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CONTINUITY OF BUSINESS REQUIREMENTS FOR N.O.L.S IN BANKRUPTCY: THE ECONOMIC EFFECTS OF § 1.269-3(d)

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I. INTRODUCTION

In recent years, the number of corporate bankruptcy filings has skyrocketed. Specifically, in 1980 there were 11,742 corporate bankruptcy filings,[2] while in

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[2] ECONOMIC REPORT OF THE PRESIDENT, FEBRUARY 1992 37-40, table B-92 (U.S. Gov't Printing Office 1992) [hereinafter 1992 REPORT].

1990 there were 60,409:[3] a 514% increase for the ten year period.[4] A large portion of this increase is likely to be permanent because it was not caused by cyclical factors such as the recent recession. This is shown by the fact that even during the boom years of the Eighties, corporate bankruptcy filings rose at a high rate.[5] Commentators have given different explanations for this increase,[6] but almost all agree that the rate of bankruptcy filings is likely to stay at a higher level than has historically been the case.[7]

Often one of the largest assets of a bankrupt corporation is its net operating losses ("NOLs").[8] An NOL results from losses or deductions that exceed taxable income for a year. The amount of the excess is the NOL for the year.[9] The excess losses do not necessarily result in an immediate tax benefit because our system does not allow for negative amounts of tax.[10] However, an NOL can be used to offset taxable income for other years.[11] Generally, an NOL is first used to offset income from the three years prior to the year the losses were incurred,[12] resulting in an immediate refund of taxes paid. If a person had no taxable income during the three prior years, the NOL can be carried forward up to 15

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[3] *Id.*

[4] This rise continued into 1991, where there were 87,592 corporate bankruptcies, a rise of over 27,000 from 1990. *Id.* However, this increase is likely due to the current recession.

[5] In the height of the 1980s boom (1983-1988) each year the number of corporate bankruptcy filings increased by approximately 120%. *Id.*

[6] James D. Key, Note, *The Advent of the Serial Chapter 11 Filing and Its Implications*, 8 BANK. DEV. J. 245 (1991). This describes how junk bonds have increased the rate of bankruptcies by increasing the amount of debt outstanding. *Id.* The rise in corporate bankruptcy filings is probably in part due to the rise in the number of incorporations during the Eighties. 1992 REPORT, *supra* note 2, at table B-92. To some extent the savings and loan crisis may have increased these numbers, although they are too big to be explained by this alone. James D. Barth, THE GREAT SAVINGS AND LOAN DEBACLE (AEI Press, Washington, D.C. 1991).

[7] *See* authorities cited *supra* note 6; *see also*, Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 COLUM. L. REV. 717 (1991); Gary B. Wilcox, *Issuing Mixed Consideration in Troubled Debt Restructurings*, 10 VA. TAX. REV. 357 (1990).

[8] Robert A. Rizzi, *Filling in the Gaps: Newly Proposed and Temporary Regs Clarify Bankruptcy Loss Carryforward Rules*, 19 J. CORP. TAX'N 134 (1992); GORDON D. HENDERSON & STUART J. GOLDRING, FAILING AND FAILED BUSINESSES ¶ 11 (CCH 1992).

[9] I.R.C. § 172(a).

[10] Although such a system has been proposed, see Mark Campisano & Roberta Romano, *Recouping Losses: The Case for Full Loss Offsets*, 76 NW. U. L. REV. 709 (1981).

[11] I.R.C. § 172(a).

[12] I.R.C. § 172(b). There is an election to use the NOLs only to offset income from future years. *Id.* In § 172(b)(3), without this election, the NOLs will first offset income in the third year prior to the creation of the NOL, then it will offset income from the year after that, and if it is not yet used up, it then will offset income of the year prior to the loss year. Only if there are NOLs remaining after this will any be carried forward. *Id.*

years.[13] A corporation which has net operating losses is often referred to as a "loss corporation."[14]

The Internal Revenue Code (the "Code") creates restrictions on the use of NOLs if the ownership of the corporation has changed between the time the NOL was created and the time it is utilized.[15] Different rules govern the use of carrybacks and the use of carryforwards.[16] The rules regarding carrybacks are contained in § 381 of the code,[17] whereas the rules governing carryforwards are contained not only in § 381, but also in §§ 382, 384, and in the consolidated return regulations under § 1502.[18] Section 269 also places additional limits on both carryforwards and carrybacks.

This paper focuses on the use of carryforwards in a bankruptcy situation. In particular, it examines the economic implications of Treasury Regulation § 1.269-3(d),[19] which was finalized on January 6, 1992. This regulation creates a presumption that if the acquirer of a loss corporation does not continue the corporation's business, the transaction was consummated for tax avoidance purposes. Therefore, under § 269, which limits the use of NOLs after an acquisition, the loss corporation's NOLs cannot be used by the acquirer. This presumption, however, can be overcome by strong evidence that other motives controlled the decision.

This article discusses the contours of the limitation created by § 1.269-3(d), and concludes that, notwithstanding the ability to overcome its presumption, this provision essentially imposes a continuity of business enterprise requirement for the NOLs of a loss company to survive. That is, an acquirer

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[13]I.R.C. § 172(b)(1)(A). Banks and REITs (Real Estate Investment Trusts) have different rules for when they can use NOLs. I.R.C. § 172(b)(1)(B)-(C).

[14]I.R.C. § 382(k)(1) defines a loss corporation as a corporation entitled to use an NOL carryover, or having an NOL for the year of an ownership change.

[15]These include I.R.C. §§ 269, 381, 382, and 384, as well as the rules that apply to a consolidated return situation under I.R.C. § 1502, such as the separate return limitation year (SRLY) and the consolidated return change of ownership (CRCO) rules- I.R.C. §§ 1.1502-15, 21. On January 29, 1991, the Treasury issued proposed regulations which eliminate the CRCO rules, CO-132-87. Prop. Reg. § 1.1502-21A(g)(3); BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 13.45[6][a] (6th ed. 1994).

[16]Carrybacks are NOLS that are used to offset prior income. KEVIN E. MURPHY, CONCEPTS IN FEDERAL TAXATION 288 (1994). Carryforwards are NOLs that are not carried back and so must be used to offset future income. *Id.*

[17]*Libson Shops Inc. v. Koehler*, 353 U.S. 382 (1957), may also place restrictions on carrybacks.

[18]There are also special alternative minimum tax NOL restrictions in I.R.C. § 56(d)(1)(A) which are not discussed in this paper.

[19]Treasury Regulations will be referred to by section numbers. They are distinguished from Code sections by the form of the section number. Code sections are a simple number, whereas Regulations have a number preceding the section number. For example, § 269 for code sections and § 1.269-3(d) for treasury regulations.

must continue the loss corporation's business or use its assets in an active trade or business in order to use the NOLs.

After discussing the scope of the rule, the article goes on to analyze whether this limit promotes economic efficiency. In particular, it examines the incentives that § 1.269-3(d) gives to new owners of a loss corporation. It also examines the differences between a "regular" situation, (i.e. where the loss corporation is not in bankruptcy) where there is an explicit continuity of business enterprise requirement[20] and in situations where § 382(l)(5) applies, which do not have a continuity of business enterprise requirement, absent this regulation.[21] The article concludes that § 1.269-3(d) creates inefficient incentives for the acquirers of a bankrupt corporation to retain the corporation's business or assets. The standard used for determining whether a tax rule promotes economic efficiency is whether it is "neutral," i.e. whether it does not alter decisions from those that would be made in a tax-free world.[22]

The article also analyzes whether the concerns which motivated the creation of this regulation are best addressed by imposing a presumption based on the continuity of business enterprise, and, if this is not the case, how the concerns that motivated the institution of this presumption can be better addressed by amending the § 269 regulations.

Part I analyzes the structure of the current law as well as discussing some of the concerns that motivated Congress, the Courts, and the Treasury in the law's creation, focusing on economic efficiency. Part II discusses whether the § 1.269-3(d)'s continuity requirement furthers the goal of economic efficiency. Part III discusses the various alternatives to § 1.269-3(d) that have been presented and gives some suggestions for how the § 269 regulations might be structured to increase efficiency.

This article does not focus on whether the rules are consistent with the legislative intent behind §§ 269 and 382, although consideration is given to this question to the extent that economic efficiency played a role in the creation of these sections. Furthermore, it does not discuss whether the Treasury had the power to impose these rules or whether it was necessary for Congress to do so. It also does not consider other controversial regulations under §§ 269 and 382

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[20]Section 382(c) requires continuity of business for any of the NOLs to be used. Its rules are based on the continuity of business requirements for reorganizations in § 1.368-(1)(d). See *infra* text accompanying notes 104-11.

[21]*See* discussion of § 1.382-3(m) *infra* text accompanying notes 115-16.

[22]Neutrality is a frequently (perhaps the most frequently) used tool for tax policy analysis. *See* JOSEPH M. DODGE, THE LOGIC OF TAX xxi (1989). There are other modes of analysis such as equity. However, when dealing with the corporate tax, it is very difficult to analyze because of the lack of clarity on the incidence of the corporate tax. J. Clifton Fleming, Jr., *Reflections on Section 382: Searching for a Rationale*, 1979 B.Y.U. L. REV. 213, 217-219. It seems particularly appropriate to use neutrality as a measure of the NOL limits because the 1986 Tax Reform was attempting to make these rules as "neutral" as possible. JOINT COMMITTEE, GENERAL EXPLANATIONS OF THE TAX REFORM ACT OF 1986 294, 295 (date) [hereinafter JOINT COMMITTEE]; *see* discussion *infra* text accompanying notes 205-207.

finalized on the same day as § 1.269-3(d).[23] All of these topics already have been examined at length elsewhere.[24]

It is possible this regulation may some day be invalidated. However, if this occurs, the analysis of this paper will not be moot. If a court invalidates this regulation, it would be on the grounds that the Treasury did not have the authority to issue it.[25] It would not be on policy grounds.[26] If this regulation is invalidated, the question would arise whether Congress should adopt this limitation. The analysis of this problem would be essentially the same as that presented in this paper.

II. Current Law

The discussion of the NOL rules will begin by illustrating the concerns which motivated their creation and subsequent revision. Then, it will lay out the basic NOL rules, while at the same time, examining how they fit into the overall plan of preventing "abuse."

The NOL rules were originally created to equalize the treatment of businesses with stable incomes and those with fluctuating incomes. To illustrate, assume there are two corporations, A and B. A earns $50 every year. B earns $150 every odd year and loses $50 every even year. Over time, the two corporations will have equal incomes [150 - 50 = 50 + 50 = 100][27] and so over time should pay the same amount of tax.[28] However, if NOLs are not allowed, B will pay a higher amount of tax. Assume that the corporate tax rate is 35%. In year 1, A pays $17.50 tax [$50 X .35] and B pays $52.50 [150 X .35]. In year 2, A pays $17.50 again and B pays $0 tax . So in every two year period, A will pay $35 in tax and B will pay $52.50, even though their incomes are the same. By allowing B to carry the year 2 loss back to the previous year, the amount of tax

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[23] However, one regulation, § 1.269-5, which was finalized on the same day, is discussed to the extent that it affects the analysis of § 1.269-3(d). *See* discussion *infra* text accompanying notes 183-87.

[24] Lee A. Sheppard, *New Tax Avoidance Regs Avoid Bankruptcy Court*, 54 TAX NOTES 116 (1992); Janet A. Meade & Janice E. McCellan, *Loss Carryovers in Corporate Bankruptcy Reorganizations Under Prop. Reg § 1.269-3(d)*, 69 TAXES 229 (1991).

[25] Many commentators argue that the Treasury did not have the authority to issue this regulation. *See* sources cited *infra* note 209.

[26] To invalidate a regulation a court must find that the Treasury has abused its authority, and the regulation is contrary to legislative intent. Manhattan Gen. Equip. Co. v. Commissioner, 297 U.S. 129, 134 (1936). This is a very difficult standard of proof. This paper makes no claims about the validity of the regulation, or whether the regulation is a reasonable interpretation of § 269. This article only analyzes the economic impact of the regulation.

[27] This ignores time value of money considerations.

[28] Under one of the basic principles of tax policy, horizontal equity, taxpayers who earn similar incomes should pay similar amounts of tax. For a discussion of horizontal equity, see Richard A. Musgrave, *Horizontal Equity, Once More*, 43 NAT'L TAX J. 113 (1990).

each pays is equalized. Under this regime, every two years, again A pays $35 but B would pay $35 as well.[29]

The limitations on NOLs were created in order to prevent abuse of the NOL rules. "Abuse,"[30] for purposes of this paper, occurs when two conditions are present: 1) there has been a change in the ownership of the loss corporation; and 2) the NOLs are used to offset income from a business other than that which generated the losses.[31] This is referred to as abuse, because NOLs were intended to equalize income within a single business.[32] To illustrate the problem, assume that A owned a corporation (X Co.) which conducted a business that had generated NOLs. A had grown weary of this business and decided to sell it. A sold X Co. to B who promptly liquidated the assets of X's current business and started a new business. Obviously, B bought X Co. for its tax attributes (specifically its NOLs) because it promptly sold all of X's other assets. If B can fully utilize all of X Co.'s NOLs, B is in exactly the same position as if it had purchased A's losses directly.[33]

The discussion of the rules dealing with the use of NOLs begins with § 381 and related case law, which determine whether NOLs survive an acquisition. Then, it will examine the limits that §§ 269, 382, and other sections place on the survival and rate of use of NOLs. The analysis breaks up into two parts: the general rules, and the rules that apply when the loss corporation is in Bankruptcy.

A. Survival of NOLs Post-Acquisition

The analysis of whether NOLs survive a corporate transaction begins with § 381. Section 381 identifies the situations in which the attributes of a corporation may be carried over into another corporation. It applies to transactions where the assets of one corporation are acquired by another either in a liquidation to which § 332 applies,[34] or by means of an "A," "C," non-divi-

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[29]B's taxes are $51 - (50 x .34 = 17) = $34.

[30]The use of the term "abuse" or "abusive" is not meant to imply a value judgement. The term is merely used to denote those transactions which have the two characteristics described above.

[31]Michael R. Asimow, *Detriment and Benefit of Net Operating Losses: A Unifying Theory*, 24 TAX L. REV. 1, 45-48 (1968). Asimow uses the same definition and argues that only when these two conditions are present should we worry about tax avoidance. *Id.* In fact, this is a common notion of what should be prevented. *See* James B. Loken, *Loss Carryovers and Corporate Alterations: Toward a Uniform Approach*, 52 MINN. L. REV. 571, 620 (1968).

[32]*See* JOINT COMMITTEE, *supra* note 22.

[33]The price paid for the NOLs being the difference between the amount B paid for X and the amount received on the sale of X's assets.

[34]An I.R.C. § 332 liquidation occurs when a subsidiary that is 80% owned by its parent is liquidated into its parent.

sive "D," "F," or "G" reorganization.[35] A common denominator among these transactions is that they are all tax-free transactions (at least in part)[36] and the acquiring corporation takes a carryover basis in the assets that it receives from the transferor.

If one of these acquisitions takes place, then the NOLs and the other attributes specified in § 381(c)[37] will carryover from the transferor corporation to the transferee corporation.[38] The acquired corporation's taxable year ends on the date of the transaction.[39]

As for transactions other than those specified in § 381(a), the code is silent. The legislative history states that both for transactions that are not specified in the section and for attributes not listed,[40] no inference is to be drawn as to whether or not they carryover.[41] Therefore, it seems that prior law would apply.[42] Prior law, which was predominantly case law, used the "Entity Approach," which allows the carryover of the attribute if the entity which incurred the loss is the same as that which is attempting to use the NOL.[43] In other words, if the corporate entity that incurred the loss survives, so do its NOLs.[44] For example, assume A purchases X Co.'s stock from B (X's current owner), and A continues to keep X Co. in existence. X Co. can continue to use

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[35]These are the transactions described in I.R.C. § 368(a)(1). Each particular transaction is referred to by the letter of its subparagraph within this section.

[36]If there is "boot", i.e. if the transferors receive property other than stock or securities of the transferee, then it is possible that the gain up to the amount of the "boot" will be recognized. I.R.C. § 361(b).

[37]The attributes described in I.R.C. § 381(c) include items such as earnings and profits, capital loss carryovers, etc.

[38]These attribute transfers are subject to certain restriction contained in I.R.C. § 381(b).

[39]I.R.C. § 381(b).

[40]This would include failed reorganizations as well as straight purchases and "B" reorganizations, which are described in I.R.C. § 368(a)(1)(B).

[41]S. REP NO. 1622, 83d Cong., 2d Sess. 277 (1954).

[42]This follows because if § 381 does not tell us, we must revert to what was the law prior to its passage. *See* BITTKER & EUSTICE, *supra* note 15, at ¶ 14.02; New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934).

[43]New Colonial Ice Co. v. Helvering, 292 U.S. 435, 441-42 (1934); Alprosa Watch Corp. v. Commissioner, 11 T.C. 240, 245 (1948).

[44]Helvering v. Metropolitan Edison Co., 306 U.S. 522 (1939), held that if the assets were acquired in a statutory merger, the identity of the transferor corporation was "submerged" into that of the transferee corporation and the NOLs could be used by the transferee. However, this doctrine only applied where local law held that the identity of the transferor and transferee were the same. *Id.* This was not always the case. *See* BITTKER & EUSTICE, *supra* note 42.

its NOLs that arose while it was owned by B.[45] On the other hand, if instead of keeping X Co. operating, A merges X Co. into Y Co. (a corporation wholly owned by A) with Y Co. surviving, in a transaction that is not specified in § 381 (e.g. a failed "C" reorganization), then the NOLs cannot be used. This is because Y Co. did not incur X Co.'s losses.[46]

B. Restrictions on the Survival and Use of NOLs

1. General Rules

a. Section 382 Limit on Rate of Use

Even though the NOLs can be carried forward under § 381 or prior case law, § 382 places restrictions on their use. The purpose behind the § 382 limits is to prevent "abusive" transactions.[47] It does this by attempting to eliminate any disparity in the value of the NOLs between the owner and the purchaser.

An NOL's value is always exactly equal to the amount of tax it can save.[48] NOLs have no intrinsic value in and of themselves.[49] Their value lies in their ability to reduce taxes. For example, if a corporation has $1 million of taxable income, and the net effective tax rate is 30%, a $1 million NOL is worth the taxes the corporation would otherwise have to pay on its income, or $300,000.

A potential acquirer will place a higher value on an NOL than the current owner only if the acquirer can use the NOL faster than the current owner.[50] This difference in value is based on the difference between the present value of the NOL to the two taxpayers. For example, if A can use the $1 million NOL all in one year, the value to A of the NOL is $300,000, assuming a 30% tax rate. If

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45This would also be the case in a "B" reorganization in which the stock of the acquiring corporation is exchanged for the stock of the loss corporation. Here, the loss corporation survives as well. Therefore, so do its NOLs.

46There are great possibilities of manipulation of this rule. For example, instead of the acquiring corporation surviving the merger, the loss corporation could survive. This would allow the survivor to use the NOLs.

47*See supra* text accompanying notes 37-50.

48For purposes of this illustration, we assume that NOLs are freely transferable. This is not the law as we shall soon see. The point is to show the possible abuses under the most liberal allowance of NOL carryforwards.

49It seems very unlikely that anyone gets any psychic income from having NOLs to offset current income.

50A disparity could also arise if there is a difference in marginal rate. But, we are dealing with corporations, and the corporate tax is essentially a flat tax. *See* I.R.C. § 11. NOLs can also have state tax consequences, but these are not analyzed in this paper. Generally, they will only alter the size of the distortions, not whether they occur.

B can only use the NOL at a rate of $333,333 a year, it has a discounted present value to B of $278,326.46.[51] The faster the NOL can be used, the higher the value.

A disparity in the value of a NOL between the purchaser and the current owner can create incentives for either a buyer to purchase the loss corporation, or the current owner to sell it. In both situations, the tax system is acting in a non-neutral way, which reduces the efficiency of the system.[52]

In the first situation (i.e. where the purchaser's incentives are altered), the tax system (via NOLs) creates an incentive for a person contemplating an acquisition to prefer acquiring a loss corporation rather than a corporation without NOLs. For example, assume there are two corporations, X and Y, both having assets worth $7 million to their respective current owners and $8 million to a potential acquirer, P.[53] P will be indifferent as to which corporation it acquires. However, if because of tax attributes such as NOLs, X is now worth $9 million to P while Y is still worth $8 million, P would prefer to purchase X.

In order for this bias to arise, there must be a disparity between P and X in the value of the tax attribute. That is, if both P and X can fully utilize an NOL at the same rate, it will have the same value to both of them.[54] In order for X's shareholders to sell their interests in X, they will have to be compensated for both the value of X's assets and the value of X's NOLs to them. This value is precisely the same as the value of the NOL to P. So, while X's total value to P is increased by the value of the NOL ($1 million in the above example), P will have to pay the full value of this increase. P then faces the choice of buying either X, which is worth $8 million, for $8 million, or Y, which is worth $7 million, for $7 million. P will again be indifferent about which it acquires.[55]

In the other situation (i.e., where the seller's incentives are altered), the tax system creates an incentive for the current owner, who, in this example is the

[51] Using a discount rate of 8%. Discounting $100,000 a year for three years at a rate of 8% equals $278,326.46. Of course, if the discount rate is higher the value to B of the loss would be even less. Consequently, the disparity in value of the NOL would be greater.

[52] *See infra* text accompanying notes 192-201.

[53] The value of an asset or a corporation to a particular owner, is equal to the net discounted present value of the future cash flows that this particular owner can generate from the asset. HARVARD BUSINESS SCHOOL, VALUING A BUSINESS ACQUISITION OPPORTUNITY 1-2 (Harvard Business School Publishing Division 1989). So, if P places a higher value on assets than the current owner, P can obtain a higher return on the assets or the same return at a faster rate. The purchase price for a corporation must at least be equal to its value to its current owners. The assumption in this example is that the current owners of both X & Y have the same negotiating skills.

[54] This assumes they are in the same tax bracket. But, as stated in note 50, the corporate tax is essentially a flat rate tax and so it is assumed throughout the paper that the taxpayers are in the same bracket.

[55] Unless P is unable to obtain financing for the $8 million price or the relative costs of raising money increase for the larger amount.

most efficient user of the assets,[56] to sell them to someone who can use the NOLs at a faster rate than the current owner. For example, if the NOL is worth $200,000 to the current owner and $1 million to a potential buyer, there is a tax-created incentive for the owner to sell. This can result in inefficient transactions.[57] It is not necessarily true that the purchaser is a more efficient user of the assets merely because an NOL is more valuable to the purchaser.[58] He may be able to use other assets more efficiently and thus create profits to offset.[59]

This preference would be created entirely by the tax system and so the system would be non-neutral as to this decision. The amount of this preference is equal to the disparity in value of the NOL. That is, if P's value and the current owner's value for the NOLs diverge by $1 million, the amount of the distortion and the loss of value the NOL rules introduce is $1 million.[60] $8). This yields a net loss to the system of $.5 (real value of Y = $8 , real value of X is $7.5).

Of course, it is possible for both patterns to be evident in a single transaction. That is, a company contemplating an acquisition might prefer to acquire a loss corporation because it has NOLs, and the acquiring company is also an inefficient user of the loss corporation's assets.

Section 382 deals with both of these situations by eliminating the disparity in value by placing an annual limitation on the use of NOLs following an ownership change. This rule restricts the amount of income the NOLs will be able to offset in any given year. The amount of the "annual limitation" for each

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[56]If the purchaser is the most efficient user, then there is no loss if the seller transfers the corporation to the purchaser. But this transfer would occur under a system which did not allow NOL carryovers as well, because the purchaser could pay the seller more for the corporation than it was worth to the seller. So, NOLs would not alter the incentives in this situation.

[57]However, it may merely be offsetting other problems such as the lock-in effect which results when holders of assets may not want to sell them because of the taxation on all the accrued gain. *See* BORIS I. BITTKER & LAWRENCE LOKKEN, 1 FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 3.5.7 (1989).

[58]For example, the purchaser may generate enormous profits from its other business and yet be able to generate no profit from the loss companies business.

[59]It is unclear whether there would be a lasting drop in efficiency. All the purchaser is really interested in is NOLs of the corporation. If the old owners were in fact more efficient users of the assets, then it would make sense to sell the assets back to them. Of course, the logic of this second transaction would depend on whether the tax code would respect the first sale if this occurred. It is ironic that limits designed to prevent inefficient transactions might in fact promote them by forcing the purchasers to inefficiently retain the assets.

[60]This distortion arises entirely because P purchases a corporation that it otherwise would not have. To illustrate, if we ignore NOLs, assume Y has a value of $8 million to P and X has a value of $7.5 million to P (X & Y each still have a value of $7 million to their respective current owners). P will prefer to purchase Y. If P places a value on X's NOLs of $.7 million, then X has a value of $8.2 million to P ($7.5 + $.7). Assume Y has no NOLs, so its value remains $8 million. All other things being equal, P will prefer to purchase X over Y ($8.2

year is equal to the long-term tax exempt rate[61] times the value of the stock of the loss company[62] immediately before the ownership change.[63] For example, if the value of the stock of the corporation is $1 million and if the current § 382 rate is 6%, the loss corporation can only use $60,000 of its NOLs per year, no matter what the total amount of its NOLs.[64] This is an attempt to determine the value of the NOL to the current owners and then ensure that the purchaser cannot place a higher value on it.[65] There are serious questions as to whether the limitation accomplishes this,[66] but this is beyond the scope of the paper.

The rules governing when there is an ownership change, which are quite complicated,[67] are designed to ensure that if true beneficial ownership of the corporation shifts, there will be a ownership change for purposes of § 382. There also are rules on what constitutes a loss, and what income can be offset against what losses, in order to ensure that tax planning yields few benefits.[68]

Section 382(c) imposes a continuity of business enterprise requirement on the carryforward of losses. If the acquirer does not satisfy the provisions of this section, the annual limit on the NOLs is reduced to zero retroactively to the date of the ownership change.

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[61]The long-term tax exempt rate is defined as federal long-term rate as determined by I.R.C. § 1274(d) and adjusted for differences between tax exempt & taxable instruments. I.R.C. § 382(f). This rate is published monthly in revenue rulings. The rate for November 1994 is 6.25%. Rev. Rul. 94-67, I.R.B. 1994-45.

[62]I.R.C. § 382(b). This includes all equity, but excludes debt. Equity includes all the stock, including I.R.C. § 1504(a)(4) stock (non-convertible, non-voting preferred).

[63]The I.R.C. § 382(l)(6) rule allows for a different value and is discussed *infra* text accompanying notes 201-206.

[64]$1 million x 6% = $60,000. *See supra* note 61 for the recent rate. Throughout the article a 6% rate will be used for illustrative purposes.

[65]It attempts to do this by establishing a rate which is similar to that which the loss company would have used. Since the owners could always have sold the assets and bought government bonds, it was decided that the NOLs should be allowed at least at that rate. *Carryover of Net Operating Losses and Other Tax Attributes of Corporations: Hearing Before the Subcomm. on Select Revenue Measures of the Comm. on Ways and Means House of Represenatives*, 99th Cong., 1st Sess. 13 (1985) (statement of Ronald A. Pearlman, Assistant Secretary (Tax Policy), Dep't of Treasury).

[66]For a discussion of this see Daniel Q. Posin, *Three Strikes Are We Out? Transfer of Loss Carryovers After the 1986 Act*, 7 VA. TAX REV. 697 (1988); Daniel L. Simmons, *Net Operating Losses and Section 382: Searching for a Limitation on Loss Carryforwards*, 63 TUL. L. REV. 1015 (1989); George K. Yin, *Of Diamonds and Coal: A Retrospective Examination of the Loss Carryover Controversy*, 48 N.Y.U. INST. ON FED. TAX'N 41 (Pt. 2 1990); Fleming, *supra* note 22.

[67]Even a brief description of these rules is lengthy. For a discussion of these rules see the series of Articles by Mark J. Silverman & Kevin M. Keyes, *New Ownership Regs under Section 382: Part I*, 68 J. TAX'N 68 (1988); *Part II*, 68 J. TAX'N 142 (1988); *Part III* 68 J. TAX'N 300 (1988); *Part IV*, 69 J. TAX'N 42 (1988).

[68]I.R.C. § 382(h) causes net unrealized built-in losses to be treated as pre-acquisition losses, and NOLs can be used freely against net unrealized built-in gain.

Ex 1. A purchases T Corp. and after the ownership change the annual limitation on A's use of T's NOLs = $100,000. If A liquidates all of T's business, A cannot use any of T's NOLs.

In order to avoid this result, the acquirer must either continue a significant historic business of the loss corporation or continue to use a significant portion of the company's assets in a trade or business for two years after the acquisition.[69] The historic business is the business the loss corporation was engaged in before the transaction.[70] For example, if T has been engaged in a clothing business for ten years, but immediately prior to, and in contemplation of its acquisition, T sells its assets and uses the proceeds to enter a business its acquirer desires, the historic business of T remains the clothing business.[71] The purchaser must either continue the clothing business or use its assets in a trade or business in order to use T's NOLs.

The effect of this limit is to deter those who are interested in acquiring only the tax attributes of a corporation. Under this limit, if A sells the unwanted assets, then A will not be able to use the "tax assets" either.

b. Section 269 Limit

After § 382 has been applied to an acquisition, the taxpayer must still overcome the hurdle of § 269 to use the NOLs. Section 269 will disallow a loss carryforward (or any other deduction or tax benefit) if the principal purpose of the acquisition of the loss corporation was tax avoidance.[72] Specifically, § 269 provides that: if 1) any person or persons acquire control[73] of a corporation; or 2) any corporation acquires property of another unrelated corporation in a carryover basis transaction,[74] and the "principal purpose" of the acquisition was evasion of federal income tax by securing a benefit the taxpayer would not otherwise enjoy, the IRS may disallow all or part of the NOLs of the loss corporation, as well as other tax benefits.[75]

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[69]This limit is the same as that for reorganizations under Treas. Reg. § 1.368-1(d). H.R. REP. NO. 841, 99th Cong., 2d Sess. 189 (1986) *reprinted in* 1986 U.S.C.C.A.N. 4075. This is helpful in defining the term, because there has been a great deal of case law under the Treas. Reg. § 1.368-1(d) rule. *See* Peter Faber, *Continuity of Interest and Business Enterprise: Is it Time to Bury Some Sacred Cows*, 34 TAX LAW. 239 (1981).

[70]Treas. Reg. § 1.368-1.

[71]Treas. Reg. § 1.368-1(d)(9) ex. 3.

[72]I.R.C. § 269(a).

[73]Control is defined as ownership of stock that possesses at least 50% of the total combined voting power of all classes entitled to vote or at least 50% of the total value of shares of all classes of stock of the corporation. I.R.C. § 269(a).

[74]For example, the transactions listed in I.R.C. § 381(a) are carryover basis transactions. A carryover basis transaction is one in which the basis of the transferor in the asset "carries over" to the transferee. MURPHY, *supra* note 16, at 462-63.

[75]I.R.C. § 269.

The key question under § 269 is whether the "principal purpose" of the acquisition was federal income tax avoidance. The regulations somewhat clarify the definition of "principal purpose." If the desire to avoid federal income tax exceeds in importance any other purpose, it is the principal purpose.[76] However, it is not necessarily true that the principal purpose of the transaction was federal tax avoidance merely because it would not have occurred but for the federal tax benefits.[77] In order for tax avoidance to be the principal purpose, it must be the most important reason.

The section seems to require placing each of the acqurier's motives into one of two categories: tax avoidance, or other motives. After this, § 269 mandates weighing the motives in both categories against each other to determine which is stronger.[78]

In making this determination, the regulations specify certain facts that should be considered. One of the most important is whether the tax attributes have already been subject to limitations such as § 382.[79] The idea is that, if § 382 so limits the NOLs as to make them of little value, it is unlikely that the acquisition was for tax avoidance purposes.

In most situations where § 382 applies, it does severely limit the usefulness of NOLs.[80] Under § 382,[81] this rate is multiplied by the value of the stock of the loss corporation to derive the annual NOL limitation. If the NOL is a significant portion of the value of the corporation, then its net present value will be substantially less than it would have been without this restriction.[82]

Section 1.269-3(b)(1) examines another important point in this analysis. Under this section, if an acquirer inputs capital from the acquirer's business into the loss corporation, this action indicates that the principal purpose of the

[76] Treas. Reg. § 1.269-3(a).

[77] For example, if tax avoidance was only one percent of the reason for the acquisition but without it the acquisition would not have taken place, then even though it is a but-for cause, it was still not the principal purpose.

[78] *See* Treas. Reg. § 1.269-3(a); *see also* J. CLIFTON FLEMING, TAX ASPECTS OF BUYING AND SELLING CORPORATE BUSINESSES ¶ 18.12 (1991).

[79] Treas. Reg. § 1.269-7.

[80] *See* Rizzi, *supra* note 8.

[81] *See supra* note 61 for recent rate.

[82] For example, if NOLs are 50% of the value of the stock and the § 382 rate is 6%, it will take 8.33 years to use up the NOLs. If these NOLs currently have a value of 50 if used immediately (the corresponding total value of the stock would be 100), the slower use results in a present value of these NOLs of 34.61, discounting at a rate of 8%. More than 30% of the value of the NOLs was lost. Notice that the 50% figure for the value of the NOLs does not imply that the NOL has a value equal to 50% of the assets. Debt, which is an important method of corporate finance, is not included in this calculation, and so the value of the NOL could be substantially below 50% of the assets and still be 50% of the value of the stock.

transaction was tax avoidance, absent evidence to the contrary.[83] This regulation directly addresses situations like that discussed in the example in section I.A.[84] Notice that placing assets in a loss corporation does not create a presumption of tax avoidance. It is merely one of many factors. If other factors indicate another motive, the principal purpose may not be tax avoidance.

As might be expected, § 269 often leads to highly unpredictable results.[85] Whenever the question is what occurred in the mind of the acquirer, it is difficult to find the truth.[86] With any given transaction, it is unclear how a court or the IRS may treat it.[87] This can introduce a great deal of uncertainty in planning transactions. Of course, under § 382 the limits are often so severe that it is unlikely that someone would acquire a corporation primarily for its loss carryforwards.[88]

2. Bankruptcy Rules

a. Section 382 Limits

If an ownership change results from a bankruptcy reorganization, different rules govern the use of NOLs.[89] There are at least three reasons for the differences. First, all bankruptcy reorganizations are reviewed by the Bankruptcy Court.[90] If the IRS wishes to object to the terms of the plan during

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[83]This section is based on the idea that if the acquirer uses the NOLs to offset income from a business other than that which generated the losses, it is possible for there to be a disparity in value of the NOLs that is not the result of an increase in efficiency.

[84]*See supra* text accompanying notes 37-50. If the new business in that example needs infusions of capital as most new businesses do (*see* Parker, *infra* note 191), then Treas. Reg. § 1.269-3(b)(1) would say this is a factor indicating tax avoidance.

[85]David E. Watts, *Acquisitions Made to Avoid Taxes: Section 269*, 34 TAX L. REV. 539, 552 (1979).

[86]Walter J. Blum, *Motive, Intent, and Purpose in Federal Income Taxation*, 34 U. CHI. L. REV. 485 (1967).

[87]This is especially true with the no rulings policy. *See* Rev. Rul. 92-3, 1992-1 I.R.B., *infra* text accompanying notes 195-200.

[88]Robert A. Rizzi, *Section 382 and the Trigger Rules: Is Congress Beating a Dead Horse?*, 14 J. CORP. TAX'N 99 (1987).

[89]These rules apply to a Title 11 or similar case. Title 11 is the Bankruptcy Code. There are two types of corporate Title 11 actions: Chapter 7 liquidations and Chapter 11 reorganizations. In a Chapter 7 action, the corporation is liquidated; it assets are sold and the proceeds are used to pay its creditors. In a Chapter 11 action, after the initial bankruptcy petition is filed, the debtor is allowed to continue to operate its business. During the bankruptcy proceeding, the debtor must file a reorganization plan. In order for the plan to become effective, the court must approve it. 11 U.S.C. § 1129 (1988). After the plan has been approved, certain debts of the corporation can be discharged.

[90]11 U.S.C. § 1129(d) (1988).

the bankruptcy proceeding, it is allowed to do so.[91] The Bankruptcy Court is not allowed to permit a reorganization that is merely for tax avoidance. The parties to the transaction have less control over the terms when a Bankruptcy Court is involved than when they planned the transaction.[92] If a purchaser planned an abusive transaction, it is unlikely to feel as confident in its ability to accomplish its goals in the Bankruptcy Court. However, the IRS has the burden of proving that the reorganization was for tax avoidance purposes.[93] While these rules may not prevent all tax-motivated transactions, it probably does weed out some very egregious cases.[94]

Also, a bankruptcy proceeding is likely to add significant costs to any "acquisition" which discourages some parties.[95] Those interested in acquiring losses may look elsewhere because this reduces the cost-effectiveness of acquiring these NOLs.

A second reason for more relaxed NOL carryover rules in bankruptcy is that a creditor is unlikely to lend money to a corporation in order to use the corporation's NOLs.[96] This would be a very inefficient way to acquire NOLs. In most bankruptcy proceedings, the creditors do not recover the entire amount owed to them.[97] Therefore, the creditor risks losing a significant portion of its investment in order to acquire these NOLs. In fact, the creditors of a bankrupt business are generally not trying to acquire losses of others businesses, but rather they are trying to recoup their own.[98]

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[91] *Id.* This section states that a plan approved should not be for a tax avoidance purpose. While this rarely occurs it does provide for some lessened concern. Robert A. Jacobs, *The Bankruptcy Court's Emergence as Tax Dispute Arbiter of Choice*, 45 TAX LAW. 971, 981-84 (1992).

[92] Bruce D. Haims, *Bankruptcy as a Tax Planning Device: Workouts vs. Chapter 11*, 49 N.Y.U. INST. OF FED. TAX'N ¶ 23, 23.02 (1991).

[93] However, in a tax court proceeding the taxpayer generally has the burden of proof. TAX CT. R. 142(a); *see also*, Welch v. Helvering, 290 U.S. 111, 115 (1933). For these and other reasons, Treas. Reg. § 1.269-3(e) states that the determination of the principal purpose by the bankruptcy court is not controlling for other courts.

[94] This provision's usefulness is limited by the IRS's reticence to use this power. *See* Jacobs, *supra* note 91.

[95] *See* Haims, *supra* note 92. A basic economic principle is that if you increase the cost of something, you get less of it.

[96] For how lenders decide whether to lend, see generally William K. Strand, *Valuation From a Lender's Perspective*, *in* HANDBOOK OF BUSINESS VALUATION (Thomas L. West et al. eds., 1992).

[97] Chaim J. Fortgang & Thomas M. Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1 (1990).

[98] Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179 (1942); *see also* Fortgang & Mayer, *supra* note 97.

A third reason for different rules in bankruptcy is the general policy encouraging the rehabilitation of businesses.[99] Bankruptcy law in general, and the bankruptcy tax rules in particular, are structured with this motive in mind. Therefore, Congress and the Treasury have created special rules to protect what is often the largest asset of a bankrupt corporation, its NOLs.

The survival of NOLs in a bankruptcy situation is particularly a problem due to the structure of § 382. As stated before, the § 382 limit is based on the value of the loss corporation. The value of the loss corporation is determined before the ownership change.[100] For an insolvent corporation, the value of its stock will be nominal.[101] The annual limit would therefore be very low,[102] and so the NOLs would have almost no value. The destruction of the NOL would discourage the rehabilitation of a bankrupt business.[103]

Congress had these considerations in mind when it created the current § 382 in 1986.[104] Congress carved out two special rules that apply to Title 11 or similar cases: § 382(l)(5) and § 382(l)(6).

The first of these rules, § 382(l)(5), allows for free transferability of NOLs with no annual limitation. However, there is a "toll charge" in order to retain these NOLs. This toll charge is comprised of two parts:[105] the NOLs are reduced by the amount of the interest that accrued during the three years prior to the ownership change on the debt that was converted into stock;[106] and 2) the NOLs are reduced by 50% of the amount that was excluded due to the stock-for-debt exception.[107] Neither of these reductions attempts to reduce the

[99]Korobkin, *supra* note 7.

[100]I.R.C. § 382(e)(1).

[101]While insolvency is not required for a bankruptcy petition, it is the case that any corporation that files a bankruptcy petition is likely to have a low stock value (because debt is high). HENDERSON & GOLDRING, *supra* note 8, at ¶ 11.

[102]0 x 6 % = 0.

[103]If the value of one of the most important assets of a company drops to zero, the total value of the company can significantly drop, as well as the desirability of reorganizing the company.

[104]Richard E. Halperin, *Planning for Loss Carryovers Under Section 382 When a Corporation is Insolvent,* 71 J. TAX'N 150 (1989).

[105] 1)There is also a special rule to ensure that there is no double reduction of NOLs from these rules. If some of the debt that was discharged is the result of accrued interest, the NOLs are only reduced once, not twice. I.R.C. § 382(l)(5)(C)(ii).

[106]I.R.C. § 382(l)(5)(B). This is because the section views the creditors as owners of the business. The interest paid is therefore to be treated as dividend and so, therefore, was not deductible.

[107]Under the normal § 108(a) rules, when cancellation of debt income is excluded, due to a Title 11 case or insolvency of the debtor, the tax attributes (NOLs, basis of assets, business credits, etc.) of the debtor are reduced. However, if the debt of a corporation is exchanged for its stock, the normal attribute reduction that results from debt cancellation in bankruptcy does not occur. Capento Securities Corp. v. Commissioner, 47 B.T.A. 691 (1942), *aff'd,* 140 F.2d 382 (1st Cir. 1944). The stock for debt exception has

disparity in value, as the § 382 limit does.[108] Rather, they are based on the idea that the debt holders who received stock should be treated as if they owned the corporation for the last three years.[109]

> Ex.2 X Co. has $1,000 of NOLs and has $700 of debt excluding interest. It has accrued $210 of interest (both paid and unpaid) in the last 3 years on this debt. As a result of a bankruptcy proceeding, X discharges half of its debt ($350) in exchange for its own stock. This stock has a value of $100. Therefore, without § 108 or the stock-for-debt exception, the corporation would have $250 of income. Assume that this reorganization results in an ownership change. If this reorganization qualifies for § 382(l)(5) treatment, the NOLs are reduced by: 1) interest accrued on the debt converted into stock ($210 x 1/2) = $105; and 2) 50% of the amount that is excluded from income due to § 108, and did not result in attribute reduction due to the stock for debt exception (here $125, which equals $250 x 50%).[110] This totals to $230. Therefore, after the reorganization, X Co. has $770 ($1,000 - $230) of NOLs which it can use immediately.

This rule applies only when there has been a § 382 ownership change in a Title 11 or similar case.[111] After the reorganization, 50% or more of the stock[112] of the corporation must be owned by historic shareholders[113] or qualified creditors. Qualified creditors include those who held the debt for 18 months or longer, and those who have lent to the bankrupt corporation in the ordinary course.[114]

These limits are aimed at preventing someone from purchasing a corporation and its NOLs by acquiring its debt immediately before the reorganization. In essence, this is the same as purchasing the stock of the

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been repealed by modifying § 108(e) for all transfers of stock occurring after December 31, 1994. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13226(a)(1), 107 Stat. 312,487 (1993). An exception is made for stock transferred in a title 11 or similar cases filed before December 31, 1993. § 13226(a)(3)(6), 107 Stat. at 487-88.

108*See* discussion *supra* notes 34-46 and accompanying text.

109If the creditors had owned the corporation for the last three years, then the interest accrued would have been a non-deductible dividend.

110*See supra* note 107.

111*See supra* note 89.

112Fifty percent of both the voting power and the value of the corporation must be held by the appropriate shareholders. I.R.C. § 382(l)(5)(A)(ii); I.R.C. § 1504(a)(2). This is in contrast to the general I.R.C. § 382(g) ownership rule which only looks to value.

113"Historic shareholders" in this context means those who held shares in the corporation immediately before the confirmation of the plan.

114I.R.C. § 382(l)(5)(E). Ordinary course means ordinary course of the loss corporation's business, not the business of the creditor.

corporation, since the creditor was aware the debt was going to be converted into stock.

The § 382(c) continuity of business requirement does not operate under § 382(l)(5), as stated in § 1.382-3(m).[115] This results because § 382(l)(5) exempts the NOLs from the § 382 limitation which includes § 382(c)'s continuity of business requirement. Practioners had assumed there was no continuity of business requirement until § 1.269-3(d) was proposed.[116] But, as we shall see, this may no longer be the case.

If another ownership change occurs within two years of the bankruptcy reorganization, then the § 382(l)(5) rules do not apply. This failure to qualify for § 382 treatment applies retroactively to the bankruptcy reorganization. Therefore, the regular § 382 limit applies *ab initio*. In addition, the § 382 limit that applies to post-second ownership change income is automatically zero.[117] Assume that A acquires a bankrupt corporation, B Co. and, because it has income for the year, uses $100,000 of B Co.'s NOLs in year 1. In year 2, if A sells B Co., the $100,000 of NOLs used in year 1 are subject to the § 382 annual limit.[118] On top of this, B Co. cannot use any of its pre-first ownership change NOLs after the second ownership change.

The second special bankruptcy rule, § 382(l)(6), applies when either the § 382(l)(5) requirements are not met, or the taxpayer has elected out of § 382(l)(5) treatment.[119] The taxpayer is likely to make this election if the "toll charge" provisions under § 382(l)(5) significantly reduce the amount of NOLs.[120]

Under § 382(l)(6), the basic § 382 rules apply, including the continuity of business requirement of § 382(c).[121] However, the value of the corporation for purposes of calculating the § 382 annual limit is increased by the amount of the debt that was cancelled in the reorganization.[122] As with § 382(l)(5) the reorganization must occur within the context or a Title 11 or similar case.

115This also follows from Treas. Reg. § 1.382-3(c) and the fact that the regular § 382 limit does not apply. Section 382(c) only applies when § 382(a)applies. Under its terms, when § 382(l)(5) applies, § 382(a) does not. Therefore, if § 382(l)(5) applies, § 382(c) and its continuity of business enterprise requirement do not.

116Halperin, *supra* note 104.

117I.R.C. § 382(l)(5)(D).

118Section 382(l)(6) may modify the size of this limit, because the corporation is in bankruptcy. Prop. Reg. § 1.382-3(n)(2).

119Section 382(l)(5)(H) permits a taxpayer to elect out of the § 382(l)(5) provisions.

120 For example, if the bankruptcy was the result of junk bonds, the interest accruals may be quite large. Section 382(l)(5) is generally used for cases where the business itself, via depreciation, deductions, etc., has generated the losses, rather than the choice of debt or equity financing.

121*See* discussion *supra* text accompanying notes 104-16; Prop. Reg. § 1.382-3(m)(2).

122Prop. Reg. § 1.382-3(j)-(l) might alter this calculation. But for simplicity, this paper uses the method described in the statute.

Ex.3 Under the same facts as Ex.2, if the value of the loss corporation after the reorganization was equal to $300 (i.e. before the reorganization it was insolvent by $50) the modified § 382 limit under § 382(l)(6) is 6% x $300 = $18.00 per year, giving the NOLs a total present value of $154.07.[123]

b. Section 269 Limit in Bankruptcy Situations

As under the general § 382 rules, even after NOLs have run the gauntlet of § 382(l)(5) or (l)(6), § 269 can still disallow them altogether if the acquisition was for tax avoidance purposes.[124] This is determined in a manner similar to that used for "regular" situations. For example, as discussed before, whether these NOLs are subject to limitation by other sections is a significant factor in determining the principal purpose.[125] NOLs that have survived up to this point have been subject to either the modified § 382(l)(6) limit or § 382(l)(5) toll charge. Either of these might severely limit the value of the NOLs.

However, § 1.269-3(d) alters the analysis if § 382(l)(5) applies. This regulation, which is the subject of this paper, states:

> Absent strong evidence to the contrary, a requisite acquisition of control or 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 (as defined by 382(l)(5)(G)). The determination of whether the corporation carries on more than an insignificant amount of an active trade or business is made without regard to the continuity of business enterprise set forth in §1.368-1(d). The determination is based on all the facts and circumstances, including, for example, the amount of business assets that continue to be used, or the number of employees in the work force who continue employment, in an active trade or business (although not necessarily the historic trade or business). Where the corporation continues to utilize a significant amount of its business assets or work force, the requirement of carrying on more than an insignificant amount of an active trade or business may be met even though all trade or business activities temporarily cease for a period of time in order to address business exigencies.[126]

[123]Assume, as before, a discount rate of 8% and maximum use of NOLs each year until they expire in 15 years.

[124]I.R.C. § 269. The acquisition in this case is the bankruptcy reorganization; here the former creditors of the loss corporation acquired stock for the old debt.

[125]*See* Treas. Reg. § 1.269-7 discussion *supra* text accompanying note 79.

[126]Treas. Reg. § 1.269-3(d).

The meaning of this provision is not crystal clear.[127] While the provision states that a loss corporation must carry on an active trade or business during and after the bankruptcy proceeding,[128] it is unclear whether the company must carry on the *same* active trade or business throughout, or whether merely conducting any active trade and business will suffice. An example illustrates the difference.

> Ex.4 Loss Co. #1 manufactured airplane parts before, during, and after the bankruptcy proceeding. Loss Co. #2 had also manufactured airplane parts before filing a Chapter 11 petition, as well as during most of the period of the bankruptcy proceeding. However, toward the end of the proceeding it liquidated its airplane parts business and used the proceeds to purchase franchises in a national fast food chain. Under both readings of § 1.269-3(d), Loss Co. #1 would be allowed to use its NOLs. Under the first reading of § 1.269-3(d) Loss Co. #2 would not be entitled to retain its NOLs, because it changed its business. The second reading, however, would allow it. Loss Co. #2 meets the standard of the second reading because it is still conducting a business.

If the second reading is accurate, a loss corporation must merely be continually engaged in some business throughout the period. If the old business need not be continued, this regulation is an active trade or business requirement, not a continuity of business requirement.[129] As long as the business is active, it does not matter what the business is. However, if the funds from the liquidation of the old business were used for portfolio investments, this would probably be insufficient.[130] To resolve this conflict, it is necessary to look at the precise wording of the regulation. It is best to start at the beginning

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[127]There is a split of opinion over the meaning of this section. *See* JACK S. LEVIN & MARTIN D. GINSBURG, MERGERS, ACQUISITIONS, AND LEVERAGED BUYOUTS ¶ 1208.032 (1994); Lewis T. Barr, *Net Operating Losses- Sections 381, 382, and 269,* Tax Management Portfolio No. 27, A-52(3), 52(4) (both stating that this is not a continuity of business requirement). *But see* Jacobs, *supra* note 91; Fergusson, *infra* note 209; Peter C. Cannellos, *Rethinking The Tax Aspects of Debt Restructuring,* 70 TAXES 808, 818 (1992) (both stating that it is a continuity of business enterprise requirement).

[128]Treas. Reg. § 1.269-3(d).

[129]An active trade or business requirement such as § 355(b)(1), requires that some business be engaged in. In fact, the § 355(b)(1) rule has two parts: 1) an active trade or business be conducted; and 2) that this business be conducted for five years prior to the § 355 transaction. In essence, this is a continuity of business enterprise requirement. However, because of the way it is defined, the active trade or business requirement is analytically distinct. Treas. Reg. § 1.355-3(b)(2)(iii) states that in order for the business to be active, the corporation must itself perform active and substantial management and operational functions. If § 1.269-(3)(d) is an active trade or business requirement, its requirements are probably similar.

[130]Under Treas. Reg. § 1.355-3(b)(1)(iv), merely holding stock or securities for investment purposes is not an active trade or business. However, because § 1.269-3(d) does not state what definition it uses for active trade or business, use of the I.R.C. § 355 definition is only suggestive.

of the regulation and work through it. Each sentence will be analyzed to see what light it throws on this question.

The relevant part of the first sentence, which sets forth the rule, requires that a loss corporation carry on a significant amount of "an active trade or business during and subsequent" to the bankruptcy proceeding.[131] This sentence is the source of the ambiguity. It is not clear whether there must be at least one active trade or business which was conducted both during and after the proceeding, or whether a loss corporation may change its business at any time as long as it is operating some business.

The next sentence states that the determination of whether the loss corporation has met the § 1.269-3(d) standard is "made without regard to the continuity of business enterprise requirement set forth in section 1.368-1(d)."[132] The regulation does not state that it is not a continuity of business requirement. It only states that it is not § 1.368-1(d). It is unclear how much this helps to resolve the issue. In defining a term, one usually takes special care to separate the object defined from the things closest to it.[133] Therefore, if the regulation takes special care to separate itself from another continuity of business requirement, this suggests it may have a continuity of business requirement. On the other hand, one also attempts to separate terms from their opposites as well. One may argue that § 1.269-3(d) is distancing itself from continuity of business requirements. However, if the intent was to state that this provision does not impose a continuity of business requirement, this could have been stated more directly. A more logical phrasing would have been "[t]he determination of whether the corporation carries on more than an insignificant amount of an active trade or business is not predicated upon whether the same business is conducted throughout the entire period." If, on the other hand, the regulation is a continuity of business requirement, but has different rules than § 1.368-1(d), it would be phrased as it is.[134] No matter how this argument is resolved, this sentence will not answer the larger question. It merely tells us that this regulation is different from § 1.368-1(d), without affirmatively stating what the standard is.

The next sentence seems to resolve the question. The regulation discusses how to determine whether the loss corporation satisfies the requirements.[135] Not surprisingly, the decision is based on all the facts and circumstances. The section then gives examples of the most important facts to be used in making the determination. The only two facts discussed are the amount of business

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[131] Treas. Reg. § 1.269-3(d).

[132] *Id.* The Treas. Reg. § 1.368-1(d) standard is the same as that used in § 382(c). *See supra* note 69.

[133] *See* Miles L. Hanley, *Synonyms and Antonyms, in* THE AMERICAN COLLEGE DICTIONARY xxv-xxvi (Random House 1953).

[134] For possible differences between § 1.269-3(d) and § 1.368-1(d), see discussion *infra* text accompanying notes 146-54.

[135] Treas. Reg. § 1.269-3(d).

assets that *continue* to be used and the number of employees who *continue* in the employ of the loss corporation.[136] The regulation gives no examples only involving the active conduct of business. This strongly implies that the regulation is a continuity of business requirement. If any active trade or business would do, the *continuity* of the employees or assets would be irrelevant. The amount and type of business assets would be important, but not whether these were used before.[137] A business can be active even on its first day of operation. However, if the question is one of business continuity, then whether the assets or employees are the same is an important benchmark of business continuity.[138]

It seems that this regulation requires that there be at least one trade or business which is conducted on a significant scale both during and subsequent to the bankruptcy proceeding. Apparently, termination of the loss corporation's "old" business will result in a complete disallowance of its NOLs.

The final sentence seems to confirm this conclusion. This sentence states that if the loss corporation continues the old business, it can temporarily stop the business for emergencies and still meet the standard. It again refers to continuity of assets and employees as the key to the section.

If, on the other hand, the section was only an active trade or business requirement, this sentence would make the section incoherent. A temporary shutdown of business is allowed only if there is continuity of business. If the business is changed, time will be needed to sell the old assets, buy new assets, hire new people etc.[139] If the business changes, there will likely be a certain amount of down time which will cause it to run afoul of the section. So even if the prior sentences allow the loss corporation to switch businesses, the last sentence makes it difficult to accomplish.

If this were an active trade or business requirement, the section as a whole would be inconsistent and incoherent. The first sentence would be ambiguous; the second would be poorly written, the third sentence would focus on irrelevant facts; the fourth sentence would impose an arbitrary restriction. However, if business continuity is required, the first sentence's lack of clarity is made up for by the examples in the third sentence, as well as by the fourth sentence's explanation.

The Treasury can argue that this is a reasonable interpretation of § 269. Any transaction to which this section applies would fit the "classic" definition of an abusive transaction: the owners would be different from those who incurred

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[136] *Id.*

[137] The fact that they need not be used in the historic business is parallel to § 1.368-1(d). Of course as with that restriction, if the same people must be employed, and the same assets must be used the choice of businesses is severely restricted.

[138] These are the most important factors in the determination of business continuity under § 1.368-1(d).

[139] For what is involved in starting a new line of business see generally RONALD E. MERRIL & HENRY P. SEDGWICK, THE NEW VENTURE HANDBOOK (1987).

the losses, and the business would have changed.[140] One could view this as a rational interpretation of § 269, which acts as a broad based attack on abusive transactions.[141]

Another source of confusion with § 1.269-3(d) is the lack of clarity of the term "strong evidence." "Strong evidence" is necessary to overcome the presumption of tax avoidance. What constitutes "strong evidence?" This standard is not used in any other place in the code or regulations.[142] Neither is this term self-defining. "Strong evidence" is probably greater than a preponderance of the evidence. Currently, if the IRS asserts a deficiency based on § 269, the taxpayer must show by a preponderance of the evidence that tax avoidance was not its principal purpose.[143] This regulation would be weakening the IRS's hand if a preponderance of the evidence is more difficult to obtain than "strong evidence." This does not seem to be the intent of the regulation. The question becomes how strong is "strong evidence?" This will have to be resolved by the courts.

Even with these ambiguities, it is clear there are differences between the "regular" continuity of business enterprise requirements and § 1.269-3(d). First, the § 1.269-3(d) restriction is a presumption which can be rebutted with strong evidence, rather that an absolute limitation like §382(c). In practice, this difference is not likely to be important. As long as the focus is on the acquisition of stock[144] and not on the acquisition of the original interest, reduction of taxes was probably the prime motivation for the acquisition.[145] Therefore, in most situations where § 1.269-3(d) applies, there is unlikely to be "strong evidence" of some other purpose, notwithstanding the ambiguity in the term "strong evidence."

Another difference between the regular § 382(c) limitation and § 1.269-3(d) is that the § 382 limit applies for two years while there is no specified length of time in the § 269 regulation. This creates even more ambiguity. There is no way to determine how long a loss corporation must continue its business based on the regulation itself. Requiring the business to continue in perpetuity seems

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140*See* discussion *supra* text accompaying notes 40-46.

141*See* discussion *supra* textaccompanying notes 109-28. *See generally* Watts, *supra* note 84.

142The only use of the term "strong evidence" in the Code or Regulations is in the regulations under § 355. These regulations state that a business purpose constitutes "strong evidence" that the spin-off is not a device. This is a different context than § 1.269-3(d). It is unclear how it would apply here. The § 355 regulations do not further define "strong evidence". For a further discussion of some of the interpretive problems with § 1.269-3(d), see Richard Reichler, *Presumption of Tax Avoidance Motive in Prop. Regs Affects Many Corporate Bankruptcies*, 74 J. TAX'N 140 (1991).

143Welch v. Helvering, 290 U.S. 111 (1933).

144Section 1.269-5 makes the focus of the analysis the acquisition of the stock itself. *See* discussion *infra* text accompanying notes 153-54.

145*Id.*

ridiculous, as does merely requiring that the business continue at least one day after the end of the proceeding. This, too, will have to be resolved by the courts.

Another distinction between the regular continuity of business requirement and § 1.269-3(d) is the business that must be continued. The § 382(c) rule requires that the "historic trade or business" be continued. The "historic trade or business" of a corporation is that which it conducted before the transaction.[146] In the case of the bankruptcy reorganization, it would be the business engaged in prior to the Chapter 11 filing.

Section 1.269-3(d) only requires that the same business be continued during and after the bankruptcy proceeding.[147] In fact, it specifically states that it does not have to be the historical trade or business.[148] Therefore, a transaction would not be caught by § 1.269-3(d) if immediately prior to the Chapter 11 filing, a loss corporation sold its historic business and acquired a new business. To illustrate,

> Ex 5. Assume Loss Co. has manufactured airplane parts for a number of years. On April 19, 1992, the company liquidated this business and used the proceeds to acquire fast food franchises. On April 20, 1992, the corporation filed a Chapter 11 petition. The historic business of Loss Co. would be the manufacture of airplane parts, because the liquidation of the business was in contemplation of the bankruptcy filing. Therefore, it remains the historic trade or business. Under the § 382(c) standard there would be no continuity of business. However, under the § 1.269-3(d) standard an active trade or business was conducted during and subsequent to the bankruptcy proceeding. Therefore, this standard would be met.

In practice, this distinction will not matter except perhaps in pre-packaged bankruptcies.[149] In order to save a loss corporation's NOLs the change in the corporation's business must occur prior to the bankruptcy filing. The historic owners of the corporation are still in control of it at that time. They decide whether to alter the business. In non-pre-packaged bankruptcies it is generally very difficult to determine who will end up acquiring control of the corporation.[150] Therefore, even if they wanted to, it would be difficult for the

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[146]*See* discussion *supra* text accompanying notes 104-113.

[147]Treas. Reg. § 1.269-3(d).

[148]*Id.*

[149]A "pre-packaged" plan occurs when the debtor obtains the acceptance of its creditors to its Chapter 11 reorganization plan prior to the filing of the bankruptcy petition. 11 U.S.C. § 1126(b)(1988). In this case, the filing of the plan and the acceptance by the court occur at almost the same time. This would allow the debtor to know who will be in control of it before the filing of the petition, since the negotiations for what the new business ought to be would be conducted prior to the filing of the petition. Therefore, it would be possible to change the business prior to the filing of the petition.

[150]Jacobs, *supra* note 91.

"historic" owners to decide what business would be most efficient for the new owners.

The wording of the two limitations implies a similar amount of continuity. Section 1.269-3(d) requires that a significant level of business be continued. Section 382(c) requires a significant level of business be continued. For the level of business to be not insignificant, it must be significant. Semantically, the limitations are the same. However, it is unclear whether "significant" has the same definition in both contexts.[151] This will have to be decided by a court, since § 1.269-3(d) implies that definitions used in § 1.368-1(d) are not determinative for purposes of the regulation.

One of the main sources of ambiguity in § 1.269-3(d) is that it neither defines its major terms, nor relies on definitions used in other regulations. The major terms, therefore, do not yet have definitions. This problem is even worse than it seems. Under most code sections, tax lawyers and planners can obtain private letter rulings to be certain of the tax treatment of the transaction. However, the service has adopted a "no-rulings" position that such rulings are not to be issued in connection with § 269 questions.[152] This increases uncertainty for those planning these transactions.

Another provision of the regulations also adds an important piece to the § 269 analysis. The relevant portion of § 1.269-5(b) states that:

> Solely for purposes of section 269, creditors of a bankrupt corporation are treated as acquiring beneficial ownership of stock of the corporation no earlier than the time a bankruptcy court confirms a plan of reorganization.[153]

If the motives of new owners are determined as of the confirmation of the plan and not when the creditors originally acquired their interests, it is very likely that in § 1.269-3(d) situations the motivation for the acquisition was to use the loss corporation's NOLs. If the new owners liquidated the old business of the corporation and have started an entirely different business, they did not acquire the corporation for its business assets. It is very likely they acquired the corporation for its NOLs. If this is so, § 269 would prevent the loss corporation from using its NOLs.[154]

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[151]The service has defined what significant is for reorganizations in various revenue rulings as well § 1.368-1(d). *See* Faber, *supra* note 69.

[152]Rev. Proc. 92-3, 1991 I.R.B. 40.

[153]Treas. Reg. § 1.269-5(b).

[154]One of the reasons for retaining the corporate shell is that certain assets such as charters, etc., cannot be separated from the shell. But if the corporation is embarking on a new business, it is unlikely that the old charters, etc., will be needed in this new business.

III. ECONOMIC EFFECTS OF § 1.269-3(d)

The analysis of the economic effects of § 1.269-3(d) is divided into four parts. The first part discusses the economic effects § 1.269-3(d) causes by altering the structure of bankruptcy reorganizations. The second part discusses the effects that occur when the section prevents bankruptcy reorganizations. If § 1.269-3(d) affects a transaction, one of these two effects must occur; people will either change their behavior, thereby invoking the first effect, or suffer the penalty, incurring the second effect. The third part discusses the effects of the ambiguity of this regulation. The final section discusses other miscellaneous issues that arise in connection with the regulation.

A. Alteration of Reorganizations

The most important economic effect of § 1.269-3(d) arises from how it alters the structure of some reorganizations. The manner in which it does this significantly impacts economic efficiency. This section will examine the characteristics of the transactions affected by § 1.269-3(d). Then, it analyzes how § 1.269-3(d) may alter these reorganizations. Finally, it discusses the effects of these changes on economic efficiency.

As discussed above, a § 1.269-3(d) transaction would be "abusive" under the "classic" definition[155] because both the owners and the businesses seeking to use the NOLs have changed since the NOLs were created. There has to have been an ownership change as a result of a bankruptcy proceeding in all of these transactions, because § 382(l)(5) must apply in order for § 1.269-3(d) to apply. In addition, at least 50% of the stock of the loss corporation must have been acquired by qualified shareholders. If § 1.269-3(d) operates to disallow the losses, the business which generated the NOLs must have been discontinued.

In a § 1.269-3(d) transaction, it is unlikely that there are any significant inputs of capital. Section 1.269-3(b)(1) states that if the owners of a loss corporation contribute capital into the corporation, such action is evidence that the acquisition was for a tax avoidance purpose.[156] Inputs of capital which go to further a new business are particularly suspect because the NOLs must offset income from a business which did not generate them.[157] This is precisely what the NOL rules are attempting to avoid. Section 1.269-3(b)(1) is only one factor to be weighed against others; it does not create a presumption. Other factors may allow these inputs.[158] However, it is likely that in any § 1.269-3(d) situation, § 1.269-3(b)(1) will essentially prevent large inputs of capital.

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[155] *See* discussion *supra* text accompanying notes 40-46.

[156] Treas. Reg. § 1.269-3(b)(1).

[157] If the old business is discontinued, and there are new inputs of capital, any income generated by the new capital is, by definition, from a business other than that which created the NOLs.

[158] For example, the inputs were small, or they were necessary to shore up an ongoing business.

Section 1.269-3(d) was designed to deal with transactions where the loss corporation discontinues its business while waiting to find a "suitor"[159] to take over the corporation. In these situations, the current owners of the loss corporation understand that any suitor is unlikely to want to continue the current business, and so they discontinue it. The Treasury viewed these transactions as "abusive" and drafted regulations in order to prevent them.[160]

In sum, § 1.269-3(d) transactions possess four characteristics: 1) the loss corporation is in bankruptcy, 2) § 382(l)(5) applies, 3) the business which generated the NOLs is discontinued, and 4) there have been no significant inputs of capital from the new owners.

Now that we have identified the affected transactions, the economic effects of § 1.269-3(d) can be examined. This section will first discuss how this provision can alter decisions made by the new owners of a loss corporation, and how this affects economic efficiency. In particular, it will examine the effect on investment decisions made by the owners of loss corporations. The analysis will then proceed in two parts: 1) whether § 1.269-3(d) transactions[161] raise efficiency concerns similar to those raised by "abusive" transactions in general, and 2) whether this regulation provides efficient incentives to the new owners of loss corporations. The discussion will show that § 1.269-3(d) transactions do not raise the same efficiency concerns as "abusive" transactions, and the regulation provides inefficient incentives to the owners of newly reorganized loss corporations.

Economic efficiency occurs when the resources within an economy are allocated so that the total value of the resources is maximized.[162] One judges the economic efficiency of a tax rule by whether it encourages people[163] to alter their activities from those in which they would have engaged in a tax-free world.[164] In a tax-free world, if someone engages in a particular activity, it is because that person believes this activity will produce the most profit.[165] By changing the activities people engage in, the tax system can reduce output by

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[159]A suitor is someone who will take over the corporation with the approval of the current management.

[160]Under the classic definition of "abusive", the Treasury is correct. In any of these transactions, the NOLs would offset income of a different business owned by different people than that which generated the NOLs. For the Treasury's motives, see Haims, *supra* note 92.

[161]A § 1.269-3(d) transaction is a transaction to which that section applies. In essence, it is a § 382(l)(5) transaction in which the old business has been discontinued.

[162]RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 11-15 (3d ed. 1986). This is actually a special kind of efficiency called allocative efficiency.

[163]"People" is used here in the same sense as the term "person" is used by the tax code. It includes individuals, corporations, partnerships, etc.

[164]POSNER, *supra* note 162; *see also* Campisano & Romano, *supra* note 10.

[165]POSNER, *supra* note 162.

causing them to stop pursuing their most efficient activities and begin pursuing others which are more profitable to them on an after-tax basis.

The efficiency problems with "abusive" transactions, as discussed in section I,[166] are the result of the tax code's incentives to acquire a corporation merely for its NOLs. If someone acquires a loss corporation because of its tax benefits, that person is not necessarily the most efficient user of the company's assets.[167] When the tax system causes a less efficient user to acquire the assets, it has caused a drop in efficiency.[168]

These concerns do not apply to § 1.269-3(d) situations. If the acquirers of these loss corporations are not the most efficient users, it does not affect efficiency. By definition, the acquirers have liquidated the loss company's assets. Presumably, they have sold the assets to the person (or persons) able to produce the most value from the assets and so are able to pay the highest price.[169] Therefore, § 1.269-3(d) transactions do not involve the same efficiency concerns as most other "abusive" transactions.

While no efficiency is gained by preventing these transactions, there is also no direct efficiency gain by allowing them. The assets are likely to be acquired by the same persons who would have held them after a Chapter 7 liquidation;[170] which would have occurred if there had been no Chapter 11 reorganization. The persons who have the highest value for the assets will still have the highest value and, therefore, be able to pay the most.[171] The assets will have the same value in either case. As discussed below, collateral efficiency effects may arise from attempting to prevent these transactions.

The second part of the analysis will discuss the incentives this regulation provides for the new owners of loss corporations to behave efficiently after the acquisition. It will show that this regulation provides incentives to the new owners to retain the current business, and this can cause a significant decrease in efficiency.

As stated before, § 1.269-3(d) requires the new owners of a loss corporation to retain a significant portion of the loss corporation's business in order to use its NOLs.[172] This creates an incentive for the new owners of the company to retain its old business[173] even though another would be more profitable. This

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[166]*See* discussion *supra* text accompanying notes 40-46.

[167]*See* discussion *supra* text accompanying notes 78-99.

[168]If an asset produces $100 if used by A and $50 if used by B, all other things being equal, it is most efficient for A to use the asset.

[169]If acquirers were the most efficient users, they would have no incentive to sell the assets because no tax advantages flow with the assets themselves.

[170]*See supra* note 89 for a definition of Chapter 7 liquidation.

[171]*See* discussion *supra* text accompanying notes 72-88.

[172]*See* discussion *supra* text accompanying notes 155-68.

[173]The old business is the business the loss corporation is engaged in at the beginning of the bankruptcy proceeding.

incentive arises because income from the old business is tax-free, up to the amount of the loss corporation's NOLs. Income earned on any other business is taxable if the loss corporation's old business is discontinued. To illustrate, assume A acquires Loss Co., which is currently involved in Business #1. A has two options: A can continue Business #1 or A can liquidate it and use the proceeds to acquire Business #2. A is in the 30% tax bracket. Business #1 will yield $50 to A per year. This income is tax-free because A can use the NOLs that Loss Co. had generated prior to A's acquisition to offset the income. Business #2 will earn A $60 a year, but the return on Business #2 is taxable because Loss Co.'s NOLs cannot be used to offset this income. A will decide which asset to acquire based on total after-tax earnings.[174] Total after-tax earnings are $50 for Business #1 and $42 for Business #2.[175] Therefore, A will retain Business #1, even though it would be more efficient for the economy if A acquired Business #2.

Section 1.269-3(d) creates this kind of incentive by allowing the loss corporation to use its NOLs only if the old business is retained. If the loss corporation retains the old business, the corporation can offset its income with the NOLs. If this business is liquidated, the NOLs cannot be used. Thus, income from the current business is tax-free, up to the amount of the NOLs, and income from any other business is taxable.

This incentive can reduce output by an amount up to the present discounted value of Loss Co.'s NOLs. That is, A would be willing to retain Business #1 until the after-tax returns of Business #2 exceed the non-taxed returns of Business #1. In the above example, Business #2 would have to earn more than $72 before A would be induced to switch.[176]

One can argue that the above analysis proves too much. This analysis applies with seemingly equal force to the continuity of business enterprise requirement for "regular" § 382 and § 382(l)(6) transactions.[177] Are these provisions inefficient as well?

The argument does apply to these sections, and some commentators have called for § 382(c) to be repealed for this reason.[178] However, there is a distinction between "regular" § 382 situations, where § 382(c) applies, and § 1.269-3(d) situations. This difference is related to the reason for § 382(c). It makes the argument against continuity requirements in § 1.269-3(d) situations even stronger than in the other situations.

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[174] *See* POSNER, *supra* note 162.

[175] Because Business #1's earnings are not taxed, pre-tax and after-tax income are the same. For Business #2, $50 x .34 = $8 of tax. So, after-tax earnings for Business #2 are $50 - $8 or $42.

[176] $72 x .34 = $12, so that the after tax earnings would equal $50.

[177] Section 382(c) applies to both types of transaction. *See* discussion *supra* text accompanying notes 104-22; Prop. Reg. § 1.382-3(m)(2).

[178] Yin, *supra* note 66.

Section 382(c) is designed to discourage the acquisition of a loss corporation for its tax attributes. The section attempts to ensure that only those interested in keeping the business or its assets will be allowed to acquire the tax attributes of a loss corporation. It does this by preventing a loss corporation which liquidates its old business from using any of its NOLs. If an acquirer is interested in either the business or the business assets of the loss corporation, it will keep them, since that is why it purchased the corporation. Such an acquirer would meet the § 382(c) requirements.

In a regular § 382 situation, acquirers are self-selected. They decide whether to acquire the corporation or to use their capital in other ways. A rule designed to alter behavior can work where the actions are voluntary. The acquirers in bankruptcy are not self-selected. Most of the time, they did not initially wish to acquire the loss corporation.[179] They agreed to acquire the corporation when it became the best way to recover their losses. This decision is very different than the kind prevented in regular § 382 situations. In essence, the creditors have already acquired the corporation even though they did not want it.[180] Deterrence cannot work when the behavior is involuntary.[181] Therefore, the new owners will suffer the penalty of this provision without behaving improperly.[182]

B. Effects of Preventing Reorganizations

Section 1.269-3(d) also causes economic effects when it disallows NOLs. When this occurs, the loss corporation will be liquidated rather than reorganized.[183] If § 1.269-3(d) applies, the corporation's business assets have been sold. It has no tax "assets" remaining because § 269 disallowes them. There

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[179] In particular, § 382(l)(5) restrictions are designed to ensure that the creditors who acquire the loss corporation did not have this intention when they acquired their interests. *See* Fortgang & Mayer, *supra* note 97.

[180] The creditors will either get the corporation itself, or the proceeds from the sale of its assets. It is the creditors who will profit or lose from changes in the corporation's value. They effectively own the corporation, even if they choose to liquidate it rather than acquire its stock.

[181] NIGEL WALKER, SENTENCING IN A RATIONAL SOCIETY 56-59 (1969).

[182] The new owners will still make the decision of whether to liquidate or not. This decision, in and of itself, however, is not likely the result of a tax avoidance motive, and so, is not likely to have efficiency consequences. The inefficiency problem results from the acquisition of the NOLs. *See* discussion *supra* text accompanying notes 47-71. Once the loss corporation has been acquired, they already have the NOLs. By itself, the decision to liquidate the assets is not the cause of the inefficiency. The new owners would only decide to sell the assets if they were not the most efficient users. The decision to liquidate is used as a proxy under § 382(c) to see if the motive for the acquisition was tax avoidance.

[183] The corporation will undergo a liquidation under Chapter 7 of the bankruptcy code rather than a reorganization under Chapter 11.

is little reason for the loss corporation's continued existence, and so, it will likely be liquidated.[184]

Under § 1.269-3(d), NOLs are disallowed when § 382(l)(5) applies, and the business of the loss corporation is discontinued. The owners of the loss corporation will liquidate the old business when another business can generate after-tax profits that exceed the old business's non-taxed profits. Since the current corporate rate is 35%, if the alternative business can earn at least 1.5 times what the old business can, the new owners will liquidate the old business.[185]

Disallowing the NOLs in these situations will create a bias against investment in risky businesses. Persons who lend money to risky businesses include in their investment calculations the potential value of the loss company in bankruptcy.[186] Section 1.269-3(d) reduces the value of a bankrupt corporation by destroying one its most important assets, its NOLs.[187] If the value of the loss corporation in bankruptcy decreases, either the creditors will be less willing to lend money to the corporation, or the creditors will demand a higher rate of interest on the debt, or both. This creates a bias against risky investments.

A bias against risky business may be compensating for a bias in their favor in another part of the code. This new bias may, in fact, be making the system more neutral. Economists refer to this as the theory of second best.[188] However, the tax system is already biased against risky businesses. In particular, the NOL rules penalize these ventures. For example, income taxes take approximately 34% of the profit of a corporation. NOLs only decrease taxes if there either has been, or will be, a profit. If there is no profit, they are worthless. The corporate income tax reduces upside profit by 34%, yet it does not decrease downside losses.[189] Risky businesses are disproportionately harmed because they are less

[184]HENDERSON & GOLDRING, *supra* note 8, at ¶ 1201.

[185]For a taxable source of income to produce as much after-tax profit as a non-taxed source, the taxable source must generate returns greater than the non-taxed source by a factor at least equal to the inverse of the tax rate. If the tax rate is 33% and the non-taxed source produces a $200 return, the taxable source must produce a return of at least $300 to give the same after-tax return. ($300 x 33.3% = $100 of tax, so total after tax return is $200).

[186]Strand, *supra* note 96.

[187]*See* Rizzi, *supra* note 8, at 140.

[188]*See* R. G. Lipsey & Kelvin Lancaster, *The General Theory of Second Best*, 24 REV. ECON. STUD. 11 (1956). The theory of second best states that when the economy is not operating at optimal efficiency, an otherwise inefficient action might increase efficiency. For example, if one type of investment is not taxed, it may increase efficiency to a place a surtax on it. This would bring the relative returns on that investment to what it would have been if it were taxed.

[189]For a fuller discussion of this point, see Campisano & Romano, *supra* note 10.

likely to produce a profit than stable businesses.[190] One particular form of risky venture, start-up companies, receives particularly harsh treatment from § 382. New companies, and risky companies generally, are likely to have more ownership changes,[191] which causes the § 382 limitation to be invoked. This substantially reduces the value of the NOLs, giving these businesses a competitive disadvantage.[192] This can have serious consequences because new and risky ventures are one of the best sources of innovation and job creation.[193] In order to be more neutral, the system ought to give preferences to risky ventures, not impose disincentives. This rule takes the system further away from neutrality and decreases efficiency.

While this provision will raise revenue,[194] it does it in an inefficient manner. It prevents transactions which present no efficiency loss, and it creates tax-favored investments without regard to their efficiency. While it is true that

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[190] A risky business is less likely to earn a profit, that is what makes it risky.

[191] This is partially as a result of the way risky businesses are financed. Because of the risk, investors do not want to initially place a lot of capital in the corporation at one time, so they stage their investments over time. This allows the investors to gain more information about the viability of the business before becoming fully committed. As new investment flows in, it is likely to cause a § 382 ownership change. *See generally* Richard L. Parker, *The Innocent Civilians in the War Against NOL Trafficking: Section 382 and High-Tech Start-up Companies*, 9 VA. T. REV. 625 (1990).

[192] If there are two businesses with equal NOLs and equal incomes, and one undergoes an ownership change while the other does not, the corporation which does undergo the ownership change is at a disadvantage because it can not fully use it NOLs while the other business can.

[193] These companies are the most important for economic growth. *See generally* GEORGE GILDER, THE SPIRIT OF ENTERPRISE (1984).

[194] The most obvious effect of disallowing NOLs is that it raises revenue. If deductions are decreased, taxes are increased. One might imagine that this increase would be equal to the present value of the NOLs disallowed. However, the amount of increase in revenue is less than this. If the NOLs are entirely disallowed because of § 1.269-3(d), the Treasury will collect more revenue because of the lack of these deductions. This increase in revenues is offset by the increased bad debt deduction that the lenders would take if the NOLs disappeared, but will not take if the NOLs survive. If the creditors of the loss corporation will incur a loss on the debt, they are entitled to a deduction (§ 166 for non-security holders and § 165 for security holders, because a liquidation will not result in a recapitalization under § 368 (a)(1))(E)). If the loss corporation could utilize the NOLs, the value of its stock would be increased. Since the value that the creditors receive is increased, the amount of their bad debt deduction is decreased. This decrease is equal to the amount by which the value of the NOLs increases the value of the stock (in other words the NOLs' present value). To illustrate this, assume Loss Co. has NOLs with net discounted present value of $20 million. The value of the stock without the NOLs is $1 million. Therefore, if the NOLs are allowed the value of the stock the creditors will receive is $21 million. The value of what the creditors receive has been increased by the value of the NOLs. The creditors deduction has therefore dropped by an amount equal to the value of the NOLs. If they are in the 30% tax bracket, the $20 million revenue loss is offset by a $6 million increase in revenue due to the creditor's not taking the deduction for their losses.

§ 1.269-3(d) transactions are "abusive," the costs to efficiency by attempting to prevent them are greater than the benefits.

C. Problems Due to Uncertainty

The above discussion assumed that when the plan is confirmed, all parties to a bankruptcy reorganization (the creditors, shareholders, etc.) are certain of § 1.269-3(d)'s consequences on the NOLs of the loss corporation.[195] However, this will often not be the case. One reason for this is the ambiguity in § 1.269-3(d). For example, while this paper concludes that the provision imposes a continuity of business requirement, there is not universal agreement on this.[196] In addition, many of the terms used in § 1.269-3(d), such as "strong evidence" and "significant" continuity of the business, as well as uncertainty as to how long the business must be continued, are ambigous.

Uncertainty in the meaning of a provision can seriously affect efficiency. It increases transaction costs because it requires more research by lawyers and accountants.[197] Risk itself is a cost because it decreases the utility of those who bear it.[198] It makes creditors less likely to lend to risky businesses which have a possibility of filing a Chapter 11 petition.[199] Furthermore, this section imposes added costs on a class of businesses least able to afford it: risky and failing businesses.[200] All of these costs are incurred without any increase in productivity, thereby decreasing efficiency.

These ambiguities will eventually be resolved by the courts. But that is a costly way to resolve them in terms of the legal bills for litigating the matter, and in terms of the costs of altered transactions that decrease output.

D. Miscellaneous Arguments

One may argue that even though a continuity of business requirement is inefficient, providing a break to one type of transaction and not to other types may decrease efficiency even more than allowing no relief. By creating a non-neutral provision, it may over-encourage the use of the tax favored type

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[195]This is when the bankruptcy court agrees with the plan for reorganization. It is then that the exact structure of the reorganization is enacted.

[196]*See* Barr, *supra* note 127; Blashek *supra* note 127.

[197]*See* James S. Eustice, *Tax Complexity and the Tax Practitioner*, 45 TAX L. REV. 7, 19 (1989); James L. Payne, *Unhappy Returns: The $600 Billion Rip-Off* TAX NOTES TODAY 264-57 (Dec. 31, 1991), *available in* LEXIS, Fedtax library, TNT file.

[198]POSNER, *supra* note 162.

[199]Roger H. Gordon & Burton G. Malkiel, *Corporate Finance, in* HOW TAXES AFFECT ECONOMIC BEHAVIOR (Aaron & Pechman eds. Brookings Institution, Washington, D.C., 1981).

[200]HENDERSON & GOLDRING, *supra* note 8; *see also* SOL STEIN, BANKRUPTCY: A FEAST FOR LAWYERS (1992).

of transaction. This is another manifestation of the theory of second best.[201] In the current situation, requiring one type of bankruptcy reorganization, § 382(l)(6) reorganizations, to continue the old business, while not requiring another type of bankruptcy reorganization, § 382(l)(5) reorganizations, to continue the old business may over-encourage the use of § 382(l)(5), and, as a result, decrease efficiency.

However, the theory of second best does not apply here. This theory only operates when there is an efficiency loss from encouraging one type of transaction over another.[202] As we shall see, whichever code section applies, the underlying business and asset structure of the loss corporation will be the same, so there is no efficiency loss from this choice.

The choice between § 382(l)(5) and § 382(l)(6) occurs in two situations: 1) if the loss corporation elects § 382(l)(6) treatment under § 382(l)(5)(H); and 2) if the loss corporation does not qualify for §382(l)(5) due to the amount of stock held by non-qualified shareholders. If the loss corporation elected for § 382(l)(6) to apply, this decision only affects the tax treatment; it would not alter the underlying structure of the deal.[203] Therefore, efficiency is the same.

If the reorganization does not qualify for § 382(l)(5), this is because too many non-qualified creditors received stock of the corporation, not because of the nature of the business the loss corporation will enter, or how it will conduct that business. This fact affects which creditors will receive equity, and which will receive debt, but it does not affect the corporation itself.[204] There is no efficiency loss by having more § 382(l)(5) transactions than § 382(l)(6) transactions.[205]

One may also argue that the reorganizations covered by § 1.269-3(d) were not intended to receive the special treatment of § 382(l)(5). The intent behind allowing special NOL rules in bankruptcy was to encourage rehabilitation of businesses. If a loss corporation does not retain the old business, then it should

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201 *See supra* note 188. Here again, the system would not be performing optimally, and so another inefficient action may increase efficiency.

202 The tax system can reduce efficiency significantly by encouraging one activity preferentially to another, and thereby changing the rate of substitution. *See* RICHARD MUSGRAVE & PEGGY MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE (3d ed. 1980).

203 If the election occurs, there are only two differences in the actions by the loss corporation: 1) an election is filed with the IRS and 2) the NOL treatment of the corporate tax returns. Neither affects how the assets of the corporation are used.

204 There may be some effects because of the different treatment of old debt holders versus new, but *a priori* it is difficult to tell how this would affect decisions. New debt holders would have to be compensated as well, and the affects depend on the compensation given, which would be different in each transaction.

205 Generally, the decision between § 382(l)(5) and § 382(l)(6) is not made based on the continuity of business. The decision is generally based upon the size of the interest deduction in the last three years. This results because § 382(l)(5) will remove these deductions from the NOLs. *See* Lee A. Sheppard, *The Unused Bankruptcy Exceptions*, 57 TAX NOTES 709, 710 (1992).

not be entitled to retain NOLs either. This is not an efficiency argument, but a question of intent behind the rules. In fact, rehabilitation is often at odds with neutrality.[206] Rehabilitation is the result of the government encouraging an activity which would not otherwise take place. Therefore, rehabilitation does not necessarily increase efficiency. From an economic standpoint, that § 1.269-3(d) encourages rehabilitation is an argument for withdrawing it.[207]

IV. ALTERNATIVES PROPOSED

Section 1.269-3(d) created a great deal of controversy when it was first proposed.[208] Almost all the commentators who addressed the regulation called on the Treasury to withdraw or substantially change it.[209] Some of the commentators proposed alternatives to the regulation. The most prominent alternatives were the American Bar Association (ABA) report[210] and The New York State Bar Association (NYSB) report.[211] These reports are similar in many ways. They both propose that the current § 269 regulations be rescinded and replaced by a list of factors to be used in determining whether the principal purpose of the acquisition was tax avoidance.[212] Both differ significantly from § 1.269-3(d) because neither allows any individual factor to create a presumption of tax avoidance. They are both "totality of the circumstances" tests.

However, significant differences exist between the reports. The NYSB proposal only applies to cases where the loss corporation is the subject of a bankruptcy proceeding. The ABA proposal, in contrast, applies to all § 269 determinations, not just those in which the loss corporation is in bankruptcy.

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[206]Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127 (1986).

[207]*See id*. at 206; *see also* Korobkin, *supra* note 7.

[208]55 Fed. Reg. 33,139 (1990).

[209]*ABA Members Find Regs on Ownership Changes Inconsistent with Tax Laws*, TAX NOTES TODAY 203-33 (Oct. 1, 1991), *available in* LEXIS, Fedtax library, TNT file [hereinafter *ABA*]; *Philadelphia Bar Asks IRS to Withdraw Tax-Avoidance Presumption Provisions*, TAX NOTES TODAY, June 12, 1991, *available in* LEXIS, Fedtax library, TNT file; New York State Bar Association, *Report on Proposed Treasury Regulations Under Sections 269 and 382*, TAX NOTES, Jan. 28, 1991, *available in* LEXIS, Fedtax library [hereinafter *NYSB Report*]; *New York Attorneys Offer a List of Factors as Replacement for Presumption Contained in Proposed Section 269 Regulations*, TAX NOTES TODAY 204-49 (Oct. 4, 1990), *available in* LEXIS, Fedtax library, TNT file (containing proposal of M. Carr Fergusson and Leslie Hoffman Altus) [hereinafter *New York Attorneys*].

[210]*ABA*, *supra* note 209.

[211]*NYSB Report*, *supra* note 209. The proposal put forth by M. Carr Fergusson and Leslie Hoffman Altus discussed in *New York Attorneys*, *supra* note 209, is very similar to the *NYSB Report*, which both helped to prepare. Due to the similarities in these reports, only the *NYSB Report* is discussed separately.

[212]*See ABA*, *supra* note 209.

The most significant difference, for purposes of this paper,[213] is the factors each uses. While the topics addressed by the two reports are similar, there is a difference in basic approach. The ABA report uses eight factors which are rather specific, and asks pointed questions. The NYSB report uses five factors which are more inclusive, and asks more general questions.

The discussion of the two reports will begin with the ABA proposal, going through its factors in order. The discussion then turns to the factors in the NYSB report, comparing and contrasting them with the ABA report. The discussion will focus on the report's impact on § 1.269-3(d) transactions, but more general points will be addressed as well. The section ends by giving some suggestions for shaping alternative regulations as well as providing other possible measures.

Under the ABA set of factors, the first factor is whether the NOLs have been subject to other limits.[214] (e.g., § 382) If the losses have been subject to other limits it is less likely that the acquisition was for tax avoidance purposes.[215] This point should be included in any analysis of motives. If the NOLs are sufficiently restricted so that they have little or no value, it is unlikely that the principal purpose of the acquisition was to obtain them for tax avoidance. If, on the other hand, the NOLs have significant value, then NOLs possibly were the purpose of the transaction.

The current § 1.269-7 asks a similar question. However, the ABA report considers limitations the regulations do not.[216] Section 1.269-7 only considers the limits imposed by §§ 382 and 383, while the ABA report also considers the limitations imposed by the SRLY and CRCO rules.[217] These later provisions can limit the usefulness of NOLs as well and so should be considered.

The second factor asks whether there was a significant shift in ownership prior to the § 382(l)(5)(E) period.[218] That is, this factor examines whether there was substantial trading in the debt claims of the loss corporation prior to the 18-month period before the filing of the chapter 11 petition. Looking at these transactions may help to find tax avoidance transactions in some cases. However, if the creditors have held the debt for longer than 18 months, they have taken a substantial business risk that either the loss corporation may recover and never file a petition, or that the corporation may incur so much debt that becoming a creditor is not a cost-effective way to acquire NOLs.

[213]This paper deals with situations where the loss corporation is in bankruptcy. Therefore, both proposals cover all the transactions at issue in this paper.

[214]*See ABA*, *supra* note 209.

[215]*See* discussion *supra* text accompanying notes 124-25.

[216]*ABA*, *supra* note 209.

[217]*See supra* note 15; *see also ABA*, *supra* note 209.

[218]*ABA*, *supra* note 209.

Because of this, Congress determined that transactions before this time are not relevant to the question and should be of minor significance at best.[219]

The third and fourth factors deal with the loss corporation's situation at the time of the original borrowing or when the new shareholders acquired their interest in the corporation.[220] If the debtor had substantial losses at that time, or was insolvent, it is more likely that tax avoidance was the purpose of the acquisition.[221] Both of these factors argue for a disallowance of the NOLs because the creditor knew or might have known that there was a substantial chance it could acquire the losses. However, in nearly all cases some of the creditors will have acquired their interests in the loss corporation when it had losses, and some when it was in bankruptcy.[222] So, this factor should not be viewed as the touchstone of tax avoidance. Furthermore, this problem is of diminished significance for § 1.269-3(d) transactions. By definition, these transactions are covered by § 382(l)(5), and this code section prevents those who acquire their interest close to or after the filing of the petition from gaining control.[223] These restrictions prevent investors who are merely interested in acquiring the NOLs from using them. In order to prevent tax motivated transactions, the question should not be merely whether the creditors knew that they may be able to acquire the losses, but should include whether acquiring the debt appeared to be a cost-effective way of acquiring the NOLs. If not, then it is unlikely the acquisition of the NOLs was the purpose of the transaction. While the facts discussed in these factors point toward a tax avoidance motive, they alone should not be sufficient for finding such a motive.

The fifth factor looks to the amount paid for the debt.[224] If the creditor paid more for the debt than its fair value based on the expected recovery of claims (excluding the tax benefits), it seems likely the creditor was paying for the tax benefits. According to the ABA report, this is evidence of a tax avoidance motive.[225] While this seems reasonable on first glance, any transaction which occurs while bankruptcy is reasonably possible will involve compensation for potential tax benefits. The seller of the interest would not sell its interest in the

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219This is the reason for the § 382(l)(5) restrictions on stock ownership. *See New York Attorneys, supra* note 209; *NYSB Report, supra* note 209. For a discussion of the operation of the market for securities of failing corporations see Fortgang & Mayer, *supra* note 97.

220*ABA, supra* note 209.

221The third factor asks if the debtor had substantial losses. The fourth factor asks if the debtor was insolvent.

222One of the chief reasons for pursuing a bankruptcy petition is to encourage creditors to start to lend to the bankrupt corporation. As long as the business continues, there will be continued need for credit. HENDERSON & GOLDRING, *supra* note 8; Stein, *supra* note 200.

223*But see* discussion of the eighth factor, *infra* text accompanying notes 236-38. It examines one type of transaction which § 382(l)(5) does not protect against.

224*ABA, supra* note 209.

225*Id.*

corporation to the purchaser unless the purchaser compensates it for the expected value of the tax benefits.[226] If an interest is acquired when bankruptcy is a serious consideration, there will be a premium for the tax benefits. While the ABA report does not specifically discuss it, any conclusion based on this factor should look to the relative amount of the acquisition premium versus the underlying value of the assets. If the premium is not substantial compared to the underlying value, tax avoidance was probably not the principal purpose.

The final three factors all deal with the actions of the loss corporation after the acquisition. In particular, the sixth factor, which is similar to § 1.269-3(d), states that if the loss corporation failed to continue a significant amount of business or generate more than nominal revenues from its historic business, this is evidence of a tax avoidance purpose.[227]

This factor has some of the same definitional problems as § 1.269-3(d). It is not entirely clear if this is a continuity of business requirement or an active trade or business requirement. If the loss corporation conducts an active business, it meets the standard of either conducting an active business or continuing the old business. However, requiring the loss corporation to either conduct an active business or continue the old business is redundant. If it continues the old business, it will almost certainly be conducting an active trade or business.

There is a way to read this factor to avoid these problems. One can view it as asking two separate questions. First, is the historic business still conducted? Second, is the loss corporation conducting an active trade or business? If the first question is answered in the negative, the inquiry moves to the second. While not continuing the historic trade or business would be evidence of a tax avoidance purpose, conducting no active business would be even greater evidence. Note that the first question is more restrictive than § 1.269-3(d) because it looks for the historic business, while the regulation is slightly more lenient.[228]

Business continuity should be part of any § 269 determination. If the old business is sold, the acquriers were not interested in the business assets of the loss corporation. In this case, acquisition of the tax attributes was very likely the prime motive. This may seem at odds with what was said in the discussion of incentives to retain the old business of the loss company.[229] However, the ABA report's approach is better than § 1.269-3(d). This principle is best included as one of many factors, rather than allowed to create a presumption. If it is merely a factor, other evidence can more easily overcome this fact, or it can be ignored in the appropriate circumstances. In § 1.269-3(d) situations, if the creditors takeover it is unlikely they acquired the debt with a tax avoidance

226Unless the seller is unaware of the tax benefits, or unable to use them.

227*ABA*, *supra* note 209.

228*See* discussion *supra* text accompanying notes 172-76.

229*See supra* section II.A.

motive.[230] Therefore the NOLs may be allowed. The loss corporation would not necessarily have to continue the old business. For example, if the corporation had substantial business reasons for the liquidation, these would more easily overcome a factor than the § 1.269-3(d) presumption, because "strong evidence" is required to override it.

The seventh factor, which is similar to § 1.269-3(b)(1), states that if the new owners of the loss corporation infused capital into the corporation, it indicates a possible tax avoidance motive.[231] This goes to the root of what causes inefficiency in acquisitions. Inefficiencies can only arise when NOLs are used to offset a "pool of capital"[232] different from that which generated them. If the corporation retains the same pool of capital, the new owners will have the proper incentive. To illustrate this, assume a loss corporation, X Co., is acquired by its creditors. Assume also that X Co. has substantial NOLs. The new owners will seek to make the most efficient use of its assets, even if the most efficient use of the assets is to sell them. If these NOLs can only offset income from the X Co.'s pre-acquisition pool of capital,[233] the NOLs cannot create inefficient incentives. In order for NOLS to create inefficient incentives for acquisitions, there must be a disparity between the value the current owners assign to them and the value a potential purchaser assigns to them.[234] If the NOLs can only offset income from the same pool of capital, and the potential purchaser has a higher value for these NOLs, the purchaser must be able to produce more income from the assets of the corporation.[235] Therefore, it would be efficient for the purchaser to acquire the assets. If no infusions of capital are allowed, the NOLs must offset the same pool of capital. Consequently, the acquisition must be efficient.

230*See* discussion *supra* text accompanying notes 127-38.

231*ABA*, *supra* note 209.

232The pool of capital of a corporation is an abstraction of the capital owned by the corporation. For example, if a corporation owns one truck, that is its pool of capital. However, the pool of capital is not identical to the truck. If the corporation sells the truck and uses the proceeds to invest in bonds, the income from the bonds is generated by the same pool of capital that produced the income from the truck. Therefore, both the actual assets themselves, or the liquidation value, are manifestations of the more abstract "pool" of capital. If on the other hand, the owners of the corporation contributed capital and purchased another truck, the income from this second truck would be generated by a different pool of capital.

233If the new owners contribute capital to the corporation, any income generated by it would not be from the pre-acquisition pool of capital.

234*See* discussion *supra* text accompanying notes 47-71.

235If there is additional income to offset the pre-acquisition NOLs, this new income can only have one source: the assets of the corporation. The NOLs can only offset income from these assets. This income may be derived either directly from the assets or indirectly by selling them. For why a higher value for NOLs equates with increased efficiency, see discussion *supra* text accompanying notes 61-70.

The eighth and final factor states that if the benefit of the losses shifts to persons other than the historical shareholders and to creditors in a transaction subsequent to the bankruptcy reorganization, it is evidence of a tax avoidance purpose.[236] This factor would act as a back-stop to the § 382(l)(5) requirements. Section 382(l)(5) restricts who can own shares if a bankruptcy reorganization results in an ownership change, and it also prohibits second ownership changes for two years. However, a literal reading of the statute would not prohibit a transaction where a new creditor acquired 49% of the debt the day before the bankruptcy filing (assuming that all the remaining creditors are qualified creditors), then after the confirmation of the plan this non-qualified creditor acquired up to 49% of the loss company stock.[237] This second acquisition of stock would not be an ownership change,[238] and so, would not be prevented by § 382(l)(5). Yet, this transaction would be an end-run around the rules. The owner of 98% of the stock of the loss corporation could have intended to acquire the NOLs all along. Nevertheless, the corporation would still be able to use the NOLs.

In contrast to the ABA report, the NYSB report only includes five factors. The first deals with business continuity.[239] If the historic business of the acquired corporation is not continued, it is evidence of a principal purpose of tax avoidance. This factor is similar to the sixth factor of the ABA report. One difference between the reports is the NYSB version's meaning is clearer than the ABA's. The NYSB report clearly looks for business continuity and not merely whether there is an active trade or business.

The second factor looks to the relationship of creditors to losses.[240] This factor is much like factors three and four in the ABA proposal. It is, however, more general in scope. Whether there were losses or whether the loss corporation was insolvent at the time is important, but other facts may also be included in this version.[241] The NYSB formulation seems better than the ABA formulation. As stated in connection with the ABA report, these ABA factors are useful but should not be decisive. If there are additional circumstances which indicate both that creditors knew there would be a Chapter 11 proceeding, and that this would be a cost-effective way to acquire the loss

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[236] *ABA, supra* note 209.

[237] This example assumes the new creditor did not hold options on the 49% of the stock acquired after the reorganization.

[238] For an ownership change there must be a 50% shift in ownership since the last ownership change. I.R.C. § 382(g). The last ownership change was the bankruptcy reorganization, and there has only been a 49% ownership shift since that time.

[239] *NYSB Report, supra* note 209.

[240] *Id.*

[241] *Id.* Examples include whether the losses were cost-effectively acquired, whether they were about to expire, and the ability of the acquirer to use the losses given its income and NOL position.

corporation's NOLs, then the NOLs should be disallowed. These facts would not be included under the ABA formulation.

The third NYSB factor looks to whether interests in the loss corporation have shifted just prior to the filing of the bankruptcy petition.[242] If there was trading right before the filing of the bankruptcy petition, it is possible those who acquired the debt knew they would acquire the corporation and could estimate the value of the NOLs. It is more likely that the creditors were attempting to obtain tax benefits if they could be certain of the value of these benefits and their ability to acquire them. However, this problem is of lessened significance for § 1.269-3(d) transactions, because § 382(l)(5) applies.[243]

The fourth factor looks to whether there was a decrease in tax benefits due to § 382(l)(5) or § 382(l)(6).[244] This is very similar to the first factor in the ABA proposal and also to § 1.269-7 of the regulations.[245] The NYSB version is similar to the ABA version because both examine all of the NOL limitations. One difference between the ABA and NYSB formulations is that the NYSB factor looks to whether the other limitations actually decreased the amount of the NOLs, whereas the ABA factor looks to whether the NOLs were subject to possible restriction. The NYSB formulation is more practical. If the NOLs were subject to limitation, but not significantly affected, tax avoidance is still possible.

The fifth and final factor in the NYSB proposal is whether there are other business purposes for the acquisition.[246] This is a catchall provision that is designed to allow for inclusion of other facts going to the intent of the acquirers. The ABA does not include this in its set of factors. It is useful to have such a factor, because it allows for inclusion of facts that could not be foreseen during the writing of the regulations. If tax motives were a large part of the decision, but there were even more substantial business motives, § 269 would allow the NOLs.[247]

As for choosing between these proposals, the NYSB report seems superior to the ABA report. The NYSB report's factors are more general, but they seem to allow for more facts to be included in the decision. Because of this generality, they give less guidance to those who must make decisions on § 269 questions. While guidance is useful, § 269 is, after all, a facts and circumstances provision,

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242 *Id.*

243 Because of the § 382(l)(5) restrictions on ownership of stock, it is less likely the new owners were attempting to acquire the NOLs. *See* sources cited *supra* note 209.

244 *NYSB Report, supra* note 209.

245 *See* discussion *supra* text accompanying note 79.

246 *NYSB Report, supra* note 209.

247 *See* discussion *supra* text accompanying notes 124-30.

not an objective rule like § 382. Therefore, if the questions asked are too specific, the analysis might ignore important aspects of the transaction.[248]

An even better approach to dealing with these situations would be to combine the ABA and NYSB proposals. Under this regime, the regulations would first ask the general question posed in the NYSB report and then elaborate on the meaning of this by including the more specific questions of the ABA report, as well as other questions.[249] or example, the § 269 regulations should examine, as the second NYSB factor does, the relationship of the creditors to the losses. The section dealing with this point might then elaborate by asking more specific questions such as, whether, if at the time of the original borrowing, the debtor had substantial losses or was insolvent, as the third and fourth ABA factors, respectively, discuss. It should also examine the amount paid for the debt as the fifth ABA factor does. If the regulations were structured this way, they would be free to consider these facts and others as well. The regulations would have both the freedom of the NYSB factors and the guidance of the ABA factors.

However the regulations are constructed, they should examine the transactions that occur subsequent to the plan confirmation. Transactions which attempt to thwart the restrictions of § 382(l)(5) should be prevented, even though the plan was already confirmed before this was apparent. This would prevent transactions such as that discussed in connection with the eighth ABA factor.

One point in favor of both of these proposals is that neither establishes a continuity of business requirement, although the lack of business continuity is a factor to consider. As examined in section II, a continuity of business requirement would be inefficient. To the extent they lessen this requirement, they improve efficiency.

Another argument supporting these reports is that § 269 is too vague and uncertain in its application.[250] To the extent that they add some certainty they should be welcomed. However, it is unclear how much certainty either adds. There have been a number of cases under § 269 and in some sense these proposals simply reiterate their holdings.[251] They do not tell judges what weight to give to each of the factors. Yet, the weight given to the factors can determine the outcome. However, adopting these proposals would result in a

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[248] Stephen J. McGarry, Note, *State of Mind Standards in Taxation*, 7 AM. J. TAX POL'Y. 249, 277 (1988).

[249] The current § 269 regulations are structured much like this. However, having been adopted at different times they are longer and more *ad hoc*. They do not set forth a clear process to decide if the transaction was for tax avoidance purposes. *See* Watts, *supra* note 85.

[250] *Id.*

[251] BITTKER & EUSTICE, *supra* note 42, at ¶ 14.02, abstract out various consistent holdings in § 269 case law. Most of these are reflected in the factors in the ABA and NYSB reports.

set of regulations that would be shorter and clearer than the current set. This clarity might yield an increase in certainty.

There are other less drastic things that could be done to solve some of the problems discussed in this paper. First, the service could issue revenue rulings with respect to points of law under § 1.269-3(d). This would clarify how the service interprets the regulation and would give planners more confidence in their calculation of the tax consequences of their transactions.

Another possibility is to rescind § 1.269-3(d) and alter § 1.269-5(b) so that no business continuity requirement exists for § 382(l)(5) transactions. As shown before, the transactions covered by these sections, while "abusive" under the classic definition, do not implicate efficiency concerns. Trying to prevent them imposes costs which outweigh the benefits.

V. CONCLUSION

Section 1.269-3(d) is an example of a regulation that seems to be preventing illegitimate transactions, but in so doing creates greater costs than benefits. Section 1.269-3(d) transactions are by the classic definition "abusive". However, as we have seen, attempting to prohibit them results in greater problems than allowing them.