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# The Carryforward of Net Operating Losses and Other Tax Attributes after Bankruptcy Reorganizations.

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# THE CARRYFORWARD OF NET OPERATING LOSSES AND OTHER TAX ATTRIBUTES AFTER BANKRUPTCY REORGANIZATIONS

**MARTIN M. VAN BRAUMAN***


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## I. INTRODUCTION

With the 1980s being referred to as the decade of the leveraged buyouts ("LBOs"), the 1990s probably will be known as the decade of the bankruptcy reorganizations caused by such LBOs. Foremost in the current bankruptcy reorganizations is the possible acquisition of a debtor corporation solely for net operating loss carryforwards and other tax attributes, which would permit the acquiring corporation to shelter future income.

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When stock is exchanged for debt in a bankruptcy reorganization, potentially abusive tax situations can result if the reorganization occurs strictly for the carryforward of tax attributes to the acquiring corporation. The basic question is to what extent the discharge of indebtedness provisions,[1] the application of the various statutory and judicial requirements pursuant to a "G" reorganization under section 368,[2] the limitation rules of section 382,[3] and the consolidated return regulations prohibit or restrict the carryforward of the tax history of the debtor corporation.

Bankruptcy reorganization for a corporation under Chapter 11[4] of the Bankruptcy Code can take the form of either a recapitalization,[5] in which the reorganization occurs within a single corporation and the debtor corporation survives, or a reorganization in which the assets are transferred from the liquidating debtor corporation to another corporation. The scope of this article is concerned with the reorganization situation, where the tax attributes of the debtor corporation are transferred to a non-affiliated corporation in an acquisitive "G" reorganization.[6]

Because a "G" reorganization usually involves a discharge of debt, Internal Revenue Code ("I.R.C.") section 108 determines the tax treatment for the debtor corporation and the extent of any reduction of the tax attributes to the debtor based upon the debt discharge.

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1. I.R.C. § 108 (1986) (income from discharge of indebtedness). Unless otherwise indicated, references are to the Internal Revenue Code of 1986 and will be labeled as "I.R.C." References to the Bankruptcy Code sections will be identified as such. References to regulations are to Treasury Regulations.

2. I.R.C. § 368(a)(1)(G) (1989) (the definition of a "G" corporate reorganization).

3. I.R.C. § 382 (1987) (a change in ownership of fifty percent or more of a corporation triggers tax attribute limitations).

4. Note: Although for bankruptcy purposes an estate is created under 11 U.S.C. § 541 (Bankruptcy Code), I.R.C. § 1399 provides that a separate taxable entity is not created when a corporation files bankruptcy. A separate taxable entity is created pursuant to I.R.C. § 1398 when an individual files for bankruptcy under chapter 11.

5. A recapitalization has been defined as the "readjustment of the financial structure of a single corporation." BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 14.17, at 14-76 (5th ed. 1987); *see* Helvering v. Southwest Consolidated Corp., 315 U.S. 194, 202 (1942) (definind recapitalization as "reshuffling of a capital structure within the framework of an existing corporation").

6. However, transactions involving a bankrupt corporation, not satisfying the "G" reorganization provisions, may qualify as another type of nontaxable reorganization under section 368(a)(1). S. REP. NO. 1035, 96th Cong., 2d Sess. 20 (1980); H.R. REP. NO. 833, 96th Cong., 2d Sess. 16 (1980). The other reorganization possibilities of qualifying for a nontaxable transaction are beyond the focus of this article.

I.R.C. section 381(a)(2) allows the acquiring corporation in a "G" reorganization to receive the tax attributes of the debtor corporation, such as net operating losses. However, the disallowance provisions of sections 382, 269 and, if an affiliated group is involved, the consolidated return regulations, may limit or prohibit the use of such tax benefits.

This article reviews the substantive tax law under the provisions of the Internal Revenue Code with respect to the cancellation of indebtedness rules, the requirements of a "G" reorganization, section 382 as applied to a "G" reorganization, and the relevant consolidated return limitations.

## II. Discharge Of Indebtedness Under I.R.C. Section 108

Discharge of indebtedness income results when a creditor accepts less than full payment for an amount of indebtedness.[7] Unless excluded by a judicial or statutory exception, the cancellation of indebtedness income is included in the gross income of the debtor.[8] Historically, the courts developed a common law stock-for-debt exception in which a corporation realizes no discharge of indebtedness income on the exchange of its stock for its outstanding indebtedness.[9]

Under section 108(a)(1)(A),[10] which restricts the common law stock-for-debt exception, the discharge of indebtedness income is not included in the debtor's gross income, but the debtor must reduce its tax attributes pursuant to sections 108(b) and 1017.[11] If an insolvent

7. Prop. Treas. Reg. § 1.108-1, 55 Fed. Reg. 50568.01 (1990). If new debt is exchanged for old debt, debt discharge income is realized when the issue price of the new debt is less than the adjusted principal amount of the old debt. Rev. Rul. 77-437, 1977-2 C.B. 28.

8. I.R.C. § 61(a)(12) (1985) (gross income defined); Treas. Reg. § 1.61-12 (1980). *See* United States v. Kirby Lumber Co., 284 U.S. 1, 3 (1931) (gross income includes solvent debtor's extinguishment of debt for less than face value).

9. *See* Motor Mart Trust v. Commissioner, 4 T.C. 931, 937 (1945), *aff'd*, 156 F.2d 122 (1st Cir. 1946), *acq.*, 1947-1 C.B. 3 (stock was considered as substitute liability for debt which did not create cancellation of indebtedness); *see also* Colonial Sav. Ass'n v. Commissioner, 85 T.C. 855, 863 (1985), *aff'd*, 854 F.2d 1001 (7th Cir. 1988), *cert. denied*, 489 U.S. 1090 (1989); Tower Bldg. Corp. v. Commissioner, 6 T.C. 125 (1946), *acq.*, 1947-1 C.B. 4.

10. I.R.C. § 108(a)(1)(A) (1986) (exclusion from gross income). Section 108(a) excludes insolvent debtors, or debtors under title 11 proceedings, from the general rule of section 61(a)(12) that cancellation of indebtedness is included in gross income. I.R.C. § 108(a)(1) (1986) is limited to a title 11 case and does not extend to receivership, foreclosure, or similar proceedings as under the "G" reorganization definition. *See* I.R.C. §§ 368(a)(3)(A), (B) (1989) ("title 11 or similar case" is defined differently for a "G" reorganization).

11. If the amount of the discharge of indebtedness income exceeds the amount of the tax

corporation is not in title 11 proceedings, the cancellation of indebtedness income is excluded from gross income to the extent of its insolvency and any excess results in income recognition.[12]

Section 108(b) requires the tax attributes of the debtor to be reduced in a specified order to the extent the debt cancellation income was excluded from gross income under section 108(a). Any remaining exclusion reduces the basis of the debtor's property.[13]

In Revenue Ruling 90-87,[14] a corporation is under the jurisdiction of the bankruptcy court in a title 11 case and is indebted to an unrelated creditor for $500,000. Pursuant to the court reorganization, preferred stock with a redemption price of $300,000 and a liquidation preference of $300,000 is exchanged for the indebtedness.

Revenue Ruling 90-87 holds that the section 108(a) exception applies only to the extent of the $300,000 redemption price and liquidation preference of the preferred stock.[15] Although the discharge of indebtedness income was not included in gross income under section 108(a)(1)(A), tax attributes are reduced in accordance with section 108(b) and 1017.[16] Also, the "*de minimis* rule" of section 108(e)(8)(A) disallows the common law stock-for-debt exception if nominal or token stock is issued. A facts and circumstances inquiry is made to prevent the stock-for-debt exception from being circumvented by the issuance of nominal or token shares to a creditor with-

attributes, the excess is disregarded. S. REP. NO. 1035, 96th Cong., 2d. Sess. 2 (1980); Prop. Treas. Reg. § 1.108-1, 55 Fed Reg. 50568-01 (1990). A debtor under a title 11 proceeding or an insolvent debtor may avoid the reduction of tax attributes of section 108(b)(1) by an election to reduce the basis of depreciable property by the amount of the excluded cancellation of indebtedness. I.R.C. § 108(b)(5) (1986). The purpose of the section 108(b)(5) election is to provide the debtor flexibility in determining whether to preserve net operating loss carryovers or its depreciation deductions subsequent to the debt discharge transaction. To the extent of the basis reduction of depreciable property, section 1017(d) subjects such reductions to recapture rules similar to sections 1245 and 1250 on early property disposition. For taxable years after 1989, section 56(g)(4)(B)(i) provides that cancellation of indebtedness income, which is excluded from gross income under section 108(a), is not subject to the alternative minimum tax under section 55. I.R.C. § 56(g)(4)(B)(i) (1989).

12. I.R.C. § 108(a)(3) (1986) (insolvency exclusion from gross income). Insolvency is determined by the excess of the liabilities over the fair market value of the debtor's assets before the discharge. I.R.C. § 108(d)(3) (1986). If stock is exchanged for debt, the fair market value of the stock, not the underlying assets, determines the cancellation of indebtedness income. I.R.C. § 108(e)(10)(A) (1990).

13. *See* I.R.C. § 1017 (1986) (discharge of indebtedness).

14. Rev. Rul. 90-87, 1990-43 I.R.B. 4.

15. *Id.*

16. *Id.*

out any real equity interest in the corporation.[17] The proposed regulations provide a nonexclusive list of factors to consider for the facts and circumstances test to determine nominal or token stock.[18]

When a class of stock is considered nominal or token, it is treated as satisfying an amount of indebtedness equal to its fair market value.[19] Usually, the stock's par value[20] substantially exceeds the fair market value of the stock, which results in a large amount of indebtedness discharge income being realized. Any discharge of indebtedness income excluded from gross income to the extent provided under section 108(a) requires a reduction of tax attributes under section 108(b).[21]

Further, the common law stock-for-debt exception does not apply for an unsecured creditor if the ratio of the value of the stock received to the amount of the creditor's indebtedness cancelled or exchanged for stock is less than fifty percent of the same ratio computed for all unsecured creditors.[22]

As an additional restriction to the common law stock-for-debt exception, section 108(e)(10)(A) eliminates this exception and the debtor corporation realizes discharge of indebtedness income to the extent the amount of the indebtedness exceeds the fair market value of the stock issued in exchange for the indebtedness.[23] However, section 108(e)(10)(B) provides that the above subparagraph (A) does not apply, and the common law stock-for-debt exception does apply, if the debtor is in a title 11 proceeding, or to the extent a debtor is

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17. S. REP. NO. 1035, 96th Cong., 2d. Sess. 17(1980); Prop. Treas. Reg. § 1.108-1, 55 Fed. Reg. 50568.01 (1990).

18. Prop. Treas. Reg. § 1.108-1(b)(1)(i), 55 Fed. Reg. 50568.01 (1990) outlines the most important factor, known as a "stock to debt ratio." Prop. Treas. Reg. § 1.108-1(b)(1)(ii) (1990) provides a second factor, known as a "stock to total consideration ratio." The third factor under Prop. Treas. Reg. § 1.108-1(b)(1)(iii), 55 Fed. Reg. 50568.01 (1990) is a "stock to total stock ratio." Special rules apply for preferred stock in calculating the "stock to debt ratio" under Prop. Treas. Reg. § 1.108-1(b)(2)(i), 55 Fed. Reg. 50568.01 (1990). Safe harbor percentages are proposed for each ratio under Treas. Reg. § 1.108-1(c) (1990).

19. *See* Prop. Treas. Reg. § 1.108-1, 55 Fed. Reg. 50568.01 (1990) (stock issued in exchange for indebtedness).

20. Par value refers to the dollar amount assigned to the shares by the company. BLACK'S LAW DICTIONARY 1011 (5th ed. 1979).

21. Prop. Treas. Reg. § 1.108-1, 55 Fed. Reg. 50568.01 (1990).

22. I.R.C. § 108(e)(8)(B) (1986) (de minimis rule for unsecured creditors).

23. I.R.C. § 108(e)(10)(A) (1986) provides that for purposes of determining income of a debtor from discharge of indebtedness, if a debtor corporation transfers stock to a creditor in satisfaction of its indebtedness, such corporation shall be treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock. *Id.*

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insolvent.[24]

If the common law stock-for-debt exception applies pursuant to section 108(e)(10)(B), gross income does not result from the exchange and the exclusion under section 108(a) does not apply.[25] With no gross income to exclude under section 108(a), no reduction of tax attributes occurs under sections 108(b) and 1017.[26]

Historically, the common law stock-for-debt exception was limited to exchanges of the debtor's corporate stock for the debtor's corporate debt.[27] However, if the debtor corporation is involved in a reorganization, the common law stock-for-debt exception to income recognition applies when stock of the acquiring corporation is exchanged for the liabilities held by the debtor's creditors.[28]

## III. "G" Reorganizations Under I.R.C. Section 368(a)(1)(G)

### A. *The Code Requirements For a "G" Reorganization*

Under I.R.C. section 368(a)(1)(G), a "G" reorganization is a "transfer by a corporation of all or part of its assets to another corporation in a title 11 or similar case; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356."[29] A title 11 or similar case is defined as a case under title 11 of the United States Code, or a receivership, foreclosure, or similar proceeding in a federal or state court.[30]

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24. I.R.C. § 108(e)(10)(B) was amended by the Revenue Reconciliation Act of 1990 to prevent its application if the stock has a stated redemption price and the stock either has a fixed redemption date or is redeemable at the option of the issuer or the holder (referred to as "disqualified stock"). Also, disqualified stock is not considered to be stock for purposes of the *de minimis* rule of section 108(e)(8). Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388 (1990).

25. Prop. Treas. Reg. § 1.108-1, 55 Fed. Reg. 50568.01 (1990).

26. *Id.*; *see* STAFF OF JOINT COMM. ON TAXATION, 98TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 168 (Comm. Print 1984).

27. S. REP. NO. 1035, 96th Cong., 2d Sess. 17 (1980), *reprinted in* 1980-2 C.B. 620, 625.

28. H.R. REP. NO. 833, 96th Cong., 2d Sess. 34 (1980); S. REP. NO. 1035, 96th Cong., 2d Sess. 34 (1980).

29. I.R.C. § 368(a)(1)(G) (1989) (the "G" reorganization can be either acquisitive or divisive in nature). I.R.C. § 368(b) includes parent corporations in "G" asset acquisitions as "a party to a reorganization."

30. I.R.C. § 368(a)(3)(A) (1989)(definition of "title 11 or similar case"). A transfer of assets of a corporation is treated as made in a title 11 or similar case only if "any party to the

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Section 368(a)(3)(C) gives "G" reorganization provisions exclusive jurisdiction over any transaction that also would qualify under the other types of section 368(a)(1) reorganizations, qualify as a section 332 liquidation, or qualify as a section 351 transfer to a controlled corporation.[31] The "G" reorganization provision does not require compliance with state merger laws as does an "A" reorganization under section 368(a)(1)(A). A "G" reorganization does not require that the debtor corporation receive solely stock (subject to the boot relaxation rules)[32] of the acquiring corporation in exchange for its assets as does a "C" reorganization under section 368(a)(1)(C). Also, former shareholders of the transferor corporation are not required to continue control over the transferee corporation as for a "D" reorganization under section 368(a)(1)(D).

Under a court approved reorganization plan, the transfer of assets for stock and securities is a nontaxable exchange to the transferor-debtor corporation under section 361,[33] and is nontaxable to the exchanging shareholders and security holders under section 354 for acquisitive, or 355 for divisive, reorganizations.[34] The exchanging security holders are taxed to the extent that consideration is attributable to accrued interest on their securities prior to the transfer.[35]

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reorganization is under the jurisdiction of the court in such case, and the transfer is pursuant to a plan of reorganization approved by the court." I.R.C. § 368(a)(3)(B) (1989). Section 368(a)(3)(B)(ii) requires a plan of reorganization approved by the court, which indicates that a "G" reorganization is not possible in a liquidating bankruptcy under Chapter 7 of the Bankruptcy Code. *See* 11 U.S.C. §§ 101-1330 (1988).

31. *See* I.R.C. § 351(e)(2) (1989) (section 351 does not apply with stock received to satisfy the indebtedness of debtor under title 11 or similar case as defined by section 368(a)(3)(A)).

32. I.R.C. § 368(a)(2)(B) (1989) (other consideration in "C" reorganization).

33. No gain or loss will be recognized by the debtor corporation upon the transfer of substantially all of its assets under section 361 and the assumption by the transferee of the related liabilities under section 357(a). Note: Under chapter 11 reorganization cases, pre-bankruptcy tax claims for a corporation are dischargeable, but must be provided for in the plan of reorganization. 11 U.S.C. § 1129(a)(9)(C) (1988) (bankruptcy code). Additionally, the general rule with respect to liabilities in excess of basis on transfers to controlled corporations under section 357(c)(2) does not apply to for any exchange pursuant to a plan of reorganization under section 368(a)(1)(G), when no former shareholder of the transferor corporation receives any consideration for his stock.

34. However, as in all nontaxable exchanges, the respective parties receive either substituted basis or carryover basis to the extent of the nonrecognition property. *See* I.R.C. § 358(a) (1986) (substituted basis to distributees); I.R.C. § 362(b) (1988) (carryover basis to corporations).

35. I.R.C. § 354(a)(2) (1980) (excess principal amount limitation in acquisitive transactions); I.R.C. § 355(a)(3) (1980) (excess principal amount limitation for divisive transactions).

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The shareholders or security holders may prefer to structure a taxable exchange if they have losses to recognize because losses are not recognized by the nontaxable provisions of sections 354 and 355.[36] Likewise, boot recognition in an exchange may be desirable, if the distribution (treated as a dividend under the general dividend-equivalence test of section 356(a)(2))[37] is to a corporate shareholder that is allowed the seventy percent dividend deduction pursuant to section 243(a)(1).[38]

Because nonrecognition for exchanges of nonsecurity debts is not provided for in section 354, nonsecurity creditors recognize a gain or loss upon the receipt of stock or debt in exchange for their original debt.[39] Also, section 351(d) eliminates nonsecurity debt of the transferee from the definition of "property" for nonrecognition purposes. If the stock value is less than the basis of the claim, the nonsecurity creditors have a bad debt loss[40] and the stock received is subject to the recapture rules under I.R.C. section 108(e)(7).[41]

Section 368(a)(1)(G) requires the transaction to qualify under sec-

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Note: Section 351(d) eliminates accrued interest on the transferee's debt from the definition of property for nonrecognition purposes under section 351(a).

36. Also, assets receive stepped-up basis versus a carryover basis in a taxable exchange. Under I.R.C. § 1032, the exchange is not taxable to the acquiring corporation, whether or not the exchange is taxable or nontaxable to the acquired corporation and its stockholders.

37. I.R.C. § 356(a)(2) (1982) (test of whether additional consideration to receive treatment as dividend or gain from exchange of property).

38. I.R.C. § 243(a)(1) (1987) (dividends received by corporations).

39. Generally, debt instruments with a five year term or less are not considered securities; whereas, debt instruments with a ten year or more term are classified as securities. BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, 14.31, at 14-119 (5th ed. 1987). For example, open account trade payables do not constitute a security for purposes of sections 354, 355, or 356. *See* Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462, 470 (1933) ("short-term purchase-money notes" payable within four months are not securities); Camp Wolters Enter., Inc. v. Commissioner, 22 T.C. 737, 750-753, *aff'd*, 230 F.2d 555 (5th Cir. 1954), *cert. denied*, 352 U.S. 826 (1956) (notes held as securities with maturities in five to nine years). The Fifth Circuit in *Camp Wolters* affirmed and quoted the Tax Court as follows:

> The test as to whether notes are securities is not a mechanical determination of the time period of the note. Though time is an important factor, the controlling consideration is an overall evaluation of the nature of the debt, degree of participation and continuing interest in the business, the extent of proprietary interest compared with the similarity of the note to a cash payment, the purpose of the advances, etc. It is not necessary for the debt obligation to be equivalent of stock since Sec. 112(b)(5) [section 351(a) under the 1954 Code] specifically includes both "stock" and "securities." *Camp Wolters*, 230 F.2d at 560.

40. I.R.C. § 166 (1986) (bad debt deduction).

41. *Id.* § 108(e)(7) (recapture of gain on subsequent sale of stock).

tions 354, 355, or 356, in which stock or securities of the transferor is exchanged for stock or securities of the transferee. However, an exchange does not qualify under sections 354, 355, or 356, if the former shareholders of the transferor corporation do not retain any equity interest after the exchange and all corporate creditors held only short-term debt or trade accounts prior to the exchange.[42] Thus, nonsecurity creditors are not regarded as "shareholders" for purposes of finding an exchange qualifying under a "G" reorganization.[43]

No gain or loss will be recognized by the acquiring corporation upon receipt of the assets and assumption of the liabilities from the debtor corporation in exchange for the stock of the acquiring corporation under section 1032(a).[44] The basis of the assets received by the acquiring corporation will be a carryover basis under section 362(b) with a tacking of the holding period.[45] The taxable year of the debtor corporation will close on the date of the transfer of assets.[46] The acquiring corporation will "succeed to, and take into account" the tax attributes described in section 381(c), subject to the applicable conditions and limitations in sections 381, 382, 383, and 384.[47]

An acquisitive "G" reorganization must satisfy section 354(b), which requires a transfer of substantially all of the corporation's assets; a distribution of the received stock, securities, and other property; and the corporation's complete liquidation.[48] For an acquisitive reorganization under section 354(b)(1), the tax history of the debtor corporation carries over to the transferee.[49] Also, in a nondivisive "G" reorganization satisfying section 354(b)(1), dropdowns (the

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42. *See* Treas. Reg. § 1.368-1(b) (1986) ("a short-term purchase money note is not a security of a party to a reorganization"). Open account trade payables do not constitute a security for purposes of I.R.C. §§ 354, 355, or 356. *Pinellas Ice & Cold Storage Co.*, 287 U.S. at 469-70.

43. Helvering v. Southwest Consolidated Corp., 315 U.S. 194, 202 (1942). Nonsecurity creditors may satisfy the continuity of interest by acquiring a proprietary interest in the insolvent corporation under Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179 (1942), but Congress requires security holders of the transferor corporation to satisfy the reorganization pursuant to section 368, which is a reorganization based upon exchanges of "stock" and/or "securities." *Southwest Consol.* 315 U.S. at 202.

44. *See* Rev. Rul. 57-278, 1957-1 C.B. 124.

45. I.R.C. § 1223(2) (1989) (holding period of property).

46. *Id.* § 381(b)(1) (operating rules for the carryovers in certain corporate acquisitions).

47. *Id.* § 381(a)(2) (general rule for carryovers in acquisitive reorganizations); Treas. Reg. § 1.381(a)-1 (1975) (general rule for carryovers in certain corporate acquisitions).

48. I.R.C. § 354(b)(1) (1980) ("substantially all" exception).

49. I.R.C. § 381(a)(2) (1989).

transfer of assets or stock to subsidiaries) are permitted.[50]

During bankruptcy, substantial assets may be distributed to satisfy various creditors, which would reduce the remaining assets for the "substantially all" transfer to the transferee. Whether "substantially all" of the transferor's assets have been transferred to satisfy section 354(b)(1)'s purposes is a facts and circumstances determination for each particular case.[51] Letter rulings concerning "G" reorganization provisions contend, as a safe harbor, that the acquiring corporation should acquire more than fifty percent of the fair market value of the gross assets and more than seventy percent of the fair market value of the operating assets held by the acquired corporation as of the date it was determined that the acquired corporation could no longer be operated as an independent going concern.[52]

Because section 381(a)(2) does not apply to divisive reorganizations, there is no carryover of tax attributes in "G" reorganizations under section 355.[53] A divisive reorganization[54] must satisfy section 355, which requires that (1) the stock exchanged or distributed must be stock of a controlled (eighty percent or more) corporation, (2) the transaction must not be used principally as a device for the distribution of the earnings and profits from the distributing corporation or controlled corporation, and (3) the active business requirement[55] must

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50. *Id.* § 368(a)(2)(C) (transfers of assets or stock to subsidiaries).

51. H.R. REP. NO. 833, 96th Cong., 2d Sess., pt. 16, at 31 (1980); S. REP. NO. 1035, 96th Cong., 2d Sess. 20, 35-36 (1980) (legislative history indicates that retention or sale of assets to pay creditors' claims may be considered necessary in context of insolvency reorganization, in determining the "substantially all" test, and "in order to leave the debtor with more manageable operating assets to continue in business"). *See* Rev. Rul. 57-518, 1957-2 C.B. 253 (retention of nonbusiness assets to discharge creditors' claims, rather than retention of operating assets, would represent "substantially all" transfer).

52. Priv. Ltr. Rul. 85-21-083 (Feb. 27, 1985); Priv. Ltr. Rul. 85-03-064 (Oct. 24, 1984) (operating assets defined as all assets other than cash, accounts receivable, and investment assets).

53. *See* I.R.C. § 312(h) (1988); Treas. Reg. § 1.312-10 (1991) (allocation of earnings and profits between distributing and controlled corporations under divisive reorganization).

54. Divisive reorganizations under section 355 are classified as either a spin-off, split-off, or split-up. A spin-off (similar to a dividend distribution) occurs when the stock of a subsidiary is distributed to the shareholders of the parent corporation. A split-off (similar to a redemption) occurs when the shareholders of the parent surrender all or part of their stock in the parent in exchange for the stock of a subsidiary. A split-up (similar to a liquidation) occurs when the parent corporation liquidates and distributes its stock in its subsidiaries to its shareholders. *See generally* BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, 13.01-13.02 (5th ed. 1987).

55. I.R.C. § 355(b) (1986) (requirements for active business).

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be met.[56]

Forward triangular mergers[57] are permitted for a "G" reorganization[58] and section 368(a)(3)(E) allows reverse triangular mergers[59] under section 368(a)(2)(E) for insolvency reorganizations. However, for reverse mergers, the shareholders of the debtor corporation cannot receive consideration for their stock and the former creditors of the debtor corporation must receive voting stock of the acquiring corporation's parent equal to eighty percent or more of the total fair market value of the debt of the debtor-surviving corporation.[60]

Also, discharge of indebtedness income does not arise in a triangular ("G") reorganization, in which indebtedness of the transferor (in a forward merger) or transferee (in a reverse merger) is exchanged for stock of the transferee's parent (in a forward merger) or stock of the transferor's parent (in a reverse merger).[61]

### B. *The Judicial Continuity of Interest Requirement Under a Reorganization*

The "continuity of interest" requirement must be satisfied to meet the nonrecognition treatment under a "G" reorganization.[62] Under

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56. I.R.C. § 355(a) (1986) (general rule for distribution of stock and securities of controlled corporation).

57. A forward triangular merger occurs when a target corporation merges into a controlled subsidiary with the controlled subsidiary as the surviving entity and the target shareholders exchanging their stock for stock of the parent corporation. BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, 14.15, at 14-62 (5th ed. 1987).

58. I.R.C. § 368(a)(2)(D) (1989) (stock of acquiring corporation cannot be used in transaction).

59. A reverse triangular merger occurs when a controlled subsidiary merges into a target corporation with the target as the surviving entity and the target shareholders exchanging their stock for the stock of the parent corporation. BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, 14.15, at 14-62 (5th ed. 1987).

60. I.R.C. § 368(a)(3)(E) (1989) (application of title 11 or similar case to reverse triangular merger).

61. Rev. Rul. 59-222, 1959-1 C.B. 80. The ruling provides that the common law stock-for-debt exception applies in a triangular reorganization and discharge of indebtedness income does not arise. *Id.*

62. Treas. Reg. § 1.368-1(b) (1990) states that:

> The purpose of the reorganization provisions of the Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures made in one of the particular ways specified in the Code, as are required by business exigencies and which effect only a readjustment of continuing interest in property under modified corporate forms. Requisite to a reorganization under the Code are a con-

the nonstatutory "continuity of interest" rule, the owners of the acquired corporation must continue to have a proprietary interest in the acquiring corporation.[63]

Continuity of interest does not exist if the shareholders of the acquired corporation receive only short-term notes[64] or bonds.[65] In an insolvency reorganization, former shareholders may receive nothing and only creditors of the acquired corporation receive a continuing interest in the acquired corporation by stock ownership in exchange for their outstanding claims.

In *Helvering v. Alabama Asphaltic Limestone Co.*,[66] the Supreme Court held that the creditors, upon filing for involuntary bankruptcy reorganization, "had effective command over the disposition of the property" and that this was the equivalent of a proprietary interest.[67] Because the creditors' interests were maintained in the reorganized corporation, the continuity of interest doctrine was satisfied despite the elimination of the former shareholders.[68]

Bona fide creditors who receive stock in the new corporation are

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tinuity of the business enterprise under the modified corporate form, and (except as provided in section 368(a)(1)(D)) a continuity of interest therein on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the reorganization.

63. *See* Southwest Natural Gas Co. v. Commissioner, 189 F.2d 332, 334 (5th Cir.), *cert. denied*, 342 U.S. 860 (1951) ("continuity of interest" test must be met before court will find merger under reorganization plan). The continuity of interest test is satisfied when it is found that (1) the "transferor corporation or its shareholders retained a substantial proprietary stake in the enterprise represented by a material interest in the affairs of the transferee corporation, and (2) that such retained interest represents a substantial part of the value of the property transferred." *Id.*

64. Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462, 470 (1933) ("an interest in the affairs of the purchasing company more definite than that incident to ownership of its short-term purchase-money notes" is required for valid reorganization).

65. Le Tulle v. Scofield, 308 U.S. 415, 420-21 (1940) (transferor does not retain "any proprietary interest in the enterprise" when only consideration exchanged is cash and transferee's bonds).

66. Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179 (1942).

67. *Id.* at 184; *see* Helvering v. Southwest Consol. Corp., 315 U.S. 194, 198 (1942) (creditors of debtor corporation acquired substantially all of proprietary interest of former shareholders).

68. *Helvering*, 315 U.S. at 184; H.R. REP. No. 833, 96th Cong., 2d Sess. 16, 31-32 (1980); S. REP. No. 1035, 96th Cong., 2d Sess. 20, 36 (1980). Under "G" reorganizations, short-term creditors who receive stock for their claims, although they must still recognize gain or loss for income tax purposes, are included within the continuity of interest. *Helvering*, 315 U.S. at 184. The Committee Reports to the Bankruptcy Tax Act affirm the continuity principles derived from Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179 (1942) and Atlas Oil & Refining Corp. v. Commissioner, 36 T.C. 675 (1961), *acq.*, 1962-2 C.B. 3.

deemed, by relation back, to have been equity owners at the time of the transfer in order to satisfy the continuity of interest requirement of stock transferring to former owners.[69] For purposes of determining continuity of interest, the most senior class of creditor to receive stock and all equal and junior classes (including shareholders who receive any consideration for their stock) are counted as the equity owners of the debtor corporation.[70]

The creditor classes, counted as "former shareholders," must receive a substantial proprietary interest in the new corporation.[71] Although a substantial interest is a facts-and-circumstances determination, the tax court has determined that the continuity is satisfied if the "former shareholders" own more than a fifty percent interest in the assets immediately after the transfer based upon the percentage of the consideration received by the "former shareholders" to the total consideration received by all "former shareholders" and other equity holders.[72]

If a third-party corporation purchases a dominant creditor position in a debtor corporation solely to acquire net operating loss carryforwards upon a bankruptcy reorganization, the continuity of interest would not exist from the historic creditors of the debtor corporation to qualify as a nontaxable "G" reorganization.[73] The nontaxable re-

69. Atlas Oil & Ref. Corp. v. Commissioner, 36 T.C. 675, 688 (1961), *acq.*, 1962-2 C.B. 3. The court considered the issue of which classes of creditors should be treated as "former shareholders" for continuity of interest purposes when some creditor classes received stock and other creditor classes received non-stock consideration. *Id.* at 677-678. In *Atlas Oil*, the first mortgage bondholders exchanged their securities for new bonds and the second mortgage bondholders exchanged their securities for new bonds and preferred stock. *Id.* at 677. The ordinary creditors received cash and the old shareholders received nothing. *Id.* at 678. For continuity purposes, all classes of creditors receiving stock (the second bondholders) and all classes junior to the class receiving stock (the ordinary creditors) were counted. *Id.* at 689. The first bondholders were not counted as a class for continuity purposes. *Id.*

70. SENATE FINANCE COMMITTEE REPORT ON BANKRUPTCY TAX ACT OF 1980, H.R. REP. NO. 833, 96th Cong., 2d Sess. 16, 31-32 (1980); S. REP. NO. 1035, 96th Cong., 2d Sess. 20, 36 (1980), 1980-2 C.B. 620, 637.

71. *Atlas Oil*, 36 T.C. at 690.

72. *Id.* at 690-91.

73. *See* Superior Coach of Fla., Inc. v. Commissioner, 80 T.C. 895, 904 (1983) (continuity doctrine requires distinguishing sale from a reorganization). In *Superior Coach*, the taxpayer purchased stock from the shareholders of a target corporation with net operating losses and on the following day merged the target corporation with the taxpayer's corporation to utilize the net operating loss carryforward. *Id.* at 905. The court ruled that a continuity of interest of the historic shareholders did not exist to qualify the merger for a valid section 368(a) reorganization, since the recently acquired stock of the target corporation was not considered "old and cold" in the hands of the taxpayer. *Id.* at 907. In *Yoc Heating Corp. v. Commissioner*, 61 T.C.

organization provisions under section 368(a) require that the historic owners retain a continuing interest in the reorganized corporation.[74]

The requirement of the continuity of interest of the historic owners "was born of a judicial effort to confine the tax-free reorganization provisions to their proper function."[75] In a reorganization, "it is necessary to look at the makeup or identity of the shareholders *before* the initial step in the series of steps and those after the final step to ascertain whether the requisite continuity of interest has been maintained by the historic shareholders."[76]

Without a qualifying section 368(a)(1)(G) reorganization for a debtor-creditor exchange, the acquiring corporation would not be entitled to any carryforward tax attributes of the debtor corporation pursuant to I.R.C. § 381(a).[77]

Also, a transaction must satisfy the continuity of business enterprise and business purpose requirements to qualify as a "G" reorganization. The continuity of business enterprise occurs when the acquiring corporation either continues the debtor corporation's historic business or uses a significant portion of the debtor's historic business assets in the business.[78] When a debtor corporation is acquired only to carry over its tax attributes to another corporation through a reorganization, the absence of a business purpose would deny a nontaxable reorganization[79] and section 381(a) would not preserve the tax attributes for the successor corporation.

168 (1973), the taxpayer purchased the stock of a target corporation and ten months later the taxpayer exchanged the assets of the target with the stock of the taxpayer's corporation. *Id.* at 173. The court held that there was a lack of continuity of interest. *Id.* at 178; *see* Estate of McWhorter v. Commissioner, 69 T.C. 650, 664 (1978), *aff'd* (opinion unpublished), 590 F.2d 340 (8th Cir. 1978) (stock interest was not "old and cold" to satisfy continuity of interest requirement); *see* Kass v. Commissioner, 60 T.C. 218, 223 (1973), *aff'd*, 491 F.2d 749 (3d Cir. 1974) (opinion unpublished) (parent's stock not "old and cold" and cannot contribute to continuity of interest).

74. *Superior Coach*, 80 T.C. at 904.

75. *Id.* (citing Cortland Specialty Co. v. Commissioner, 60 F.2d 937, 939-940 (2d Cir. 1932), *cert. denied*, 288 U.S. 599 (1933)).

76. *Superior Coach*, 80 T.C. at 905. The court in *Superior Coach* applied the step-transaction doctrine to determine whether the continuity of interest requirement was satisfied for the historic shareholders. *Id.*

77. *Id.* at 907.

78. Treas. Reg. § 1.368-1(d)(2) (as amended in 1980) (general rule for continuity of business enterprise).

79. *See id.* § 1.368-1(c) (as amended in 1980) (scheme which is an abrupt departure from normal procedures of reorganization, object of which is preconceived plan with no purpose in business, not a plan of reorganization).

Section 381(a)(2) provides that the tax attributes[80] of the debtor corporation carry over to the transferee, if the transaction constitutes a reorganization under sections 368(a)(1)(G) and 354(b)(1) (i.e., an acquisitive reorganization), subject to the limitations of section 382.

## IV. I.R.C. Section 382 As Applied To "G" Reorganizations

### A. *The Special Rule of I.R.C. Section 382(l)(5)(A)*

Section 382 provides a set of limitations to prevent the "trafficking" in net operating loss carryovers, which is extended by section 383 to include other loss and tax credit carryovers.[81] Section 382 is triggered by an ownership change of fifty percent or more of a corporation, resulting from a change involving a "5-percent shareholder or any equity structure shift"[82] from a section 368(a) reorganization.[83]

If an ownership change of a loss corporation results, the maximum amount of its income (or tax) in any post-change year that can be offset by pre-change losses (or credits) is the value of the loss corporation multiplied by the "long-term tax-exempt rate" of section 1274(d),

80. Segal v. Rochelle, 382 U.S. 375 (1966) (Court held that net operating loss carryback, or right to refund, was property of bankruptcy estate); *In re* Prudential Lines, Inc., 107 B.R. 832 (Bankr. S.D.N.Y. 1989), *aff'd*, 114 B.R. 27 (Bankr. S.D.N.Y. 1990) (Bankruptcy Court considered its jurisdiction over non-debtors who claimed interest to tax attributes in dispute). The bankruptcy court in *Prudential Lines*, which relied upon *Segal v. Rochelle*, held that a net operating loss qualified as a bankruptcy code section 541(a) asset of the estate, based upon the tax savings it would produce from estimated future cash flow. *Prudential Lines, Inc.*, 107 B.R. at 836-41.

81. Section 383 adds capital loss, general business credit (such as investment credit and research and development credit), foreign tax credit, and minimum tax credit carryovers to the limitations of section 382. Also, section 384 was added to restrict the utilization of built-in gain items of a profit corporation from the losses of a merging loss corporation. Section 384 prevents the pre-merger losses from offsetting after-merger realized gains by segregating the built-in gain items for a five year period. I.R.C. § 384 (1986).

82. I.R.C. § 382(g)(1)-(2) (1991) (ownership change); *see* Temp. Treas. Reg. § 1.382-2T(e) (as amended in 1989). I.R.C. § 382(k)(7) (1986) and Temp. Treas. Reg. § 1.382-2T(g) (as amended in 1989) define the five percent shareholder. The attribution rules identify the five percent shareholders in which stock owned by an entity is attributed to its owners. Temp. Treas. Reg. § 1.382-2T(h) (as amended in 1989). The option attribution rule treats stock subject to an option as exercised for the purpose of determining whether an ownership change results. Temp. Treas. Reg. § 1.382-2T(h)(4) (as amended in 1989). The aggregation and segregation rules identify public shareholders and public owners in determining public groups as five percent shareholders. Temp. Treas. Reg. § 1.382-2T(j) (as amended in 1989).

83. I.R.C. § 382(g)(3) defines an "equity structure shift" as any reorganization under section 368, except a reorganization under subparagraph (F) and divisive reorganizations under (D) or (G). *See* Temp. Treas. Reg. § 1.382-2T(e) (as amended in 1989).

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plus any unused 382 limitation from prior years.[84]

However, section 382(a) will not apply pursuant to the special rule of section 382(l)(5)(A), if the "old loss corporation"[85] is under bankruptcy jurisdiction and the shareholders and/or creditors of the old loss corporation continue to own at least fifty percent of its qualifying stock after the reorganization.[86] When the special rule of section 382(l)(5)(A) applies, different limitations arise.

First, the pre-change losses and excess credits carried to a post-change year are reduced by any accrued interest on indebtedness exchanged into stock if the interest was accrued during the three years preceding, and including, the taxable year of change.[87] Second, tax attributes are reduced by fifty percent of the amount which would have been applied in reducing tax attributes under section 108(b), except for the stock-for-debt exception of section 108(e)(10)(B).[88] Finally, if a change of ownership in the "new loss corporation"[89] occurs within two years after a reorganization pursuant to the special rule of section 382(l)(5)(A), the section 382(b) limitation is treated as zero after the second ownership change.[90]

However, a new loss corporation may elect not to have this special

84. I.R.C. § 382(a), (b) (1987) (general rule for section 382 limitation). The "long-term tax exempt rate" (a rate of return published periodically in the Internal Revenue Bulletin) is defined under I.R.C. § 382(f) (1986). The section 382(b) limitation is based upon the approximate amount of income that a loss corporation could have received for a return on equity with its capital invested in tax exempt securities. BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, 16.25, at 16-82 (5th ed. 1987). Also, the "anti-stuffing rule" disregards pre-change capital contributions, which are part of a plan to increase the section 382(b) limitation by inflating the loss corporation's section 382(e) value. I.R.C. § 382(l)(1)(1989).

85. The term, "old loss corporation," is defined by I.R.C. § 382(k)(2) as the loss corporation before the ownership change. *See* Temp. Treas. Reg. § 1.382-2T(f) (as amended in 1989).

86. I.R.C. § 382(l)(5)(A) (1989) (operating rules for title 11 or similar case). *See* Prop. Treas. Reg. § 1.382-3(a), 55 Fed. Reg. 33137 (1990).

87. I.R.C. § 382(l)(5)(B) (1989) (reduction for interest payments to creditors).

88. I.R.C. § 382(l)(5)(C)(i) (1989) (cutback rule of section 382(l)(5)(C) only effective when debtor in title 11 case and using the continuity of interest exception of section 382(l)(5)(A) to avoid section 382(g) ownership change). Also, the indebtedness for interest paid or accrued on indebtedness exchanged into stock required to be subtracted from losses and excess credits under section 382(l)(5)(B) is subtracted from the indebtedness amount computed for purposes of section 382(l)(5)(C)(i). I.R.C. § 382(l)(5)(C)(ii) (1989).

89. The term, "new loss corporation," is defined by I.R.C. § 382(k)(3) as a corporation which is a loss corporation after an ownership change. *See* Temp. Treas. Reg. § 1.382-2T(f) (as amended in 1989) (general definitions with respect to ownership change for loss corporations under section 382).

90. I.R.C. § 382(l)(5)(D) (1989) (ownership change within two years).

rule apply and elect to be governed by the general provisions of section 382(a).[91] When a corporation elects out of the special rule, the section 382(e) value of the old loss corporation for purposes of computing the section 382(b) limitation is increased in the amount attributable to the indebtedness discharge under the bankruptcy.[92]

Thus, a corporation in bankruptcy must decide whether or not to elect out of the special rule under section 382(l)(5)(A). The section 382(b) limitation controls the timing of the deductions or credits (i.e., an annual limitation); whereas, section 382(l)(5) actually may eliminate a portion of the tax attributes for future use (i.e., a single reduction). A corporation needs to compare the remaining amount of the tax attributes, if the special rule applies, versus the amount and timing, if the corporation elects out.

For purposes of ownership change[93] under section 382, the term "stock" is defined as stock excluding "straight preferred" stock as described in section 1504(a)(4).[94] "Straight preferred" stock is defined as nonvoting, nonconvertible, nonparticipating preferred stock with redemption and liquidation rights not exceeding the stock's issue price.[95] However, "stock" may be treated as "not stock," if the likely participation in corporate growth is small compared to its value when issued or transferred as a proportion to the total value of the outstanding corporate stock. "Not stock" may be treated as "stock" if it offers a potential of significant participation in the growth of the corporation when issued or transferred.[96]

Section 382 will control the application of section 381 based upon ownership changes, in which the debtor's creditors as well as its former stockholders are considered to the extent of continued ownership. The creditors of a debtor corporation in a title 11 or similar case are

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91. I.R.C. § 382(l)(5)(H) (1989) (election out).

92. I.R.C. § 382(l)(6) (1989) (special rule if election out). For the section 382(l)(6) increase to apply in the value of the section 382(b) limitation, the exchange transaction must be subject to section 368(a)(1)(G) or represent an exchange of debt for stock in a title 11 or similar case as defined in section 368(a)(3)(A).

93. In determining ownership change, the percentage change of stock is based upon value, rather than the number of shares. I.R.C. § 382(k)(6)(C) (1986).

94. I.R.C. § 382(k)(6)(A) (1986) (definition of "preferred stock" and "stock"); *see* Temp. Treas. Reg. § 1.382-2T(f)(18) (as amended in 1989) (definition of "stock").

95. I.R.C. § 1504(a)(4) (1984) (definition of "preferred stock" and "stock").

96. I.R.C. § 382(k)(6)(B) (1986) (regulatory authority to define "stock" for purposes of section 382); *see* Temp. Treas. Reg. § 1.382-2T(f)(18) (as amended in 1989) (defines what is "stock" and "not stock").

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to be treated as equity owners in applying the continuity rules of section 382(b).

The legislative history under the 1954 act indicates that the continuity of interest principle was of fundamental importance to section 382(b), by stating that the former shareholders of the loss corporation indirectly suffered the burden of the net operating losses of the prior years and should represent a certain percentage of the surviving equity ownership that would be entitled to any future loss carryforwards of those prior net operating losses. The legislative history under the Bankruptcy Tax Act of 1980 defined the term "creditor" under section 382 in terms of the historic creditor.

Under the committee conference report,[97] which pertains to the limitations of ownership changes under the 1986 provisions of section 382, historic creditors are creditors known as historic creditors for at least eighteen months before the filing of bankruptcy proceedings or are historic trade creditors.[98] The 1986 and current section 382(l)(5)(E) incorporatesthis definition and defines "creditor" by this mechanical eighteen-month rule for historic creditors or as historic trade creditors.[99]

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97. H.R. REP. No. 841, 99th Cong., 2d Sess. II-194 (1986).

98. *Id.* Only holders of accounts payable, compensation claims and other trade debt arising in the "normal, usual, or customary conduct of its business" would qualify under the second definition of a historic creditor. *Id.* The indebtedness can be "related to ordinary or capital expenditures of the loss corporation." *Id.*

99. Under section 382(l)(5)(E), "old and cold" creditors are defined as having continuously held such indebtedness for at least eighteen months prior to the filing of the bankruptcy petition or whose indebtedness arose in the ordinary course of the corporation's business "and is held by the person who at all times held the beneficial interest in such indebtedness."

An amendment to Proposed Treasury Regulation § 1.382-3, relating to qualified indebtedness for treatment under section 382 (1)(5)(E), was published in the Federal Register on September 23, 1991. Prop. Treas. Reg. § 1.382-3, 56 Fed. Reg. 47921 (1991). The amendment states that section 382 (1)(5)(E) should not require the loss corporation with significant amounts of "widely-held indebtedness" to determine whether such indebtedness was owned for the "continuity period" on an individual creditor basis. *Id.*

The amendment provides guidance on determining the amount of widely-held indebtedness, that qualifies under section 382(1)(5)(E). *Id.* "Widely-held indebtedness" is defined as "any indebtedness in registered form (within the meaning of section 163(f)) if indebtedness of the same class is owned by more than 50 beneficial owners on any day." *Id.* The "continuity period" begins on the day eighteen months before the filing of the title 11 or similar case (or the day the indebtedness was incurred, if later) and ending with the ownership change date. *Id.*

Under the proposal, a loss corporation treats a part of each class of its widely-held indebtedness, owned by "less-than-five-percent beneficial owners," as always owned by the same beneficial owners, regardless of the time the beneficial owners actually owned the indebtedness. *Id*

If the taxpayer is denied the status as a historic creditor under section 382(b), the same denial of creditor status disallows the "G" reorganization under section 368(a)(1)(G). Thus, if historic creditor status does not exist for the "G" reorganization requirement, section 381(a)(2) would prevent the carryover of tax attributes.

Under section 382(c),[100] the continuity of business enterprise requirement[101] is the same as under the nontaxable reorganization provisions of section 368.[102] A loss corporation or its successor must continue the historic business or use a significant amount of the historic business assets.[103]

However, the continuity of business enterprise requirement of section 382(c) does not apply to ownership changes when section 382(l)(5) applies.[104] Furthermore, if section 382(a) does not apply to limit the timing at which pre-exchange surviving losses and credits can be used, the potential for tax evasion or avoidance is possible in a bankruptcy reorganization to which section 382(l)(5) applies.

### B. *The Avoidance of Tax Provision Under I.R.C. Section 269*

Section 269 is a complementary argument to section 382 for the

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A "less-than-five-percent beneficial owner" is defined as the beneficial owner of indebtedness, who owns less than five percent of the class on the change date. *Id.* However, the loss corporation must determine on an individual creditor basis other widely-held indebtedness not owned as qualified indebtedness during the continuity period. *Id.*

A special rule disqualifies indebtedness owned by a beneficial owner, who has an ownership change during the continuity period and has indebtedness representing more than twenty-five percent of the beneficial owner's gross assets on its change date. *Id.* The effective date of the proposed amendment is for ownership changes occurring on or after September 20, 1991. *Id.*

100. If the loss corporation does not continue the business enterprise for two years after the ownership change, section 382(c) reduces the section 382(b) limitation to zero, except to the extent of the amount of any recognized built-in gains and any excess limitation carried over from prior years. I.R.C. § 382(c) (1987).

101. The continuity of business enterprise under the *Libson Shops* doctrine was made obsolete by section 382(c). Libson Shops Inc. v. Koehler, 353 U.S. 382, 390 (1957) (the *Libson Shops* doctrine prevented a pre-merger loss carryover from offsetting income "not produced by substantially the same businesses which incurred the losses"); *see* H.R. REP. NO. 841, 99th Cong., 2d Sess. 194 (1986).

102. H.R. CONF. REP. NO. 841, 99th Cong., 2nd Sess., II-189 (1986).

103. *See* Treas. Reg. § 1.368-1(d)(2) (as amended in 1980) (continuity of business enterprise).

104. Prop. Treas. Reg. § 1.382-3(b), 55 Fed. Reg. 33140 (1990). However, Congress retained a somewhat limited continuity of business enterprise requirement under the proposed regulations for section 269. *See* Prop. Treas. Reg. § 1.269-3(d), 55 Fed. Reg. 33139 (1990) ("more than an insignificant amount of an active trade or business").

denial of the carryforward of tax attributes.[105] Section 269 provides that if any corporation acquires, directly or indirectly, control[106] of another corporation, and the principal purpose[107] for the acquisition is evasion or avoidance of federal income tax[108] by obtaining deductions, credits, or other allowances which the corporation would not otherwise receive, the secretary may disallow such deductions, credits, or other allowances.[109] For example, a plan may contemplate no substantial business activity following the reorganization and the exchange of stock-for-debt was accomplished for the purpose of the tax attributes surviving bankruptcy.[110]

The proposed regulations under section 269 provide that:

> absent strong evidence to the contrary, a requisite acquisition of control of property in connection with an ownership change to which section 382(l)(5) applies is considered to be made for the principal purpose of evasion or avoidance of Federal income tax unless the corporation carries on more than an insignificant amount of an active trade or business during and subsequent to the title 11 or similar case.[111]

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105. *See* Prop. Treas. Reg. § 1.269-7, 55 Fed. Reg. 33140 (1990) (permits application of section 269 to disallow loss or credit, even if sections 382 and 383 also limit or reduce the loss or credit); *see also* Prop. Treas. Reg. § 1.269-3(d), 55 Fed. Reg. 33139 (1990) (imposes section 269 in certain situations when section 382(l)(5) applies).

106. Control under section 269 is defined as acquiring "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." I.R.C. § 269(a) (1983); Prop. Treas. Reg. § 1.269-5(a), 55 Fed. Reg. 33140 (1990). For section 269 purposes, creditors of a bankrupt corporation acquire control of the stock at the time the bankruptcy court confirms the reorganization plan and whether the creditors acquired control with the principal purpose of evasion or avoidance is determined at the time of confirmation. Prop. Treas. Reg. § 1.269-5(b), 55 Fed. Reg. 33140 (1990).

107. The principal purpose (tax reasons) "exceeds in importance any other purpose [non-tax business reasons]" for the acquisition. Treas. Reg. § 1.269-3(a) (1962). *See* U.S. Shelter Corp. v. United States, 13 Cl. Ct. 606, 622-23 (1987) (analysis of principal purpose test); Scroll, Inc. v. Commissioner, 447 F.2d 612, 616-17 (5th Cir. 1971).

108. Although "evasion or avoidance" of tax is not defined under the regulations, Treas. Reg. § 1.269-1(b) (1962) provides examples of transactions indicative of the purpose to evade or avoid tax.

109. I.R.C. § 269(a) (1983) (general rule for acquisitions made to evade or avoid income tax).

110. *See* Jupiter Corp. v. United States, 2 Cl.Ct. (despite initial acquisition of twenty-five percent of corporation by creditor for valid business reasons, subsequent acquisition of control to obtain tax attributes was subject to section 269); *see also* Briarcliff Candy Corp. v. Commissioner, 56 T.C.M. (CCH) 2614 (1987) (purchase of profitable subsidiary by loss corporation may be subject to section 269).

111. Prop. Treas. Reg. § 1.269-3(d), 55 Fed. Reg. 33139 (1990). *See* Prop. Treas. Reg.

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The determination of whether a corporation "carries on more than an insignificant amount of an active trade or business" is a facts-and-circumstances test.[112]

Generally, an acquiring corporation succeeds to the tax attributes of a controlled subsidiary on a complete liquidation of the subsidiary.[113] Under pre-1982 law, if the acquiring corporation (following a qualifying purchase of a target corporation's stock) liquidated the target's stock under section 332 within two years, the carryover of the target's loss history was terminated since the liquidation of the target was subject to the stepped-up basis rule of former section 334(b)(2)[114] and did not constitute a section 381 transaction.[115]

As a result of amendments made by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), section 334(b)(2) was repealed and replaced by an elective "deemed asset sale" rule under section 338.[116] When section 338 is elected, the tax attributes are purged, but if section 338 is not elected, the tax history is preserved with carryover to the purchasing corporation under section 381(a)(1) on a section 332 liquidation.

Under TEFRA, the application of the disallowance provision under section 269 "was not clear when a purchased subsidiary corporation with unexpired carryforward items was liquidated into the acquiring corporation."[117] Therefore, section 269(b) was added to the code in 1984,[118] providing the service with specific authority to disallow the

§ 1.382-3(b), 55 Fed. Reg. 33140 (1990) (continuity of business enterprise requirement of section 382(c) does not apply, if section 382(l)(5) applies).

112. Prop. Treas. Reg. § 1.269-3(d), 55 Fed. Reg. 33140 (1990) (facts and circumstances may include amount of historic business assets continuing to be used or amount of work force continuing in employment).

113. I.R.C. § 381(a)(1) (1989) (general rule for tax history carryovers).

114. In *Kimbell-Diamond Milling Co.*, the court held that the purchase of the stock of a target corporation for the purpose of obtaining its assets through a prompt liquidation is treated as a single transaction (step-transaction doctrine) of the purchase of the target's assets with the purchaser receiving a cost basis in the assets. Kimbell-Diamond Milling Co. v. Commissioner, 14 T.C. 74, 80 (1950), *aff'd per curiam*, 187 F.2d 718 (5th Cir.), *cert. denied*, 342 U.S. 827 (1951). Section 334(b)(2) was added in 1954 to codify the holding in *Kimbell-Diamond*. *See* S. REP. NO. 1622, 83d Cong., 2d Sess. 257 (1954).

115. *See* Treas. Reg. § 1.269-6, Ex.(3) (1962).

116. Section 338 was "intended to replace any nonstatutory treatment of a stock purchase as an asset purchase under the *Kimbell-Diamond* doctrine." H.R. CONF. REP. NO. 760, 97th Cong., 2d Sess. 536 (1982).

117. GENERAL EXPLANATION OF THE REVENUE PROVISIONS, JOINT COMMITTEE ON TAXATION, TAX REFORM ACT OF 1984, H.R. REP. NO. 4170, 98th Cong., 2d Sess. (1984).

118. Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 942 (1984).

tax attributes of a subsidiary that is liquidated into its parent corporation within two years of its acquisition and thus to prevent tax-motivated corporate acquisitions.[119]

Section 269(b) disallows tax attribute carryover if:

(1) the acquiring corporation purchases at least 80 percent of the stock of a target corporation within a twelve month period;[120]
(2) the acquiring corporation does not make a section 338 election;[121]
(3) the target corporation is liquidated within two years of the acquisition;[122] and
(4) the principal purpose for the liquidation is tax avoidance.[123]

The application of the principal purpose test is with respect to the liquidation part of the overall transaction for section 269(b).[124] A business purpose may exist for an acquisition to satisfy section 269(a), but a lack of a business purpose for the subsequent liquidation would deny tax attribute carryover under section 269(b).

Although section 269(b) disallows the use of a loss corporation's net operating losses and other tax attributes when a loss corporation is liquidated upstream into its parent within two years of its acquisition, a downstream merger of the parent corporation into the acquired loss corporation avoids the section 269(b) disallowance.

If the debtor's business was continued by the acquiring corporation (satisfying the continuity of business enterprise), section 269 is more difficult to support. Whereas, if the historic business is discontinued or is substantially eliminated and significant net operating losses are maintained, the requirements of section 269 are likely to be satisfied.

119. The General Explanation of the Revenue Provisions of the 1984 Act, in discussing the section 269(b) provision, states that with respect to a liquidation within two years of acquisition, "in the absence of evidence to the contrary, this situation is ordinarily indicative that the principal purpose of the liquidation is tax avoidance." *Id.*

120. *See* I.R.C. § 269 (b)(1)(A), (b)(2) (1988). Sections 269(b)(1)(A) and (b)(2) reference the definition of a "qualified stock purchase" to section 338(d)(3), which defines such as a purchase, within a twelve month period, of at least eighty percent of the combined voting power and at least eighty percent of all other classes of stock of the target corporation, except non-voting limited preferred stock.

121. *See* I.R.C. § 269(b)(1)(B) (1988). Section 269(b)(1)(B) refers to the section 338 election, which treats a stock purchase as an asset purchase.

122. I.R.C. § 269(b)(1)(C) (1988) refers to a subsidiary liquidation under section 332.

123. I.R.C. § 269(b)(1)(A)-(D) (1984) (general rule for subsidiary liquidation after qualified stock purchase).

124. The effective date of the amendments to section 269(b) under the Tax Reform Act of 1984 applies "to liquidations after October 20, 1983, in taxable years ending after such date." Texas Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 942 (1984).

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The subjective application of section 269 complements the objective tests of section 382. Section 269 requires proof that tax avoidance was the primary purpose of the transaction (i.e., the taxpayer's motives or state of mind). The provisions of section 382 adopt mechanical rules of thumb to eliminate probing into the tax motivation of the taxpayer.

### C. *"Avoidance of Taxes" Under 11 U.S.C. § 1129(d)*

In determining, under proposed section 269, if an acquisition pursuant to a bankruptcy reorganization was made for the principal purpose of evasion or avoidance of Federal income tax, whether or not the government sought a determination under 11 U.S.C. § 1129(d) in the prior bankruptcy proceeding is *not controlling*.[125]

Section 1129(d) of the Bankruptcy Code provides as follows:

> Notwithstanding any other provision of this section, on request of a party in interest that is a governmental unit, the court may not confirm a plan if the principal purpose of the plan is the avoidance of taxes or the avoidance of the application of section 5 of the Securities Act of 1933 (15 U.S.C. 77e). In any hearing under this subsection, the governmental unit has the burden of proof on the issue of avoidance.[126]

The service has objected to confirmation under section 1129(d) in only a few cases.[127] However, the service has raised the argument that a tax avoidance motive shows a lack of good faith and a plan cannot be confirmed that is not filed in good faith pursuant to 11 U.S.C. § 1129(a)(3).[128]

## V. CONSOLIDATED RETURN LIMITATIONS

A consolidated return may be filed by an affiliated group of corporations, as defined by section 1504(a),[129] in lieu of separate corporate

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125. Prop. Treas. Reg. § 1.269-3(e), 55 Fed. Reg. 33139 (1990).

126. 11 U.S.C. § 1129(d) (1988) (bankruptcy code). The burden of proof for the government is especially difficult to achieve in the bankruptcy court, since the court is more likely to find any reasonable means to confirm a plan, rather than the alternative of liquidating the debtor corporation.

127. *See In re* Rath Packing Co., 55 B.R. 528 (Bankr. N.D. Iowa 1985) (service failed to sustain burden of proof under section 1129(d), since court determined that debtor's status as publicly held corporation to be as important as net operating losses).

128. *In re* Maxim Industries, 22 B.R. 611, 614 (Bankr. D. Ma. 1982) (holding that plan was not proposed in good faith and only purposes presented were tax motivated).

129. I.R.C. § 1504(a) (1988). Section 1504(a) defines an affiliated group as one or more chains of "includible corporations" connected with a common parent corporation by stock ownership meeting the eighty percent voting and value test. Section 1504(b) defines the term

returns.[130] The consolidated return is taxed on the consolidated taxable income, which eliminates intercompany profit and loss.

An advantage of filing a consolidated return is that losses of one affiliate may be offset against income of another affiliate in determining consolidated income (or loss) for the group. However, to the extent losses of one affiliate are used to reduce consolidated taxable income, the basis of stock or obligations of the loss corporation, held by other members of the group, is reduced.[131] Also, under a consolidated return certain intercorporate distributions are nontaxable[132] and gain or loss on certain intercompany transactions is deferred until realized outside the consolidated group or triggered by certain events.[133]

The advantages of offsetting income and loss among affiliated members by filing consolidated returns may be limited by the restrictions under the separate return limitation year ("SRLY") rule, the consolidated return change of ownership ("CRCO") rules, the built-in deductions provision, or the reverse acquisition provision.

Consolidated return regulations limit the use of net operating losses and net capital losses attributable to a separate return limitation year, or SRLY, of a member of the group. The SRLY of a member of a consolidated group is defined as the taxable year the member was not part of the group.[134] Therefore, the portion of a consolidated net operating loss carryover attributable to a SRLY of a member of the group can be used only to offset income attributable to that

"includible corporation." Section 1504(b)(3) excludes foreign corporations from the consolidated group. *See* Rev. Rul. 71-83, 1971-1 C.B. 268 (nonvoting cumulative convertible preferred stock does not constitute "stock" for purposes of section 1504(a)).

130. I.R.C. § 1501 (1954) (privilege to file consolidated return). The election to file a consolidated return is referred to as a "privilege" under the regulations. Treas. Reg. § 1.1501-1 (1955).

131. Treas. Reg. § 1.1502-32(a) (1990) (parent corporation is required to make special annual investment basis adjustments to basis of common and preferred stock in each affiliate member).

132. Treas. Reg. § 1.1502-14 (1990) (intercompany distributions with respect to stock, bonds and other obligations of members).

133. Treas. Reg. § 1.1502-13 (1990) (intercompany transactions). *See* I.R.C. § 267(f) (1984) (loss deferral rule for property transferred within controlled group). However, Treas. Reg. § 1.1502-13 governs, except as provided under Temp. Treas. Reg. § 1.267(f)-2T. Temp. Treas. Reg. § 1.267(f)-2T(B) (1984).

134. Treas. Reg. § 1.1502-1(f) (1990) (definition of separate return limitation year).

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member.[135]

The SRLY rules are avoided when income producing assets are contributed to the capital of the loss member, or by merging or liquidating a profitable member into the loss member. However, section 269 may prevent the use of losses that would otherwise be limited by the SRLY rules. Also, section 482 may require the reallocation of income if income is shown to be artificially diverted to the loss member to use the SRLY losses and credits.[136]

The consolidated return change of ownership, or CRCO, rules limit the carryover of net operating losses and net capital losses when the ownership of the common parent changes.[137] Losses incurred by a corporation, belonging to an affiliated group before a CRCO, cannot be used to offset income of corporations that become members after the CRCO.[138] The limitation is targeted at the acquisition of a loss group by the shareholders of a profitable corporation who attempt to apply the losses against the profitable corporation's income in a consolidated return. The purpose of the CRCO provision is to preserve the general rule: that losses of the acquired corporation remain in that corporation and are offset only against its own income.

The CRCO ownership change is based upon the old section 382(a) type increase of more than a fifty percent ownership change of the fair market value of the stock (except nonvoting preferred) of the common parent by the ten largest shareholders over a two year period.[139]

If there is a fifty percent or more increase in ownership by the ten persons holding the greatest amount of stock (as defined by section 382(a)(2))[140] of the common parent of a consolidated group, and any member of the group does not continue to conduct a trade or business substantially the same as before any ownership change, the portion of any consolidated net operating loss sustained in prior taxable years

135. Treas. Reg. § 1.1502-21(c) (1980) (limitation on net operating loss carryovers and carrybacks from separate return limitation years).

136. However, section 482 authorizes only the reallocation of income or deductions, but does not disallow deductions as do sections 269 and 382. I.R.C. § 482 (1986).

137. Treas. Reg. § 1.1502-1(g) (1990) (definition of consolidated return change of ownership).

138. Treas. Reg. § 1.1502-21(d) (1990) (CRCO limitation for carryovers); Treas. Reg. § 1.1502-22(d) (1980) (CRCO limitations on capital loss carryovers).

139. Treas. Reg. § 1.1502-21(e) (1990) currently applies the change of ownership rules of old section 382 to consolidated groups. These ownership change rules of section 382 were repealed by the Tax Reform Act of 1986.

140. Treas. Reg. § 1.1502-1(g)(1)(i) (1990).

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attributable to the member not continuing to carry on such trade or business may not be carried over.[141]

The proposed regulation sections 1.1502-90(1991) through 1.1502-99(1991) replace the CRCO rules with the single entity approach in the application of section 382 to consolidated groups. The regulation section 1.1502-92(1991) refers to ownership changes as defined under the current section 382(g)(1986) and Temporary Treasury Regulation § 1.382-2T(1989). The special rule for reorganizations under section 382(l)(5)(A)[142] would not cause an ownership change as defined by section 382 and would avoid an ownership change activating the present CRCO rules.

The built-in deductions provision limits a consolidated group's ability to acquire a corporation with assets that have depreciated in value and then use the losses inherent in the assets to offset the income of other group members.[143] The built-in deduction rule is concerned with a corporation's deduction recognized in a consolidated return year, but which was economically accrued in a SRLY year.[144]

The limitation does not disallow the deduction to the loss member in determining its taxable income, but limits its use against consolidated income. However, as with the general SRLY limitation, the built-in deduction limitation is avoided by liquidating or merging the loss member into a profitable member.

The proposed regulation section 1.1502-15 conforms portions of the definition of built-in deductions to the rules provided under section 382(h) for consistency and refers to the limitation as "built-in losses," rather than "built-in deductions." Under the proposed regulations, a new member that has a net unrealized built-in loss as defined by section 382(h)(3) is treated as having an ownership change at the time it becomes a member. The built-in losses, subject to the SRLY limitation, adopt the built-in loss rules of section 382(h) with the five-year recognition period.

The reverse acquisition rules are designed to prevent a taxpayer

141. Treas. Reg. § 1.1502-21(e) (1980) (limitation on net operating loss carryovers under section 382).

142. I.R.C. § 382(l)(5)(A) (1989) (exception to ownership change under title 11 or similar case).

143. Treas. Reg. § 1.1502-15(a)(4)(b) (1980) (built-in deduction limitation applies if losses exceed fifteen percent of value of all acquired assets excluding cash, marketable securities and goodwill).

144. Treas. Reg. § 1.1502-15(a) (1980) (limitations on built-in deductions).

from reversing the form of an acquisition to avoid the limitations on losses under the consolidated return regulations. A reverse acquisition is an acquisition in which the shareholders of the acquired corporation own, after the acquisition, more than fifty percent of the fair market value of the stock of the acquiring corporation and a consolidated return is filed for the first year ending after the acquisition.[145]

The reverse acquisition rules treat the years of the acquiring corporation and its group ending on or before the date of acquisition as an SRLY limitation. The proposed regulations include reverse triangular mergers under section 368(a)(2)(E) within the application of the reverse acquisition rules.[146]

Although literal compliance with the consolidated return statutes may be satisfied, if a corporation is acquired solely for the use of its tax attributes in a consolidated return, the requisite affiliation may be denied on business purpose grounds.[147] Also, the denial of a parent corporation's use of an acquired corporation's pre-affiliation and post-affiliation losses on a consolidated return to offset post-affiliation profits can be raised under section 269.[148]

Proposed consolidated return regulations under section 1502 have been released for public hearing and comment with respect to the application of sections 382 and 383 in determining consolidated return limitations and procedures.[149] For non-SRLY tax years, the proposed consolidated return regulations reflect a single entity approach to determine ownership changes and the section 382 limitation for consolidated corporations. Under section 382 limitations, members are treated as divisions of a single taxpayer with the common parent as

145. Treas. Reg. § 1.1502-75(d)(3) (1972) (reverse acquisitions).

146. 26 C.F.R. § 1.1502-75 (1991).

147. *See* Elko Realty Co. v. Commissioner, 29 T.C. 1012, 1015 *aff'd per curiam*, 260 F.2d 949, 950 (3d Cir. 1958) (denied affiliation for all purposes required separate return filing).

148. Hall Paving Co. v. United States, 471 F.2d 261, 263 (5th Cir. 1973) (following *R.P. Collins*, section 269 was applied to post-acquisition losses denying consolidated return filing eligibility); R.P. Collins & Co. v. United States, 303 F.2d 142, 145 (1st Cir. 1962) (section 269 denied post-affiliation loss deductions on consolidated return from taint of taxpayer's unrelated pre-acquisition tax-avoidance purpose); American Pipe & Steel Corp. v. Commissioner, 243 F.2d 125, 128 (9th Cir.), *cert. denied*, 355 U.S. 906 (1957) (consolidation denied under section 269). Section 269 would disallow the use on the consolidated return of the tax attributes that motivated the acquisition. *Id.*

149. CO-132-87, 1991-8 I.R.B. 6-26 (operation of sections 382 and 383 with respect to consolidated groups); CO-77-90, 1991-8 I.R.B. 26-34 (application of section 382 in short taxable years and with respect to controlled groups); CO-78-90, 1991-8 I.R.B. 34-51 (consolidated returns—limitations on use of certain losses, deductions and credits).

the sole agent for each member.[150] Also, the proposed regulations extend the single entity approach to loss subgroups within consolidated groups.[151]

An ownership change occurs if the common parent of a loss group has an ownership change as defined by I.R.C. section 382(g) and Temporary Treasury Regulation section 1.382-2T.[152] An ownership change occurs for a loss subgroup if the loss subgroup parent has an ownership change under section 382(g) and section 1.382-2T.[153]

Under the above "parent change method," shifts of ownership in a subsidiary of the group or loss subgroup do not affect the determination of whether the loss group or loss subgroup has an ownership change.[154] For a post-change year, the consolidated section 382 limitation is equal to the value of the loss group immediately before the change, multiplied by the long-term tax-exempt rate.[155]

Under the present regulations, the SRLY limitation operates on a member-by-member or "fragmentation" basis, rather than a single entity approach.[156] These regulations apply section 382 separately to corporations that join or leave a consolidated group.[157]

Under the proposed regulations, the concept of limiting a member's SRLY losses is retained based on the member's contribution to consolidated taxable income, which is measured cumulatively over the

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150. Prop. Treas. Reg. §§ 1.1502-91-93, 56 Fed. Reg. 4199-4215 (1991). The proposed regulations apply the single entity treatment on the loss group in determining whether the continuity of business enterprise requirement of section 382(c) is satisfied. Prop. Treas. Reg. § 1.1502-93(d), 56 Fed. Reg. 4215 (1991). Note: Prop. Treas. Reg. § 1.1502-97 (1991) is reserved for the application of section 382 to consolidated groups in "title 11 or similar cases," which may adopt a single entity approach. Prop. Treas. Reg. § 1.1502-97, 56 Fed. Reg. 4227 (1991).

151. A loss subgroup consists of two or more corporations with carryover losses which are continuously affiliated, but cease to be members of a prior consolidated group. Prop. Treas. Reg. § 1.1502-91(d), 56 Fed. Reg. 4199 (1991).

152. Prop. Treas. Reg. § 1.1502-92(b)(1)(i), 56 Fed. Reg. 4203 (1991) (ownership change of loss group).

153. *Id.* § 1.1502-92(b)(1)(ii) (ownership change of loss subgroup).

154. *Id.* § 1.1502-92(b)(2), Ex.2.

155. Prop. Treas. Reg. § 1.1502-93(a)(1), 56 Fed. Reg. 4214 (1991) (consolidated section 382 limitation).

156. Preamble to proposed revisions to consolidated return regulations, CO-78-90, 1991-8 I.R.B. 34, 36.

157. Prop. Treas. Reg. § 1.1502-94, 56 Fed. Reg. 4215-4217 (1991) ("coordination with Code section 382 and Regulation section 1.382-2T when a corporation becomes a member of a consolidated group"); Prop. Treas. Reg. § 1502-95, 56 Fed. Reg. 4213-4224 (1991) (rules on ceasing to be member of loss group).

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time the member is within the group.[158] The proposed rules generally eliminate fragmentation and apply the SRLY limitation on a subgroup basis rather than separately to the members of the subgroup.[159]

## VI. Conclusion

The tax issues addressed in this article concern potential tax consequences after a bankruptcy confirmation. Although the Internal Revenue Service may not have a pre-petition tax liability claim during a bankruptcy proceeding, the tax consequences of a confirmed plan may be significant with potential tax-attribute carryover.

With respect to the basic issues, the discharge of indebtedness provisions, the applications of the various statutory and judicial requirements pursuant to nontaxable reorganization, the tax attribute limitation rules, and the consolidated return regulations are effective to prohibit abusive situations involving net operating losses and other tax attributes. In fact, the complexity and scope of the limitation provisions under section 382 and the proposed consolidated return regulations are so encompassing, that the ability to currently structure an acquisition solely for the carryover of tax attributes from a non-affiliated corporation is somewhat comparable to Sir Galahad's quest for the Holy Grail.[160]

Ride on! the prize is near.
So pass I hostel, hall, and grange;
By bridge and ford, by park and pale,
All-arm'd I ride, whate'er betide,
Until I find the holy Grail.

—Sir Galahad by Alfred Lord Tennyson[161]

158. *Id.*

159. Prop. Treas. Reg. § 1.1502-21(c)(2), 56 Fed. Reg. 4238 (1991) (SRLY subgroup limitation).

160. *See* Sir Thomas Malory, *The Tale of the Sangreal*, in Le Morte d'Arthur (London, Caxton 1485).

161. John Matthews Manly, English Poetry (1170 - 1892) at 465 (1st ed. 1907).