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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL
Attn:

FROM: Deborah A. Butler
Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT: Net Operating Loss Carryovers

This Field Service Advice responds to your memorandum dated February 10, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Corp1 =

Corp2 =

Corp3 =

Corp4 =

Corp5 =

Corp6 =

Corp7 =

Partnership =

[redacted]

PartnerA =

PartnerB =

Name1 =

Name2 =

Name3 =

StateA =

StateB =

Business1 =

Business2 =

Business3 =

Business4 =

Asset1 =

Year1 =

Year2 =

Year3 =

Year4 =

Year5 =

Year6 =

Year7 =

Year8 =

Year9 =

Year10 =

Date1 =

Date2 =

Date3 =

Date4 =

[redacted]

Date5	=
Date6	=
Date7	=
Date8	=
Date9	=
MonthA	=
MonthB	=
$aa	=
$bb	=
$cc	=
$dd	=
$ee	=
$ff	=
$gg	=
%x	=
%y	=
%z	=
#r	=
#s	=
#t	=
#u	=

ISSUE:

Whether a $aa net operating loss ("NOL") carryover of the Corp2 and Subsidiaries consolidated return group can offset the Year8 through Year9 post-acquisition taxable income of Corp3, the survivor of a merger with the Corp4 group's Corp5, when Corp4's Corp5 was not a member of Corp2's consolidated return group during the pre-acquisition years and Corp3 was a defunct, empty shell corporation when it merged with Corp5.

[redacted]

CONCLUSION:

Under the facts presented by this case, I.R.C. § 269 would apply to disallow the use of the NOL carryovers. [redacted]

FACTS:

Prior to Year5, Corp2 was the common parent of an affiliated group of corporations that filed consolidated returns. Several members of the group, including Corp3 (then known as Name1), ran Business1s and had been involved in Business2. Another member was engaged in Business3. Corp2 filed a bankruptcy petition in Year2 and emerged from bankruptcy in Year4 with a large deficit in retained earnings and large NOL carryovers from Year1, Year2 and Year3.

In MonthA Year5, Corp2's shareholders approved an increase in the number of authorized shares of common stock from #r to #s shares. At the same time, the shareholders also granted an option to Partnership to acquire #t shares of the common stock at a price of $bb per share.[1/] Partnership exercised the option to acquire #u million shares on Date1, and at the same time made a tender offer for any and all of Corp2's outstanding common stock at a price of $cc per share. The tender offer was completed on Date2, and as of Date3, Partnership owned approximately %x of Corp2's issued and outstanding shares. Subsequently, Partnership acquired additional shares of Corp2, and by Date4, owned %y of Corp2's outstanding stock.

At the time Partnership acquired its interest in Corp2, the Corp2 group had total consolidated NOLs from Year1, Year2 and Year3 of approximately $dd. In addition, Corp2 had a deficit in retained earnings of approximately $ee. After Partnership exercised the option in Year6, Corp2 did not report any limitation under section 382 (before or after the 1986 amendments) on the use of its pre-acquisition losses but treated those losses as subject to the consolidated return change of ownership ("CRCO") rules of Treas. Reg. §§ 1.1502-1(g) and 1.1502-21(d).

On Date9, Corp2 acquired approximately %z of the stock of Corp4 in a friendly takeover that was the culmination of an open bidding process. Corp4 was a StateB corporation that was the common parent of an affiliated group of corporations that filed consolidated returns. Corp4 was a conglomerate whose principal assets comprised (1) Asset1 and (2) Business4. The acquisition was effected by having Corp7, a newly formed subsidiary of Corp6, a member of the Corp2 group, merge

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[1/] Partnership is a StateA partnership constructively controlled by PartnerA and PartnerB, both of whom also constructively control Corp1, an S corporation.

[redacted]

into Corp4, with Corp4 as the surviving corporation.[2/] The former shareholders of Corp4 received a cash payment of $ff per share. Subsequent to the acquisition of Corp4, Corp2 issued various debt securities and used the proceeds to retire debt incurred to acquire Corp4. Excess proceeds from the securities issuance, in the amount of approximately $gg, were distributed by Corp2. Because Corp2 had no earnings and profits, that distribution was treated as a return of capital under I.R.C. § 301(c)(2).

On Date5, Corp3 sold its Business1, including all assets and the use of the Name1 name, to an unrelated purchaser. After Date6, Corp3, which had no employees and no operating assets, changed its name to Name2.

On Date7, Corp5, a subsidiary of Corp4, merged into Corp3, with Corp3 as the surviving corporation. Corp3 immediately changed its name to Name3. At the time of the merger, Corp3 was a shell corporation. Corp5 was profitably engaged in Business4. After the merger, Corp2 offset the group's CRCO losses against the income of Corp3.

LAW AND ANALYSIS

A. Section 382

Prior to 1987, I.R.C. § 382(a) denied the carryover of a corporation's net operating loss if the corporation experienced a change in the ownership of at least 50 percentage points among its ten largest shareholders, the change resulted from a purchase of the corporation's stock, and the corporation failed to carry on a trade or business substantially the same as that conducted before any ownership change ("business continuity requirement"). The test of whether the corporation continued to carry on substantially the same business was applied at the close of the taxable year of the acquisition and the subsequent taxable year. I.R.C. § 382(a)(1)(A); Treas. Reg. § 1.382(a)-(1)(a).

The regulations under section 382 (for tax years beginning before 1987) provide that, in determining whether a corporation has continued to carry on substantially the same business after an ownership change, all the facts and circumstances of

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[2/] The agreement and plan of merger executed Date8 is among Corp4, Corp1, and Corp7. The agreement describes Corp1 as "Parent" even though it has no direct ownership interest in either Corp2 or Corp7.

[redacted]

the case are taken into account. Relevant factors to be taken into account include "changes in the corporation's employees, plant, equipment, product, location, customers, and other items which are significant in determining whether or not there is, or is not, a continuity of the same business enterprise." Treas. Reg. §1.382(a)-1(h)(5). "These factors shall be evaluated in light of the general objective of section 382(a) to disallow net operating loss carryovers where there is a purchase of the stock of a corporation and its loss carryovers are used to offset gains of a business unrelated to that which produced the losses." *Id.*

The Tax Reform Act of 1986 substantially revised section 382. After the 1986 amendments, I.R.C. § 382(a) generally limits the amount (the “section 382 limitation”) of a loss corporation's loss carryovers and built-in losses that can be offset against the corporation's taxable income in years after an "ownership change." The "section 382 limitation" is defined by I.R.C. § 382(b) as the loss corporation's value (before the ownership change) multiplied by the applicable long-term tax-exempt bond rate (defined in I.R.C. § 382(f)). A "loss corporation" is defined by I.R.C. § 382(k)(1) as a corporation with a net operating loss or "net unrealized built-in loss" (as defined by I.R.C. § 382(h)(3)).

The pivotal event that triggers the operation of I.R.C. § 382 after 1986 is an "ownership change," which occurs under I.R.C. § 382(g) whenever, immediately after (i) an owner shift involving a 5% shareholder or (ii) any equity structure shift, the percentage of stock of the loss corporation owned by one or more 5% shareholders has increased by more than 50 percentage points over the lowest percentage of stock of the loss corporation (or any predecessor corporation) owned by such shareholders at any time during the testing period.[3/] As provided in I.R.C. § 382(k)(6)(C), determinations of the percentage of stock held by any person is made on the basis of value. Under I.R.C. § 382(i), the testing period is generally the three-year period ending on the day of any owner shift involving a 5% shareholder or equity structure shift.

For an ownership change to occur, there must be an increase of 50 percentage points by one or more 5% shareholders. The increase of each 5% shareholder is determined separately, comparing the 5% shareholder's percentage of stock ownership immediately after the close of the testing date with that shareholder's *lowest*

[3/] An "owner shift involving a 5-percent shareholder" is any change in the respective ownership of stock of a corporation which affects the percentage of such stock owned by any person who is a 5% shareholder before or after such change. I.R.C. § 382(g)(2). An "equity structure shift" is defined in I.R.C. § 382(g)(3) to mean any reorganization (within the meaning of I.R.C. § 368) except for reorganizations described in subparagraph (E) or (G) of I.R.C. § 368(a)(1) not meeting the requirements of I.R.C. § 354(b)(1) or reorganizations described in subparagraph (F) of I.R.C. § 368(a)(1).

[redacted]

percentage ownership during the testing period. All increases during the testing period are aggregated to determine whether the 50 percentage point increase has occurred during the testing period, regardless of whether the changes result from related or unrelated transactions. Temp. Treas. Reg. § 1.382-2T(c)(1), (3).

The 1986 amendments to section 382 apply only with respect to ownership changes after December 31, 1986. The transition rule provides that the testing period for determining an ownership change begins on the later of May 6, 1986, or in the case of ownership change that occurs after May 5, 1986, and is not subject to the 1986 amendments, the first day following the date on which such ownership change occurs. *See* Tax Reform Act of 1986, Pub. L. 99-514, § 621(f)(3). The legislative history states that, for purposes of this transition rule, an option or other interest in a corporation is treated as exercised pursuant to section 382(l)(3)(A)(iv). S. Rep. No. 100-445, at 54-55 (1988).

In this case, Partnership acquired more than 50% of the stock of Corp2 on Date1, when it exercised its option to acquire #u shares of Corp2 stock. This would constitute an ownership change under I.R.C. § 382(g) of the 1986 Code. However, under the transition rule for the 1986 amendments, the option granted to Partnership in MonthA 1986 would be treated as exercised at that time. Accordingly, the change of ownership occurred prior to 1987, meaning that the 1986 amendments are not applicable and the acquisition would be subject to the unamended section 382 under the 1954 Code.

Inasmuch as the facts indicate that Partnership acquired the stock of Corp2 in a cash purchase and acquired more than 50% of the Corp2 stock in MonthB Year6, the acquisition would be subject to former section 382(a) if Corp2 failed to carry on a trade or business substantially the same as that conducted before the ownership change at the end of the first two taxable years after the transaction. However, the available facts do not indicate that Corp2 failed to satisfy that requirement. Accordingly, former 382(a) would not prohibit the use of Corp2's preacquisition losses after its acquisition by Partnership.

B. <u>Consolidated Return Change of Ownership</u>

A CRCO occurs during any taxable year ("year of change") of the common parent for the taxable year to which the tax attribute is carried if (i) the requisite increase in ownership of the common parent's stock occurs and (ii) the increase results from a purchase or a decrease in the amount of stock outstanding. The required increase occurs if one or more of the persons described in former I.R.C. § 382(a)(2) (as it existed under the Internal Revenue Code of 1954) – i.e., the ten persons who own the greatest percentage of the fair market value of such stock at the end of the taxable year – own at least 50 percentage points more of the fair market value of the outstanding stock of the corporation than such person or persons owned at the

[redacted]

beginning of the taxable year or at the beginning of the preceding taxable year. If the CRCO rules apply, the corporations that were members of the group immediately preceding the first day of the taxable year in which the CRCO occurs collectively constitute the "old members" of the group. Treas. Reg. § 1.1502-1(g)(3)(i).

After a CRCO, the group's pre-acquisition consolidated NOL carryovers are subject to the limitation determined under Treas. Reg. § 1.1502-21(d). In particular, the limitation amount of the pre-acquisition consolidated NOL carryovers that may be included in the group's consolidated NOL deduction for any post-acquisition consolidated return year is determined by recomputing the consolidated taxable income for the taxable year (without regard to the CNOL deduction), including only the items of income and deduction of the old members.

In the instant case, as a result of acquiring more than 50% of the stock of Corp2 by cash purchase, Partnership's ownership interest increased by more than 50 percentage points in Year6. Consequently, a CRCO occurred, and the losses of the Corp2 group from tax years Year1 through Year3 were subsequently subject to the CRCO limitation of § 1.1502-21(d).

C. Section 269

Under I.R.C. § 269(a), the Service may disallow the deduction of NOL carryovers in certain circumstances. Specifically, I.R.C. § 269(a) provides:

> (a) IN GENERAL. If –
>
> > (1) any person or persons acquire, . . . directly or indirectly, control of a corporation, or
> >
> > (2) any corporation acquires, . . . directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation,
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> and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit or other allowance which such person or corporation would not otherwise enjoy, then the Secretary may disallow such deduction.

[redacted]

For purposes of section 269, "person" is defined in Treas. Reg. § 1.269-1(d) to include any individual, trust, estate, partnership, association, company, or corporation. Section 269(a) defines "control" to mean the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation. For purposes of determining control, there are no applicable rules of attribution. *See Brick Milling Co. v. Commissioner*, T.C. Memo. 1963-305 (attribution rules of I.R.C. § 318 do not apply in determining control under I.R.C. § 269); Rev. Rul. 80-46, 1980-1 C.B. 62. The concept of an "acquisition" of corporate control is interpreted broadly and may include the incorporation of a new corporation. Treas. Reg. § 1.269-1(c); *Borge v. Commissioner*, 405 F.2d 573 (2d Cir. 1968).

As a guide to applying this rule, Treas. Reg. § 1.269-3(a) provides that "[i]f the purpose to evade or avoid Federal income tax exceeds in importance any other purpose, it is the principal purpose." Determining the purpose for which an acquisition was made requires scrutiny of the entire circumstances of the transaction. *Id.* Moreover, the principal purpose of the acquisition is determined as of the time of the transaction rather than as of some later date. *See Hawaiian Trust Co. v. United States*, 291 F.2d 761, 768 (9th Cir. 1961) (determining factor is the intention at the time of the acquisition).

In a situation where the requisite acquisition of property exists within the meaning of I.R.C. § 269(a)(2), Treas. Reg. § 1.269-3(c)(1) provides the following example of a transaction which, in the absence of evidence to the contrary, is indicative that the principal purpose for acquiring the property was evasion or avoidance of tax:

> A corporation acquires property having in its hands an aggregate carryover basis which is materially greater than its aggregate fair market value at the time of such acquisition and utilizes the property to create tax-reducing losses or deductions.

Although I.R.C. § 269(a) is applied more frequently in situations where a profitable corporation acquires a corporation with loss carryovers, it also applies to a loss corporation that acquires a profitable corporation to obtain the "benefit" of its own carryovers. *See Vulcan Materials Co. v. United States*, 446 F.2d 690, 698 (5th Cir.), *cert. denied*, 404 U.S. 942 (1971); *see also Southland Corp. v. Campbell*, 358 F.2d 333 (5th Cir. 1966) (§ 269 may apply where a loss corporation acquires a profitable corporation in order to secure the benefit of a loss it would not otherwise have enjoyed); *Briarcliff Candy Corp. v. Commissioner*, T.C. Memo. 1987-487 (§ 269 may apply where a loss corporation acquires control of a profitable corporation).

[redacted]

In *Vulcan Materials*, a loss corporation discontinued its historic business (steel operations) and sold all its assets for cash in 1954 and in the same year acquired by merger all the assets of two profitable corporations engaged in unrelated businesses (chemicals and building materials, coal, and ice). At the time of the 1954 merger, the loss corporation was a non-operating company with approximately $9 million in liquid assets and an NOL of approximately $6 million resulting from the sale of its assets. The loss corporation was the surviving corporation in the merger, and its shareholders held 57 percent of the stock of the surviving corporation, with the shareholders of the two profitable corporations owning the remaining 43 percent. The Internal Revenue Service determined that the principal purpose of the merger was the avoidance of tax, *i.e.*, to use the loss corporation's NOL to offset future income of the surviving corporation. Accordingly, the taxpayer's attempt to use the NOL carryover against taxable income in 1957 was disallowed under I.R.C. § 269. The taxpayer presented no evidence of the business purpose of the merger, and the Fifth Circuit concluded that the taxpayer failed to meet its burden of proving that the Commissioner's determination was in error.

In *Scroll, Inc. v. Commissioner*, T.C. Memo. 1969-154, *aff'd*, 447 F.2d 612 (5th Cir. 1971), the taxpayer had substantial NOL carryovers when it was acquired in 1961. Approximately seven months after the effective date of the acquisition, a profitable, commonly owned corporation that was engaged in a separate and independent business was merged into it. The taxpayer was the surviving corporation, and its substantial pre-acquisition NOL carryovers were set off against subsequent earnings of the combined businesses. The Tax Court treated the acquisition of the taxpayer and the subsequent merger as interrelated steps in a single transaction.

In this case, the merger of Corp5 into Corp3 had no apparent business purpose since Corp3 up to that time had no experience in the retailing business. Indeed, at the time of the merger, Corp3 had no employees and conducted no business of any kind. Thus, the obvious purpose of that merger was to "stuff" a new income generating business into an old member of the Corp2 group in order to offset the Corp2 group's CRCO NOL carryovers against Corp5's income. In this way, Corp2 (and through it Partnership) was able to secure the benefit of the CRCO NOL carryovers. Although this merger is thus tainted by the tax avoidance purpose, section 269 does not apply inasmuch as Corp3 and Corp5 were commonly controlled immediately before the merger. *See* I.R.C. § 269(a)(2) (applicable only to property acquired from corporation not controlled, directly or indirectly, immediately before the acquisition, by the acquiring corporation or its stockholders).

The available facts, however, suggest that Partnership acquired Corp2 principally for its large loss carryovers. Neither Partnership nor its alter ego Corp1 were engaged in Corp2's businesses, and the subsequent disposition of Corp2's businesses supports that view. Under the CRCO rules, however, Partnership could obtain the benefit of Corp2's preacquisition losses only to the extent the old

members of the Corp2 group had income. Accordingly, the subsequent acquisition of Corp4 and the merger of Corp4's profitable subsidiary Corp5 into Corp3, an inactive old member of the Corp2, were essential parts of the overall plan to obtain the desired benefit from the Corp2 group's CRCO losses. Viewed as steps of an integrated plan to secure the benefit of Corp2's losses, Partnership' acquisition of Corp2, coupled with Corp2's acquisition of Corp4 and the merger of Corp5 into Corp3, comes within the prohibition of section 269. Alternatively, Corp2's acquisition of Corp4, in conjunction with the subsequent merger of Corp5 into Corp3, is also within the scope of the section 269 prohibition. *See Vulcan Materials, supra*, 446 F.2d at 698.

D. The *Libson Shops* Doctrine

In *Libson Shops, Inc. v. Koehler*, 353 U.S. 382 (1957), the Supreme Court held that pre-merger NOL carryovers could not be applied against post-merger income produced by a different business from the one which originally produced the carryovers. That case involved the merger of 16 commonly-owned operating corporations into another commonly owned corporation that provided management services to the other 16 corporations before the merger. After the merger, each of the former 16 corporations was operated as a branch of the surviving corporation. The businesses of three of the absorbed corporations operated at losses, both before and after the merger. The surviving corporation sought to apply the pre-merger NOL carryovers of the three absorbed corporations to its aggregate post-merger income. The Supreme Court disallowed the carryovers "since the income against which the offset is claimed was not produced by substantially the same businesses which incurred the losses." 353 U.S. at 390.

Although *Libson Shops* was decided in 1957, it involved tax years 1948 and 1949, which were governed by the Internal Revenue Code of 1939. The 1939 Code contained no statutory provisions explicitly providing for the inheritance of a corporation's NOL carryovers by a successor corporation or for the disallowance of inherited NOL carryovers where a change of ownership occurs. However, the taxpayer in *Libson Shops* would have prevailed under sections 381(a) and 382 of the 1954 Code.

In Rev. Rul. 58-603, 1958-2 C.B. 147, the Service announced that it would not apply the *Libson Shops* doctrine to the acquisition of a loss company's assets in a transaction described in section 381(a). In Rev. Rul. 63-40, 1963-1 C.B. 46, the Service announced that it would not apply *Libson Shops* if there was less than a 50% shift in the benefits of the NOL carryover attributable to a discontinued business. At the same time, the Service left open the possibility of contesting the availability of the carryover against income of a new activity where there is more than a minor change in stock ownership of a loss corporation that acquires a new business enterprise.

[redacted]

In *Maxwell Hardware Co. v. Commissioner*, 343 F.2d 713 (9th Cir. 1965), the Ninth Circuit held that the *Libson Shops* doctrine is not applicable to any case arising under the 1954 Code. The Sixth Circuit reached a similar conclusion in *Frederick Steel Co. v. Commissioner*, 375 F.2d 351 (6th Cir. 1967), *cert. denied*, 389 U.S. 901 (1967). In *National Tea Co. v. Commissioner*, 793 F.2d 864 (7th Cir. 1986), the Seventh Circuit applied *Libson Shops* in the context of a carryback of NOLs but indicated that it viewed the regulatory scheme contained in sections 381 and 382 of the 1954 Code as displacing the previously applicable judicial scheme for NOL carryovers. Other courts have suggested, but have not expressly held, that the doctrine was replaced by the 1954 Code. *See Exel Corp. v. United States*, 451 F.2d 80 (8th Cir. 1971); *Daytona Beach Kennel Club v. Commissioner*, 69 T.C. 1015 (1980). The Service announced in Technical Information Release No. 773 (October 13, 1965) that it disagreed with the Ninth Circuit's holding in *Maxwell Hardware* and that it would continue to apply *Libson Shops* "in any loss carryover case under the 1954 Code . . . where there has been both a 50 percent or more shift in the benefits of a loss carryover . . . and a change in business as defined in section 382(a) and the regulations thereunder."

In adopting the 1986 amendments to section 382, Congress declared that the *Libson Shops* doctrine would not apply to transactions subject to the provisions of section 382 as amended by the 1986 Act. *See* H. R. Conf. Rep. No. 99-841 at II-194 (1986).

The acquisition of Corp2 in the instant case is not governed by the 1986 amendments to section 382 and therefore falls under the 1954 Code. The position announced in T.I.R. No. 773, *supra*, arguably would permit application of the *Libson Shops* doctrine in this case since the ownership of Corp2 changed in Year6 and Corp2's business appears to have changed.

<u>CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:</u>

[redacted]

[redacted]

[redacted]

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If you have any further questions, please call (202) 622-7930.

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