[JOINT COMMITTEE PRINT]

SPECIAL LIMITATIONS ON THE USE OF NET OPERATING LOSS CARRYOVERS AND OTHER TAX ATTRIBUTES OF CORPORATIONS

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS

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PREPARED BY THE STAFF

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INTRODUCTION

The Subcommittee on Select Revenue Measures of the Committee on Ways and Means has scheduled a public hearing on May 22, 1985, regarding special limitations on the use of a corporation's net operating loss ("NOL") carryovers and other tax attributes following a change in ownership or control. This pamphlet,[1] prepared in connection with the hearing, provides descriptions of present law, several proposals for change, and related issues.

The first part of the pamphlet contains a summary. The second part is a detailed description of the background of the special limitations on the use of carryovers and related rules, including present law. Part three is a discussion of proposals for change. Part four contains a discussion of economic issues relating to NOL and other carryovers, and part five is an analysis of present law and the principal proposals for change.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Special Limitations on the Use of Net Operating Loss Carryovers and Other Tax Attributes of Corporations* (JCS-16-85), May 21, 1985.

I. SUMMARY

Background

In general, a corporate taxpayer is permitted to carry a net operating loss ("NOL") forward for use against future income. The tax attributes (including NOLs) of one corporation can also be carried over to another corporation as the result of certain tax-free acquisitions. Historically, the carryover of tax attributes has been subject to special limitations.

Under present law, the application of special limitations turns in part on specified changes in ownership in a corporation that incurred the NOLs (referred to as the "loss corporation"). The Tax Reform Act of 1976 amended the present-law special limitations to coordinate the rules for taxable and tax-free transactions and correct technical defects; however, the effective dates of these amendments have been delayed several times (currently scheduled to go into effect for taxable years beginning after 1985). Thus, the law in effect prior to the 1976 Act amendments continues to govern.

Principal proposals

The principal proposals for change are the merger rule (the paradigm for which is a partnership between a profitable corporation and a loss corporation) and the purchase rule (which seeks to limit the use of NOL carryovers by reference to a deemed rate of return that the loss corporation's assets would have generated absent a change in ownership).

II. BACKGROUND

A. Overview

In general, a corporate taxpayer is permitted to carry NOLs and other tax attributes forward for use against future income. Statutory rules provide for the carryover of tax attributes (including NOLs) from one corporation to another in certain tax-free acquisitions; however, the carryover of tax attributes is subject to several limitations.

A statutory provision authorizes the disallowance of tax attributes in certain acquisitions where the principal purpose of the transaction is tax avoidance. In addition, Treasury regulations that govern the filing of consolidated tax returns restrict the use of tax attributes following the acquisition of a new member by an affiliated group of corporations or a substantial change in the ownership of the group itself.

Special limitations provided by statute apply to terminate or reduce NOL carryovers following, respectively, certain taxable acquisitions and tax-free reorganizations. Under the rule for taxable acquisitions (or "purchases"), the special limitations come into play if there is a 50-percent change in ownership *and* the loss corporation fails to continue an historical trade or business. For tax-free reorganizations, the special limitations apply only if the loss corporation's shareholders end up owning less than 20 percent of the successor corporation. The special limitations on the use of NOL carryovers also apply to certain other tax attributes.

The Tax Reform Act of 1976 (P.L. 94-455) amended the statutory provisions for special limitations, in order to coordinate the rules for purchases and reorganizations and to correct technical defects. The effective dates of the 1976 Act amendments have been delayed several times, and are now generally scheduled to go into effect for taxable years beginning after 1985.

B. General Rules Applicable to NOL Carryovers

1. Net operating loss deduction

Although the Federal income tax system generally requires an annual accounting, taxpayers are permitted to carry NOLs forward for use against future income (sec. 172). The rationale for the allowance of a NOL deduction is that a taxpayer should be able to average income and losses from a trade or business over a period of years, in order to reduce the disparity in the tax treatment of businesses that experience fluctuations in income as compared with businesses that have stable incomes. This rationale is particularly persuasive in view of the existence of tax provisions that deliberately mismatch income and related expenses in order to provide investment incentives (e.g., the accelerated cost recovery system and the intangible drilling costs provisions).

A NOL may be carried back 3, and carried forward 15, taxable years. In the case of carrybacks, the taxpayer is entitled to a refund equal to the reduction in tax liability in the 3 prior years which results from taking the NOL into account in those years. If the NOL exceeds the sum of the taxable income in each of the preceding three years, the taxpayer may deduct the unused NOL from taxable income in the 15 succeeding years. (Similar rules apply to certain unutilized tax credits related to business activity, such as the investment credit.)

2. Carryovers to successor corporation

In general, the tax attributes of a corporation are preserved so long as the corporation's legal identity is continued. Thus, the acquisition of all or part of a corporation's stock does not generally affect the corporation's tax history (e.g., NOLs). Statutory rules provide for the carryover of tax attributes from one corporation to another in certain tax-free transactions (sec. 381). These rules are applicable if the assets of a loss corporation are acquired by another corporation in one of the following transactions:

(1) the liquidation of an 80-percent owned subsidiary (sec. 332);

(2) a statutory merger or consolidation (sec. 368(a)(1)(A));

(3) the acquisition of substantially all of the assets of one corporation for voting stock of another corporation, followed by the complete liquidation of the transferor (sec. 368(a)(1)(C));

(4) the transfer of substantially all of a corporation's assets to a controlled corporation, followed by the complete liquidation of the transferor (secs. 368(a)(1)(D) and 354(b)(1));

(5) a mere change in identity, form, or place of organization of a corporation (sec. 368(a)(1)(F)); and

(6) a tax-free bankruptcy reorganization (secs. 368(a)(1)(G) and 354(b)(1)).

In addition to NOL carryovers, other tax attributes that carry over from one corporation to another include: unused business credits that can be carried forward under sections 30 and 39; unused foreign tax credits that can be carried forward under section 904(c); and net capital losses that can otherwise be carried forward under section 1212.

3. Acquisitions to evade or avoid income tax

The Secretary of the Treasury is authorized to disallow deductions, credits, or other allowances following an acquisition of control of a corporation or a tax-free acquisition of a corporation's assets if the principal purpose of the acquisition was tax avoidance (sec. 269). This provision applies in the following cases:

(1) where any person or persons acquire (by purchase or in a tax-free transaction) at least 50 percent of a corporation's voting stock, or stock representing 50 percent of the value of the corporation's outstanding stock;

(2) where a corporation acquires property from a previously unrelated corporation and the acquiring corporation's basis for the property is determined by reference to the transferor's basis; and

(3) where a corporation purchases the stock of another corporation in a transaction that qualifies for elective treatment as a direct asset purchase (sec. 338), a section 338 election is not made, and the acquired corporation is liquidated into the acquiring corporation (under section 332).

Treasury regulations under section 269 provide that the acquisition of assets with an aggregate basis that is materially greater than their value, coupled with the utilization of the basis to create tax-reducing losses, is indicative of a tax-avoidance motive (Treas. reg. sec. 1.269-3(c)(1)).

4. Consolidated return regulations

In general, if an acquired corporation joins the acquiring corporation in the filing of a consolidated tax return by an affiliated group of corporations, the use of the acquired corporation's pre-acquisition NOLs against income generated by other members of the group are limited by the "separate return limitation year" (SRLY) rules (Treas. reg. sec. 1.1502-21(c)). Because an acquired corporation is permitted to use pre-acquisition NOLs to offset "its own" income, the SRLY rules could be avoided by diverting income-producing activities (or contributing income-producing assets) from elsewhere in the group to the newly acquired corporation. *But see* Treas. reg. sec. 1.269-3(c)(2) (to the effect that the transfer of income-producing assets by a parent corporation to a loss subsidiary filing a separate return may be deemed to have tax avoidance as a principal purpose).

Applicable Treasury regulations provide rules designed to prevent taxpayers from circumventing the SRLY rules by structuring a transaction as a "reverse acquisition" (defined in regulations as an acquisition where the "acquired" corporation's shareholders end up owning more than 50 percent of the value of the "acquiring" corporation) (Treas. reg. sec. 1.1502-75(d)(3)). Similarly, under the "consolidated return change of ownership" (CRCO) rules, if more than 50 percent of the value of stock in the common parent of an affiliated group changes hands, tax attributes (such as NOLs) of the group are limited to use against post-acquisition income of the members of the group (Treas. reg. sec. 1.1502-21(d)).

Treasury regulations also prohibit the use of an acquired corporation's built-in losses to reduce the taxable income of other members of an affiliated group (Treas. reg. sec. 1.1502-15). Under the regulations, built-in losses are subject to the SRLY rules. In general, built-in losses are defined as deductions or losses that economically accrued prior to the acquisition but are recognized for tax purposes after the acquisition, including depreciation deductions attributable to a built-in loss (Treas. reg. sec. 1.1502-15(a)(2)). For example, if the acquired corporation owns a building with a basis of \$100 and a value of \$50 as of the acquisition date, the \$50 potential loss may be treated as a built-in deduction. The built-in loss limitations do not apply unless, among other things, the aggregate basis of the acquired corporation's assets (other than cash, marketable securities, and goodwill) exceeds the value of those assets by more than 15 percent. Further, assuming that section 269 is inapplicable, the application of the SRLY rules to built-in losses can be avoided by causing the acquired corporation to generate additional taxable income (as described above).

5. Allocation of income and deductions among related taxpayers

The Secretary of the Treasury is authorized to apportion or allocate gross income, deductions, credits, or allowances, between or among related taxpayers (including corporations), if such action is necessary to prevent evasion of tax or clearly reflect the income of a taxpayer (sec. 482). Section 482 can apply to prevent the diversion of income to a loss corporation in order to absorb NOL carryovers.

6. *Libson Shops* doctrine

In *Libson Shops* v. *Koehler*, 353 U.S. 382 (1957) (decided under the 1939 Code), the U.S. Supreme Court adopted a test of business continuity for use in determining the availability of NOL carryovers. The court denied NOL carryovers following the merger of 16 identically owned corporations (engaged in the same business at different locations) into one corporation, on the grounds that the business generating post-merger income was not substantially the same business that incurred the loss (three corporations that generated the NOL carryovers continued to produce losses after the merger).

There is uncertainty regarding whether the *Libson Shops* doctrine has continuing application as a separate nonstatutory test under the 1954 Code. *Compare Maxwell Hardware Co.* v. *Commissioner*, 343 F.2d 713 (9th Cir. 1965) (holding that *Libson Shops* is inapplicable to years governed by the 1954 Code) with Rev. Rul. 63-40, 1963-1 C.B. 46, as modified by T.I.R. 773 (October 13, 1965), (indicating that *Libson Shops* may have continuing vitality where, *inter alia*, there is a shift in the "benefits" of a NOL carryover).[2]

C. Present Law Special Limitations

The purpose of the present law special limitations has been thought to encompass the prevention of (1) trafficking in loss corporations, (2) windfalls to an acquiring corporation that did not suffer the loss, (3) the offsetting of losses incurred in one business against profits of an unrelated business, and (4) the distortion of economic decisions regarding transactions involving loss corporations.

Under section 382, the application of the special limitations on NOL carryovers is triggered by specified changes in stock ownership of the loss corporation. In measuring changes in stock ownership, section 382(c) specifically excludes "nonvoting stock which is limited and preferred as to dividends." Different rules are provided for the application of special limitations on the use of carryovers after a purchase and after a tax-free reorganization. Section 382 does not address the treatment of built-in losses.

If the principal purpose of the acquisition of a loss corporation is tax avoidance, section 269 could apply to disallow NOL carryovers even if section 382 is inapplicable. Similarly, the SRLY rules could

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[2] The legislative history of the 1976 Act amendments to the statutory special limitations—discussed in part II.C.5., below—specifically provides that *Libson Shops* has no application to years governed by these amendments. *See* S. Rep. No. 938, 94th Cong., 2d Sess. p. 206 (1976).

apply even though a transaction that passes muster under section 382.

1. Taxable purchases

If the special limitations apply after a purchase, NOL carryovers are disallowed entirely. The rule for purchases applies if (1) one or more of the loss corporation's ten largest shareholders increase their common stock ownership within a two-year period by more than 50 percentage points, and (2) the loss corporation fails to continue the conduct of a trade or business substantially the same as that conducted before the proscribed change in ownership (sec. 382(a)). An exception to the purchase rule is provided for acquisitions from related persons.

2. Tax-free reorganizations

After a tax-free reorganization to which section 382(b) applies, NOL carryovers are allowed in full so long as the loss corporation's shareholders receive stock representing 20 percent or more of the value of the successor corporation (and section 269 does not apply). For each percentage point less than 20 percent received by the loss corporation's shareholders, the NOL carryover is reduced by five percent (e.g., if the loss corporation's shareholders receive 15 percent of the acquiring corporation's stock, 25 percent of the NOL carryover is disallowed). Where an acquiring corporation uses stock of a parent corporation as consideration (in a triangular reorganization), the 20-percent test is applied by treating the loss corporation's shareholders as if they received stock of the acquiring corporation with an equivalent value, rather than stock of the parent corporation. An exception to the reorganization rule is provided for mergers of corporations that are owned substantially by the same persons in the same proportion. (Thus, the result in the *Libson Shops* case is reversed.)

3. Special limitations on other tax attributes

Section 383 incorporates by reference the same limitations contained in section 382 for carryovers of investment credits, work incentive credits, foreign tax credits, and capital losses.

4. Technical problems in present law

Present law is subject to criticism because of discontinuities in the treatment of taxable purchases and tax-free reorganizations, as well as defects in the technical rules.

a. Discontinuities

Under the rule for purchases, a 100-percent change in ownership does not result in the disallowance of NOL carryovers if the loss corporation's business is continued (even if a new profitable business is added to absorb the NOLs), assuming section 269 is inapplicable. Under the rule for reorganizations, whether the loss corporation's business is continued is immaterial.

On the other hand, the rule for reorganizations is not triggered unless the loss-corporation shareholders' continuing interest drops below 20 percent, permitting ownership changes of up to 80 percent. In contrast, the purchase rule comes into play if more than 50 percent of the loss corporation's stock changes hands.

Further, if the purchase rule applies all NOL carryovers are disallowed, whereas the rule for reorganizations merely reduces NOL carryovers in proportion to the change in stock ownership.

b. Scope of the special limitations

Section 382 is inapplicable to the following transactions that effect changes in control: (1) tax-free transfers of appreciated property to a loss corporation where the transferor ends up with an 80-percent interest immediately after the transfer (sec. 351); (2) capital contributions; (3) the liquidation of a partner's interest in a partnership that owns stock in a loss corporations; and (4) type "B" reorganizations (stock-for-stock acquisitions described in section 368(a)(1)(B)).

c. Triangular reorganizations

The rule for reorganizations can be circumvented by use of a subsidiary to acquire a loss corporation's assets in exchange for stock of a parent corporation. This result obtains because the 20-percent test is applied by comparing the value of the parent corporation's stock received by the loss-corporation shareholders to the value of the acquiring subsidiary's stock.

d. Measurement of beneficial ownership

Taxpayers have circumvented the rules for determining whether a change in ownership has occurred by acquiring nonvoting preferred stock in a loss corporation. *See Maxwell Hardware Co.* v. *Commissioner*, 343 F.2d 713 (9th Cir. 1965) (where the loss corporation's old shareholders retained common stock representing 60 percent of the corporation's value but were entitled to share in only 10 percent of the corporation's earnings). Similarly, NOL carryovers can be preserved after a reorganization by issuing limited preferred stock (voting or nonvoting) to loss-corporation shareholders, so long as the value of the stock is at least 20 percent of the value of the acquiring corporation's outstanding stock.

e. Other technical issues

The requirement that a loss corporation continue a trade or business after a purchase raises difficult issues relating to the point at which a change in merchandise, location, size, or use of assets should be treated as a change in the business. Critics have also argued that it is uneconomic to compel new owners to continue what may be a failing business.

Finally, the present law rules only limit the use of NOLs that are incurred in prior taxable years (excluding the taxable year in which there is a proscribed change in ownership).

5. 1976 Act amendments

The Tax Reform Act of 1976 extensively revised section 382 to provide more nearly parallel rules for taxable purchases and tax-free reorganizations and to address the technical problems cited under present law. The 1976 Act amendments were to be effective in 1978; however, in response to criticism (primarily because of the complexity of the rules), the effective dates have been delayed several times. The 1976 Act amendments to the rule for purchases are currently scheduled to become effective for years beginning after December 31, 1985; the amended reorganization rules are to apply to reorganizations pursuant to plans adopted on or after January 1, 1986. Present law continues to govern until the 1976 Act amendments take effect.

a. Coordination of purchase rule and reorganization rule

The 1976 Act eliminates the test of business continuity under the purchase rule; thus the revised provision focuses solely on changes in stock ownership. For purposes of both rules, loss-corporation shareholders must retain a 40-percent continuing interest in order for NOL carryovers to be allowed in full. Further, as described more fully below (in part II.C.5.d.), the proportional reduction approach is used under both rules where the limitations apply.

The 1976 Act also introduced the concept of "participating stock" (i.e., stock that represents an interest in a corporation's growth potential), in order to prevent acquiring corporations from using specially tailored preferred stock to circumvent the rules for determining whether a change in ownership has occurred. Under the amendments, changes in ownership percentages are measured by reference to the lesser of the value of participating stock or the value of all stock in the loss corporation (or the acquiring corporation, as the case may be).

The 1976 Act amendments apply the special limitations to NOLs incurred in the year of a proscribed ownership change, as well as prior years.

b. Expansion of scope

The 1976 Act expands the scope of the purchase rule to include (1) acquisitions by contribution or merger of an interest in a partnership that owns stock in a loss corporation, or an acquisition of such stock by a partnership by means of a contribution or merger, (2) section 351 exchanges, and (3) capital contributions. Further, the reorganization rule is extended to type B reorganizations.

c. Treatment of triangular reorganizations

Under the 1976 Act, continuity of interest after a triangular reorganization is measured by the loss-corporation shareholders' percentage interest in the parent of the acquiring corporation.

d. Other amendments

In addition to amendments that addressed specific issues raised by present law, discussed above, the 1976 Act applies a proportional reduction approach under both the purchase rule and the reorganization rule. For each percentage point (or fraction thereof) less than 40 percent but not less than 20 percent, the NOL carryover is reduced by 3-1/2 percentage points. For each percentage point less than 20 percent, the NOL carryover is reduced by 1-1/2 percentage points. Thus, a 100-percent change in ownership results in complete disallowance.

The shareholders taken into account in measuring changes in ownership under the rule for purchases are those who hold the 15 largest percentages of the total value of the loss corporation's stock on the last day of its taxable year. The relevant points for determining the extent of ownership changes as of the end of a taxable year are the beginning of the year under examination and the beginning of the first and second preceding taxable years. Thus, the test period was extended from two to three years.

In order to discourage the owners of a profitable corporation from artificially satisfying the continuity rules by buying stock in a loss corporation and then merging with it within a short period of time, a 3-year rule disqualifies certain owners of a loss corporation from being included in the continuity test. This rule applies to stock acquired in the loss corporation within 36 months before the reorganization by the other party to the reorganization, or by one or more shareholders who own more than 50 percent of the fair market value of the stock of such party, or by a controlled subsidiary of such other party. Any such stock must be disregarded in measuring continuity.

A separate rule covers a situation where a holding corporation (or an operating corporation) that controls a loss corporation merges or otherwise reorganizes with a profitable corporation (regardless of which corporation acquires the other). The 1976 Act requires, in effect, that the stock received (or retained) by the holding corporation's shareholders will determine how much of the loss corporation's carryovers survive the reorganization.

e. Other tax attributes

The 1976 Act also amended section 383 to incorporate the same amendments as those made to section 382.

III. PROPOSALS FOR CHANGE

A. Overview

Present law has been criticized for the lack of a coherent rationale for imposing limitations on the use of tax attributes after a substantial change in ownership. The American Law Institute ("ALI") has proposed special limitations that are designed to reduce the significance of NOL carryovers in making investment decisions and to promote tax neutrality by preventing new owners of a loss corporation from using a NOL carryover more rapidly than it would be used had there been no change in ownership.[3] Other commentators have taken the position that tax neutrality also encompasses the notion that the value of a NOL carryover in the hands of old owners should be preserved in the hands of new owners.

The approach of present law (*viz.*, the disallowance or reduction of NOL carryovers) has been criticized as being too harsh where there are continuing loss-corporation shareholders. On the other hand, critics recognize that the approach of present law is too liberal to the extent that a portion of a NOL carryover that survives a reduction provides an incentive to traffic in loss corporations. For these reasons, the ALI proposed a "merger rule" that would limit the earnings against which a NOL carryover could be used (rather than reducing the NOL carryover itself). Other commentators agree with the ALI approach but propose different mechanics for limiting earnings under variations of a "purchase rule." In general, credit carryovers would be converted to deduction equivalents and subjected to the same limitations that apply to NOL carryovers.

It is contemplated that section 269, as well as the limitations imposed by the consolidated return regulations would be retained in conjunction with the enactment of revised special limitations.

B. The ALI Merger Rule

The merger rule is based on a pool of capital concept: NOL carryovers should be unavailable, except to the extent of earnings that are attributable to the pool of capital that created the losses. The merger rule is intended to approximate the results that would occur if a loss corporation's assets were combined with those of a profitable corporation in a partnership. This treatment can be justified on the ground that the option of contributing assets to a partnership is available to a loss corporation. In such a case, only the loss corporation's share of the partnership's income could be offset by the NOL carryover.

In general, if a loss corporation's assets are combined with those of a profitable corporation in a nontaxable transaction, the portion

[3] American Law Institute, *Federal Income Tax Project, Subchapter C*, pp. 198-301 (1982).

of the post-acquisition income that could be offset by the loss corporation's NOL carryover would be limited to the income generated by assets that the loss corporation contributed to the combined enterprise. The ALI proposed that the earnings attributable to assets contributed by the loss corporation be determined generally by reference to the percentage of the acquiring corporation's stock issued to the loss corporation's shareholders. Where a loss corporation's assets are acquired for preferred stock, the use of NOL carryovers would be limited to the dividends payable on such stock.

Under a strict application of the pool of capital concept, no limitation on NOL carryovers would be imposed as the result of a sale of stock in a loss corporation, in the absence of capital contributions by the new shareholders. There is a concern, however, about the potential for new shareholders to provide a loss corporation with income-producing opportunities that are equivalent to capital contributions but difficult to detect. For this reason, with respect to purchased stock, the ALI proposed that post-acquisition income available for offset be limited to imputed earnings calculated under the purchase rule described below (in part III.B.1.).

1. Built-in gains and losses

Under the pool of capital concept, the realization of a built-in gain after an acquisition of a loss corporation should be offset by the loss corporation's NOL carryover. Conversely, built-in losses should be subject to special limitations just as NOL carryovers are. (Similarly, a partnership is required to allocate built-in gain or loss to the contributing partner.)

2. Allocation of post-acquisition earnings

Two methods for computing earnings that could be offset by NOL carryovers were proposed by the ALI, for use where the only consideration received by a loss corporation's shareholders is stock: (1) the actual allocation of after-tax income (in accordance with applicable corporate charters); and (2) the allocation of taxable income (before allowance of a NOL deduction) among shares in proportion to value. Neither method addresses the case in which split consideration is used. Further, the actual allocation method is susceptible to abuse. The allocation of taxable income on the basis of relative values, as proposed by the ALI, would be too generous if the value included the premium paid for the NOL carryover; reducing the value of a loss corporation to take account of the premium would involve arbitrary assumptions regarding the present value of the NOL carryover. A third option involves allocating taxable income by use of a statutory table.

a. Actual allocation

The actual allocation method follows the partnership analogy; only the earnings and profits actually allocable to the loss-corporation shareholders are offset by the NOL carryover.

Complexity.—The actual allocation rule cannot be reduced to a formula and would require taxpayers to engage in circular computations (because the amount of after-tax earnings would depend on the tax and the tax would depend on the extent to which NOLs are allowed); however, this problem may be no more than an inconvenience. Alternatively, a statutory table could be prescribed to obtain approximate results.

Special allocations.—Another more significant issue relates to the possibility that taxpayers would attempt to make special allocations of earnings during the carryover period (e.g., by tailoring preferred stock issued to loss corporation shareholders in a manner that will maximize deductions, analogous to "flip-flops" in partnership deals). Thus, the use of the actual allocation rule would require a grant of authority to disregard actual earnings allocations that are disproportionate to the long-term interest of stock held by loss-corporation shareholders.

Hybrid securities.—Another problem area relates to the treatment of hybrid securities. For example, where convertible preferred stock is issued to the loss corporation's shareholders and no dividends are paid on the common, a decision would be required as to whether the limitation should be based on the fixed dividend or on what the share of earnings would be if the stock were converted.

Dilutable common.—Where common stock is used as consideration, but there are convertible preferred stock (or warrants) outstanding that are convertible into twice the number of shares issued to the loss corporation shareholders, what should the limit be?

Effect of the source of post-acquisition income.—Where post-acquisition income includes income that is not subject to tax, the actual allocation method would permit fully taxable income to be offset to the maximum possible extent. This is so because the rule operates with respect to after-tax earnings from whatever source derived. The value proration method is more restrictive than the actual allocation method to the extent that post-acquisition earnings consists of tax-exempt income.

b. Value proration

The value proration rule would avoid the problems of the merger rule, but only if all shareholder interests are properly valued (taking long-term prospects into account).

Determining the value of "hard assets."—The principal objection to the value proration method is that it is too generous. For example, after a merger in which loss-corporation shareholders receive 10 percent of the common stock of the combined enterprise, if taxable income is $1 million, the actual allocation method would permit a deduction of only $58,621.50 but the value proration method would allow a deduction of $100,000.

Effect of the source of post-acquisition income.—If the value proration method were adopted, a loss could be absorbed more quickly following a merger into a corporation with a high effective tax rate than after a merger into a corporation with less taxable income, assuming the same allocation of after-tax earnings to the loss corporation shareholders in either case. For this reason, the ALI chose the actual allocation method because it was viewed as being less sensitive to differences in the income mix of an acquiring corporation.

3. Exceptions

The ALI proposed a number of exceptions to the strict application of the pool of capital concept.

a. Capital contributions by existing shareholders

Under an exception for new stock issued to existing shareholders, a 50 percent increase in proportionate ownership is permitted.

b. Stock for debt of a loss corporation

Although the conversion of debt into stock increases equity capital, the ALI proposal provides an exception where the debt was in existence when the NOL was incurred.

C. Proposals for a Purchase Rule

The ALI proposed a purchase rule as a backstop to the basic merger rule. Critics of the ALI proposal have expressed the concern that the existence of two sets of rules would increase the complexity involved in planning transactions and the potential for inconsistent treatment of similar transactions. For these reasons, various commentators have argued that a single (objective) limitation similar to the ALI purchase rule should apply to all acquisitive transactions (including mergers).

1. ALI purchase rule

The purchase rule proposed by the ALI provides for an annual limitation on the use of NOL carryovers equal to a deemed rate of return on the price paid for purchased stock. This limitation is designed to prevent new owners from infusing new capital into the loss corporation to obtain greater utilization of NOL carryover than the old owners could have. In view of the rationale for the purchase rule, the ALI concluded the limitation should not apply unless there is a substantial ownership change that raises the possibility of disguised capital contributions.

2. 1958 Subchapter C Advisory Group proposal to use 50-percent of purchase price

The proposal of the Subchapter C Advisory Group appointed by the Ways and Means Committee is contained in its report dated December 11, 1958. This proposal would have limited carryovers to 50 percent of the purchase price paid for a corporation with NOL carryovers. Under such a limitation, tax considerations by necessity would be a minor element of the transaction. This conclusion derives from the fact that, even at a 50-percent rate, somewhat more than 75 percent of the price would have to be paid for assets other than tax benefits. The proposal would have imposed no limitation on the timing of carryover deductions following a change in ownership, however, and an NOL carryover could therefore result in greater benefit to an acquiring corporation with enough income to absorb it immediately than it would have provided to the loss corporation in the absence of a change in ownership. This advantage would be particularly significant in the case of carryovers close to expiration, which the loss corporation might not be able to absorb.

3. The purchase price as a limitation

A suggestion has been made to provide a limitation on carryovers equal to the full purchase price paid for a loss corporation.[4] Under this proposal, the price would be reduced by the cash and investment assets held by the loss corporation and there would be a requirement to retain the loss company's business assets following the acquisition. These modifications deal with efforts to inflate the price, and thus the allowable carryovers, by contributions of cash or investment assets in anticipation of the transfer, and also reflect the conclusion that an ongoing business enterprise is an essential element of the corporate identity to which the carryovers are attributed. This proposal, like that of the 1958 Advisory Group, imposes no limitation on the timing of carryover benefits which would result, in some cases, in greater and more rapid utilization of carryovers than the loss corporation would have enjoyed in the absence of a change in ownership.[5]

4. ABA proposal

The ABA has recommended a limitation that would permit the use of NOL carryovers to the extent of built-in gains recognized within five years after the change in control, plus 24 percent of the purchase price in each of the five years following the year of the change. The rationale for this proposal is based on a "neutrality" concept that embraces the notion that the new owners of a loss corporation should be able to use a NOL carryover to the same extent as the old owners could have. The proposal assumes that the value of a loss corporation (as determined by the purchase price of its stock or assets) is a reasonable measure of future earnings. To prevent taxpayers from making pre-sale contributions of assets to inflate the purchase price, the price would be reduced by the value of assets contributed to the loss corporation during the two-year period preceding the transaction (with certain exceptions, e.g., contributions to finance current losses).

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[4] Bacon and Tomasulo, "Net Operating Loss and Credit Carryovers: The Search for Corporate Identity," *Tax Notes*, September 12, 1983, p. 835.

[5] This rule is justified on the basis that the purchase price, properly adjusted, equals the present value of a stream of after-tax income on the purchase price which is of infinite duration. For a corporation with sufficient loss carryovers to absorb its anticipated income indefinitely, however, its after-tax income and pre-tax income will be the same for, at most, 15 years, the maximum carryforward period. If one then treats 15 years as if it were infinity and assumes that all income of the loss company for that period will be exempted from tax by the carryovers, one could equate the purchase price limitation with an income limitation, as the authors of proposal do. However, assuming a loss corporation with a value (aside from carryover benefits) of $1,000 and a pre-tax return of 20 percent, the assets will produce an infinite stream of income of $200 per year. If one assumes carryovers to shelter the income for 15 years, one would value the corporation by adding to the $1,000 of "hard assets", the present value of the benefit of $200 of deductions for 15 years. The present value is calculated by using an after-tax discount rate which, for a 46-percent taxpayer, is 10.8 percent. The present value of the deductions would be $1,454 and the present value of the tax benefit (46% of $1,454) would be $669. Under these assumptions, assuming rules which limit the present value of tax benefits to $669 after a change in ownership, a purchaser would pay at most $1,669. Under the purchase price limitation, however, a purchaser might be willing to pay $1,850 ($1,000 for "hard assets" and tax savings of $850 attributable to a currently available deduction of $1,850 at a 46-percent tax rate). Further, the purchase price limitation makes available to a purchaser able to use them not only fresh losses but older losses that would expire unused in the absence of a change in ownership. The greater ability of the purchaser to absorb carryovers is inconsistent with the goal of neutrality of tax considerations in deciding whether to retain or sell a loss corporation.

D. Proposals to Reduce the Need for Special Limitations

As an alternative to imposing special limitations on the carryover of tax attributes in order to prevent "trafficking" in NOL's, etc., the tax laws could be changed to restrict the ability of taxpayers to engage in transactions that result in the tax-free treatment in the first instance. For example, a corporation, substantially all of whose stock has been acquired by a new taxpayer or taxpayers could be treated as having terminated its existence (i.e., liquidated) and then been recreated as a new corporation by the new owners. The new corporation would have a fair market value basis for its assets and none of the "tax history" of the old corporation. This treatment is presently available in certain cases on an elective basis (sec. 338), but it could be made a mandatory rule.

Further, the tax free treatment of combinations of unrelated corporations could be restricted, by, for example, disallowing tax-free reorganization treatment to the merger, etc. of corporations of disparate sizes. For example, the Internal Revenue Code of 1954 as it passed the House of Representatives contained a provision denying tax-free treatment to certain acquisitive reorganizations (such as mergers) where the shareholders of the smaller corporation held less than 25 percent of the participating stock of the combined entity.

Also, under present law a corporation generally recognizes income, and thus reduces it net operating loss, when it retires its debt in exchange for its own stock with a value less than principal of the debt. An exception (sec. 108 (e)(10)(B)) allows bankrupt or insolvent corporations[6] to retain their NOLs where the creditors receive stock for their debt. This has the effect of allowing the creditors to benefit from the corporation's NOLs notwithstanding that the source of the funds creating the losses may have been supplied by shareholders whose interests are terminated. This ability to use NOLs could be reduced if the insolvency and bankruptcy exceptions from the "stock for debt" rule were eliminated.

If some or all of these limitations were adopted, the need for special rules to limit NOL carryovers would be reduced.

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[6] An exception for certain "workouts" is scheduled to take effect on January 1, 1986, if the 1976 amendments to section 382 become effective at that time.

IV. ECONOMIC ISSUES

A. Overview

Loss recoupment is limited by tax liability on past and future income. Thus, there is an incentive for loss companies to increase their taxable income or combine with profitable companies in order to accelerate the rate at which loss and credit carryovers can be utilized. The statutory provisions that restrict loss recoupment in situations where corporate ownership changes have been the source of a prolonged controversy between those advocating unrestricted sale of loss corporations ("free trafficking") and those favoring anti-trafficking rules.

The economic arguments have focused on the question of whether a system which refunds the tax on losses ("refundability") is in principle preferable to the current system of limited recoupment. Supporters of the refundability concept favor either outright payments of refunds by the Treasury to taxpayers with NOLs or free trafficking in losses. The free trafficking approach relies on an acquiring corporation to act as a tax intermediary, passing through the benefit of more rapid recoupment, in the form of a larger acquisition price, to the loss company's shareholders.

In comparing refundability with limited recoupment, many issues arise. Of particular concern is the comparative efficiency of these two systems. Efficiency would require that acquisition and reorganization decisions not be influenced by the tax system. Another issue is the interaction between loss recoupment and other mechanisms for tax benefit transfers, such as leasing and special allocations within partnerships. Other issues include the revenue cost, equity, and public perception of refundability. As indicated below, neither the refundability nor partial recoupment approach is entirely satisfactory from the standpoints of equity and efficiency.

If refundability of losses is adopted, the current law limitations on the sale of NOLs generally would be irrelevant. Alternatively, if refundability is not adopted, then there are two general options for changing the limitations on the sale of losses under current law. One approach would allow free trafficking in loss carryovers, similar to the free sale of depreciation deductions and investment credits provided by the safe-harbor leasing provisions adopted in 1981 (and repealed in 1982). The second approach would reformulate current law limitations to eliminate purely tax-motivated mergers and acquisitions. For example, the value of NOLs to the purchaser of a loss corporation's stock could be limited to the amount that the loss corporation would have benefited had it remained independent. This option, which would allow the loss corporation to sell a limited amount of its losses to the purchaser, has been developed by the American Law Institute (ALI) and the American Bar Association (ABA).

B. Refundability vs. Limited Recoupment

In a pure refundability system, a taxpayer with a net operating loss would get a refund equal to the tax savings which would have been realized had the taxpayer been able to use the NOL in the current tax year.[7] In the absence of a merger or acquisition, the value to a loss company of its unutilized NOL carryovers may be less under current law than in a refundable system. This occurs most clearly when the NOL is extinguished because it cannot be used within the 15-year carryover period or because the loss company goes out of business. Even if the NOL is eventually utilized within the 15-year carryforward period, its value will be less than current utilization under a refundable system (i.e., the present value of an NOL deduction in the future is less than a current deduction). As a result, under present law, the value of loss carryovers varies among companies depending on their past and future income.

1. Arguments in favor of refundability

Advocates of refundability argue that it is more efficient and equitable than the carryover system in present law. They view the lack of refundability as particularly unfair to start-up and undiversified companies. A start-up company is unable to get any immediate benefit from NOLs because it has no prior-year income. As an example, consider an investment project which throws off a loss of $10 in the first year and a profit of $20 in the second year. Assuming a 50-percent tax rate, a loss company undertaking this project would not be able to use the $10 loss deduction until the second year. An ongoing company undertaking this investment would realize a $10 tax deduction in the first year. The cumulative tax deduction over the two-year life of the investment is $10 for both taxpayers; however, the present value of the deduction is greater for the ongoing company than the start-up company. Only if the start-up company diversifies (by investing in assets which generate taxable income sufficient to utilize its losses) will it be able to compete on a level playing field.

Any investment for which there is some probability of loss is more attractive from a tax standpoint to a diversified company than a specialized company. This is the case because a diversified company has a more stable income stream, and consequently, a higher probability of utilizing tax deductions in the year they arise. Thus, the limited loss recoupment under present law provides a tax incentive for firms to diversify and merge into other lines of business, even where conglomerate organization may be less efficient (apart from tax considerations).

Further, the present system of partial recoupment encourages various types of otherwise non-economic financial arrangements in order to obtain or accelerate the utilization of loss carryovers.

[7] With graduated rates, however, the tax rate at which to compute the taxpayer's refund would be ambiguous.

Firms with large loss and credit carryovers can increase their net worth by executing a properly structured merger with a company possessing substantial taxable income. Code sections 269, 381, and 382, and other provisions, limit, but do not eliminate, loss trafficking. Indeed, these provisions may encourage the operation of unprofitable assets, following acquisition, to preserve the right to utilize acquired carryovers. Further, these anti-trafficking provisions do not prevent a company with an NOL from acquiring assets whose income can be sheltered by the carryover.[8] If a company has (or anticipates having) an NOL, then there is an incentive to lease as opposed to own assets, because the company may be unable to obtain the full benefit of depreciation deductions and the investment credit.[9] All of these transactions, to the extent they are tax-motivated, tend to reduce economic growth since the efforts of lawyers, bankers, and businessmen, among others, are devoted to asset-rearranging, rather than asset-increasing, activities.

Under current law, the government taxes profits thrown-off by an investment, but does not necessarily share equally in refunding tax on losses. Thus, relative to a refundable income tax imposed at the *same* rate as current law, there may be less corporate risk-taking.[10] This may reduce innovation and hurt the ability of the U.S. economy to compete worldwide in the high technology market.

2. Arguments against refundability

A refundable income tax system, with the *same* tax rate as present law, would tend to increase high-risk investments; however, this additional risk-taking is not unequivocally beneficial to society. Economic analysis shows that a refundable income tax system may increase risky investments beyond the level which would exist in the absence of the tax.[11] This can occur because refundability provides insurance against losses, thus reducing the variance of after-tax returns and making risky investments more attractive to certain investors. Also, it is not clear that present law significantly limits total risk-taking since companies with large amounts of historic taxable income are effectively able to refund losses using the 3-year carryback rule. Consequently, there may only be a shift in the ownership of risky investments (to large and diversified companies and away from small and undiversified companies), rather than a reduction in the volume of these investments.[12]

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[8] For example, a recent stockholder report of the Fedders Corporation indicated its plans to restructure assets in order to use NOLs. "Concerning the divestiture of our central air conditioning businesses, we are encouraged by the interest shown by potential purchasers. These businesses, together with our real estate being offered for sale, should generate in excess of $60,000,000 in cash that can be used for working capital, expansion of our continuing businesses or acquisitions that would utilize our substantial loss carryforward which presently amounts to approximately $120,000,000 or about $10 per share." (Fedders Corporation, "Highlights of the Annual Meeting of Stockholders, June 30, 1983.")

[9] Repeal of the "safe-harbor" leasing provisions in 1982 restricted tax benefit transfers; however, conventional and "finance" leasing can also be used to achieve similar results. For a discussion of issues related to leasing, see *Analysis of Safe Harbor Leasing*, a report by the staff of the Joint Committee on Taxation, (JCS-23-82) June 14, 1982.

[10] A. B. Atkinson and J. E. Stiglitz, *Lectures on Public Economics*, pp. 112-115.

[11] A. B. Atkinson and J. E. Stiglitz, p. 107.

[12] This shift in the ownership and control of risky investment projects may be cause for concern if large companies are intrinsically less innovative than small or start-up companies.

Critics of refundability also argue that this proposal would not be perceived as more equitable than the current system of partial recoupment. After the enactment in 1981 of the safe-harbor leasing provisions, which moved the tax system closer to refundability, there was a widespread public perception that these provisions were unfair. Ultimately, these sentiments played a role in Congress' decision to phase-out safe-harbor leasing in 1982. Similar perception problems might arise with the adoption of refundability. Companies with hundreds of millions of dollars of losses would receive refund checks from the Treasury (for the amounts lost times the corporate tax rate) without any government conditions on investment or employment decisions. Where management incompetence was perceived to be the cause of these losses, taxpayers would likely resent the huge payments required by refundability. Taxpayer compliance could decline as a result of these perceptions of unfairness.

Opponents of refundability also argue that it would have a sizable revenue cost. To prevent an increase in the deficit, this revenue loss would have to be made up by raising the rate of the corporate income tax or increasing other taxes. Each of these options may reduce economic efficiency by more than the gain (if any) from refundability.

Under present law, the revenue cost and economic impact of the numerous deductions and credits in the Code are limited by taxpayers' abilities to generate taxable income. In a system of complete refundability, no such limitation would exist. This is a very important problem with the refundability concept since many of the current tax provisions which enlarge tax losses, such as accelerated depreciation, have been criticized as preferences that distort economic activity. Without a substantial reduction in allowable deductions and credits, refundability could increase both the revenue loss and economic misallocations caused by these provisions.

Because a portion of all business tax deductions would automatically be offset by the Treasury, refundability could increase the incentive to exaggerate wage and interest expense, to accrue paper losses, and to incur deductions in pursuit of businesses that are disguised hobbies. Obviously, these problems exist under current law, and there are Code sections which deal with them.[13] Nevertheless, refundability could place substantially more pressure on these rules and increase the costs of monitoring and enforcement.

A final argument made against refundability is that, due to graduated tax rates, the bias against start-up and undiversified companies would not be eliminated by refundability. Under both present law and refundability, for example, a $100,000 loss on an investment reduces the tax liability of a company with $200,000 of taxable income more than a company with only $100,000 of taxable income ($46,000 vs. $26,750). Clearly, any graduated rate income tax is nonneutral in this sense. To achieve a completely neutral tax system (a goal advocated by proponents of refundability) would re-

[13] For example: Sec. 162(a)(1) (imposing a "reasonable" limit on salaries that may be deducted); and sec. 385 (authorizing the IRS to promulgate regulations for classifying investments as debt or equity). See M. Campisano and Roberta Romano, "Recouping Losses: The Case for Full Loss Offsets," *Northwestern University Law Review*, Vol. 76, No. 5, (December 1981), pp. 709-744.

quire a flat-rate corporate income tax, which many small corporations may perceive as inequitable.

C. Options for Change

Two major options for changing the present law rules have received considerable attention: refundability and rationalized anti-trafficking rules. The pros and cons of both approaches are discussed below.

1. Refundability

Refundability may appeal to those who believe that there are significant advantages in more nearly equalizing the benefit which different taxpayers receive from available deductions and credits. One way in which this objective may be partially accomplished would be to eliminate the anti-trafficking rules (primarily secs. 269, 381, and 382). However, this option is inferior to a pure refundability approach in several respects. First, in an acquisition, the loss company's shareholders would typically end up sharing a portion of the value of their tax losses with the acquiring company's shareholders. This sharing would be arbitrary, since the value of the loss company's shares would depend on a potential buyer's ability to use the tax benefits. Second, free trafficking would encourage the churning of assets through mergers, acquisitions, and partnerships which have no economic rationale other than tax savings.

Refundability could be adopted along with certain changes in the income tax system to minimize the disadvantages of refundability. These collateral changes might include: (1) redefinition of taxable income to conform more closely with the concept of economic income, (2) elimination of graduated corporate tax rates, and (3) reduction of income tax rates. (These changes are similar to those contained in various comprehensive income tax proposals.) Without such changes, the accelerated depreciation and other preferences in the Code would result in the refunding of artificial losses, and the incentive to generate such losses would be magnified.

2. Rationalized anti-trafficking rules

A second option for change would be to retain the limited recoupment approach of present law but to adjust the anti-trafficking rules in order to eliminate purely tax-motivated mergers and acquisitions. This objective is consistent with the limitations on partial liquidations in the Tax Equity and Fiscal Responsibility Act of 1982. One way of achieving this objective would be to assume that when a corporation purchases the stock of a loss corporation, it is, in substance, purchasing the assets of that corporation. Under this logic, a corporation which purchases all the stock of a loss corporation should not be allowed to use any of the loss corporation's losses, since no losses would have been available had the assets been purchased directly. Another way of achieving this objective would be to estimate how much benefit the loss corporation would have obtained from its losses had its ownership not changed, and to limit its benefit from the sale of its losses to this amount. If this rule could be implemented precisely, losses would not be a factor in mergers, since a potential buyer would not be willing to pay more for a corporation's losses than the benefit the sellers could have realized if a sale did not take place. Consequently, acquisitions would be more likely to occur for reasons of economic efficiency rather than taxes. Of course, the success of such a rule is likely to depend on the accuracy of the assumptions used in deriving an estimate of the value of losses absent a sale. Empirical evidence regarding the value of NOLs to a loss corporation is discussed below.

A disadvantage of limiting the sale of losses to prevent tax-motivated mergers is that it would not achieve a completely level playing field. Diversified and ongoing companies would still have an advantage, relative to start-up and loss companies, in undertaking risky investments and other activities which generate tax losses. Merger and diversification would still be encouraged in *anticipation* of the chance of future unutilized loss carryovers.

The primary advantage of rationalizing the limited recoupment approach is that it would reduce tax-motivated acquisitions without the revenue loss and perception problems entailed by refundability. Also, there would be less incentive to operate uneconomic assets acquired from a loss company for the sole purpose of preserving the right to use loss carryovers.

3. Value of NOLs to a loss company

A number of proposals to reform section 382 are designed to achieve "loss neutrality": The buyer's utilization of NOLs would be limited in present value to the loss carryover that would have been used by the selling corporation, absent acquisition. Such proposals are intended to eliminate the incentive for mergers based solely on the acquisition of NOL deductions. To implement loss neutrality, it is first necessary to estimate the use of loss carryforwards by loss corporations. Taxable income (before deduction of loss carryforwards) is an upperbound estimate of the annual amount of NOL utilization (since NOL deductions cannot exceed taxable income).

Table 1 shows 1981 effective taxable income before NOL deduction as a percent of book net worth ("absorption rate") for 3 categories of corporations: (1) corporations claiming an NOL deduction; (2) corporations claiming an NOL deduction or reporting excess credits; and (3) all corporations. Table 1 shows that corporations able to deduct accumulated NOLs in 1981 had a maximum NOL absorption rate of 5.46 percent per year (as a percent of net worth).

Table 1.—Corporate Loss Absorption Capability, 1981

Category of corporations	Absorption rate [1]
1. Claiming an NOL deduction	5.46
2. Claiming an NOL deduction or reporting excess credits	4.39
3. All corporations	6.49

[1] The absorption rate is defined as tax liability before NOL deduction divided by the top corporate tax rate (.46) as a fraction of net worth.

Some corporations with NOLs were unable to deduct losses in 1981 since they had not yet returned to profitability. Such corporations have a zero absorption rate and are not included in the category of corporations claiming a NOL deduction. Many of these corporations report excess credits and, consequently, are included in the category reporting excess credits. Table 1 shows that the loss absorption rate of companies claiming NOL deductions or reporting excess credits was just 4.39 percent per year.[14]

Some proponents of limitations designed to achieve loss neutrality have assumed that loss corporations are able to absorb NOLs at a 20-percent annual rate. Based on the evidence in Table 1, it is clear that even profitable corporations with unused NOL deductions were unable to utilize such deductions at a rate faster than 5.46 percent per year in 1981. Thus a rule designed to achieve loss neutrality based on an assumed loss absorption rate of 20 percent is probably too generous. Many loss corporations would have an incentive to be acquired in a merger or acquisition in order to utilize losses at the 20-percent rate.

Another proposal would limit the sale of NOLs to the amount that a loss company could use if it sold its assets and invested the proceeds in long-term Treasury bonds. The Treasury Department currently computes a monthly index of the average yield on Treasury bonds with a maturity of nine years or more (i.e., the long-term "applicable Federal rate") which could be used for this purpose. Advocates of this proposal contend that a loss limitation based on a lower absorption rate would discourage stock acquisitions and mergers of loss corporations in favor of asset sales (where the loss corporation retains its NOLs). However, this argument cannot account for the fact that the average loss corporation absorbs losses at a far slower rate than the yield on Treasury bonds (see Table 1) even though current law permits a loss corporation to reinvest the proceeds of asset sales in Treasury obligations (or other assets).

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[14] Corporations do not report on income tax forms whether or not they have unused NOL deductions. Thus, it is not possible to directly infer the absorption rate of such corporations. The absorption rates in Table 1 may be reduced by the recession in 1981. However, the accelerated depreciation rules enacted in 1981 probably were only effective for part of 1981, and have probably put downward pressure on taxable income in subsequent years.

V. ANALYSIS OF PRESENT LAW AND PRINCIPAL PROPOSALS FOR CHANGE

The major options for change are the merger rule and a variation of the purchase rule. Both proposals would eliminate the incentive to acquire shell corporations solely to take advantage of NOL carryovers because the tax savings derived from use of the NOLs would always be less than the value of the consideration required to make the acquisition. Apart from enforcement problems, section 269 is equally effective in preventing acquisitions of shell corporations under present law.

Although commentators agree that the merger rule is conceptually sound, there is concern about the requirement that valuations be made where none is required under present law. In addition, to the extent that the merger rule as proposed by the ALI departs from its stated rationale (e.g., by providing an exception for contributions to capital by historic shareholders), the rule is subject to the criticism that the stated rationale is not consistently adhered to. Finally, because of section 269 and similar tax avoidance rules, the results under the merger rule would be no more certain than those under present law.

The basic purchase rule (providing for a limitation based on a deemed rate of return) is subject to criticism because of the need to make an arbitrary assumption regarding the rate of return on the purchase price.

Finally, there are certain issues that would arise under both proposals.

A. The Principal Proposals

1. General concerns

a. Old and new complexities

The 1976 Act amendments to section 382 are often criticized as being excessively complex. The introduction of the concept of "participating stock" is often cited as an example. It should be noted that much of the complexity results from attempts to deal with problems that would also arise under a merger rule or a purchase rule. For example, measuring changes in the "beneficial" ownership of a NOL carryover, which is addressed by the use of participating stock, would still be required. Further, new issues would be presented, such as the treatment of foreign tax credit carryovers (discussed in V.A.2.e., below). In addition, the principal proposals would require valuations in circumstances where present law does not. In the case of a merger rule, valuations would be required of both the loss corporation and the profitable corporation at the time of acquisition (except, possibly, in cases where common stock is the only consideration received by loss-corporation shareholders). A single-purchase rule would require a valuation of the loss corporation at the time of acquisition.

b. Appropriate rate of return under purchase rule

In general, most of the variations of the basic purchase rule provide for an annual limitation based on some percentage of the value of acquired stock. What that percentage should be turns, in large part, on the rationale that is relied on. For example, the ALI purchase rule is designed to provide an objective measure of the income a loss corporation's assets would have generated had there been no acquisition. This purchase rule may be viewed as undesirable because it only approximates the results of the merger rule, independent of the actual earnings experience of an acquired loss corporation. If an average rate of return is selected, it is likely that there will be many loss corporations with actual rates of return that exceed the deemed rate. On the other hand, there are sure to be loss corporations that experience lower rates of return.

On the other hand, a purchase rule based on the view of tax neutrality embodied in the ABA proposal might be construed to require the making of the assumption that all assets generate the same market rate of return, with the result that the new owners of a loss corporation with unprofitable assets would benefit from an unrealistic assumption.

2. Common issues

a. Passive assets

Neither the pool of capital theory nor the rationale for a purchase rule calls for distinguishing between passive assets and active business assets. Thus, under the theory of either proposal, taxpayers could attempt to traffic in NOLs by reducing the loss corporation's assets to cash or other passive assets, and then selling off the NOL carryover plus the passive assets. To preclude this type of tax avoidance, it would be necessary to define the types of assets that should be excluded from the value of the loss corporation for purposes of computing the limitation. Under present law, the sale of a loss corporation with passive assets might run afoul of section 269.

b. Pre-sale infusions of assets

Another issue that would arise under either proposal is the extent to which capital contributions made by historical shareholders should be taken into account. A pre-sale infusion of assets would inflate the value of a loss corporation and facilitate the use of a NOL carryover more rapidly. The theory of the merger rule argues for backing out all capital contributions made after the year in which the loss was incurred. Nevertheless, the ALI proposed an exception for shareholder contributions to capital. Capital contributions would not trigger the application of a purchase rule in the absence of a sufficient shift in the value held by historic shareholders. Thus, the contribution of income-producing assets to a loss corporation prior to or after a purchase could enable new owners to make use of NOLs (up to the amount of the prescribed rate of return) in cases where the loss corporation's historical assets would yield an insignificant return.

c. Treatment of creditors

The take-over by creditors of a loss corporation would increase equity capital and result in a limitation under a pure merger rule. Similarly, under the basic purchase rule, NOL carryovers would be unavailable after such a transaction because there would be little or no value attributable to equity. Nevertheless, the ALI proposed an exception for stock issued for debt, as does present law. Such an exception under either proposal might be susceptible to abuse (*e.g.*, a profitable corporation could make tax-motivated acquisitions of loss-corporation securities to position itself to take advantage of NOL carryovers). Thus, an anti-abuse rule may be needed here.

d. Redemptions

The combination of a redemption and a new stock issuance has the effect of a purchase of stock; however, different treatment would result under the basic rules of each proposal. A pure merger rule would not result in the imposition of a limitation at the time of the redemption, but would limit the use of NOLs against earnings generated by assets that are contributed after the redemption to restore the historical pool of capital. For example, no limitation would apply if a shareholder were redeemed out, but the subsequent issuance of stock to a new shareholder might result in a limitation measured by the earnings attributable to the interests that did not change hands. If the new shareholder simply purchased the interest from the old shareholder, no limitation would apply. The concern is that economically similar transactions should not receive inconsistent treatment. If shareholders are redeemed out before the merger, then the limitation after the merger would be based on the post-redemption value of the loss corporation. If, instead, the shareholders received stock in the merger and then sold the stock for cash, the limitation would be based on all of the loss corporation's assets. Similar issues could arise under a purchase rule.

e. Foreign tax credits

The amount of foreign taxes that can be claimed as a credit is limited to the U.S. tax imposed on foreign-source taxable income. This limitation is computed by multiplying the U.S. tax by a fraction, the numerator of which is foreign-source taxable income and the denominator of which is worldwide taxable income. In view of the FTC limitation, and unlike investment credit carryovers, FTC carryovers cannot be treated by simply converting the amount of the credits to an equivalent deduction.

Prior to 1972, the ability to carry unused FTCs over to a post-acquisition year depended on whether foreign-source taxable income resulted from the continuation of the business that created the carryover. In general, for taxable years beginning after 1971, FTC carryovers are treated just as unused investment credits are (i.e., reduced where required but not otherwise limited). The ALI proposed allocating post-acquisition U.S. taxes on foreign-source income by looking at the business operations contributed by each party, for purposes of determining the availability of FTC carryovers. Others have suggested disallowing FTC carryovers except as provided in regulations. This issue does not arise under present law because FTC carryovers subject to limitations are simply reduced, and the allowability of the reduced amount remains subject to the general rules.

f. Built-in gains and losses

Reaching the correct economic result with respect to the treatment of built-in gains and losses would involve complicated issues of identification and valuation (as is the case under present law).

B. Present Law, as Amended by 1976 Act

The basic approach of present law is said to be too harsh because the reduction of NOL carryovers penalizes continuing shareholders. Nevertheless, the principal proposals for change would also impose limitations as the result of substantial changes in ownership.

Present law is also said to be too lenient in those instances in which surviving NOLs, after the limitations are applied, may be used to shelter income of the acquiring corporation. This criticism is equally applicable to the proposals for change. It may be questioned whether any set of objective standards by themselves will prevent tax motivated transactions. It is for this reason that, whatever limitations may be adopted, it is contemplated that section 269 and the consolidated return SRLY and CRCO rules will continue to be applicable.

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