to acquire a percentage of the newly issued stock equal to ***one-half*** of the percentage it owned immediately before the issuance. §1.382-3(j)(3)(i). *See also id.* at (j)(4) (limiting the amount deemed owned by the existing public groups to the amount of issued stock less the issued stock owned by any 5-percent shareholder (other than a direct public group)); *id* at (j)(5)(ii) (allowing the loss corporation to increase the amount of stock owned by the existing public groups based on actual knowledge).

Therefore, assuming that L Corp. issued its stock in the public offering for cash, its existing public group, which owned 100% of the L stock before the public offering, is deemed to purchase 50% (one-half of 100%) of the L stock issued in the public offering. Thus, although a 60% block of L stock was issued in the public offering, only half of that block is deemed purchased by a new public group, and the existing public group is deemed to purchase the remaining stock. Thus, the new public group is deemed to own only 30% of the L stock, while the existing public group is deemed to own 70% of that stock (40% historically held plus 30% deemed purchased in the public offering). Because the new public group increased its ownership percentage by only 30 percentage points (from 0% to 30%), the public offering did not result in an ownership change.

13-2c. On the merger of L into P, no ownership change has occurred since the former P shareholders (treated as a single taxpayer) own only 40% of the new loss corporation. However, when C acquires a 50-percent interest in the new loss corporation, there has been a more than 50-percentage point change in ownership during a three-year period ending on C's purchase. During that period, the former P shareholders and C have increased their ownership interest in the new loss corporation by 70 percentage points. Thus, C's acquisition causes an ownership change.

13-3a. This problem is based on example 22 found at page II-186 of the Conference Report accompanying the Tax Reform Act of 1986. The first step is to determine if an ownership change under §382(g) has occurred. The consolidation constitutes an "equity structure shift" under §382(g)(3) since it is an A reorganization. This equity structure shift is an ownership change for both X Corp. and Y Corp. since the percentage of stock owned by

C in the new loss corporation W Corp. (60 percent) is more than 50 percentage points greater than the percentage of stock (0 percent) in the old loss corporations X Corp. and Y Corp. There is no ownership change for Z Corp. since A's ownership increased by 10 percentage points, and B's increased by 30 percentage points.

Since there is an ownership change with respect to X Corp. and Y Corp., the ability of W Corp. to use the pre-change NOLs is limited under §382(b). There is a separate §382(b) limitation for each corporation. For X Corp., under §382(b) the limitation equals $3,000 times 10 percent or $300. For Y Corp., the limitation equals $9,000 times 10 percent or $900. For each post-change year, those limitations mark the amount of X Corp. and Y Corp.'s NOLs that can be used to offset W Corp. income. Any unused NOLs get carried forward under §382(b)(2).

The amount of taxable income of W Corp. that may be offset by X Corp. and Y Corp.'s pre-change losses is $400 - the $300 §382 limitation for X Corp.'s NOLs and all $100 of Y Corp.'s NOLs -since that amount is less than the §382 limitation. The unused portion of Y Corp.'s limitation may not be used to augment X Corp.'s §382 limitation amount.

13-3b. In drafting §382, Congress created special rules for built-in gains and losses. In the problem, if X Corp. has a $600 built-in gain at the time of the consolidation that is subsequently recognized, W Corp. can use X Corp.'s NOLs to offset that gain. §382(h)(1) (allowing recognized built-in gain to increase the §382 limitation). Accordingly, $900 of X Corp.'s NOLs can be used to offset W Corp.'s $1,400 of income. Notice that the ability of X Corp. to offset the recognized built-in gain depends on the presence of net unrealized built-in gain at the time of the consolidation in excess of 15 percent of the fair market value of X Corp.'s assets (or, if smaller, $10 million). §382(h)(3)(B). Otherwise, §382(h)(3)(B) would deem X Corp. to have no net unrealized built-in gain, and therefore no increase would be allowed in the §382 limitation amount. Note also that in order to increase the §382 limitation amount, the gain must be recognized during the 5-year recognition period. See §382(h)(7).

13-3c. This problem is the converse of problem 13-3b. If X Corp. has a net unrealized built-in loss at the time of the consolidation, any recognized built-in loss during the 5-year recognition period will be treated as a pre-change loss, subject to the §382 limitation. §382(h)(1)(B).

In this problem, the loss could be used to offset W Corp.'s income only to the extent of $300 - X Corp.'s §382 limitation. Use of that loss would exhaust the §382 limitation so that the remaining $300 of the loss plus the $10,000 NOL carryforward of X Corp. would be carried forward to the next year. §§382(h)(4) and (b)(2).

If X Corp. did not have a net unrealized built-in loss equal to at least 15 percent of the fair market value of the X Corp. assets (or, if smaller, $10 million), then the limitation rule would not apply to the recognized loss. As a result, Y Corp. could use the loss to offset income without limitation under §382 and could also use $300 of X Corp.'s NOL.

13-4a. Section 382 does not apply here as the ownership of L does not change. However, §384 does apply so that any gain realized by P within 5 years cannot be used in any L-P consolidated return to offset L's pre-acquisition losses.

13-4b. If L elects §338 with respect to P, §384 would not apply. However, P must recognize any gain or loss on the deemed asset sale under §338 and that gain or loss cannot be included in any consolidated return filed by L and P.

13-4c. Section 382 applies, and if P and L file consolidated returns, §384 applies. Presumably, §382 is applied first with §384 picking up any excess.

13-4d. Section 382 does not apply to limit the use of L's losses as C does not increase C's percentage ownership in L by more than 50 percentage points. C goes from a 0 percent shareholder to a 40 percent shareholder. However, §384 does apply if P and L file a consolidated return.

13-4e. If B ends up with less than 40 percent of the stock of P, then both §§382 and 384 apply.

13-4f. Sections 382(m)(3) and 384(f)(1) are anti-abuse provisions that would probably prevent this attempted end run around both §382 and §384.