# Trafficking in Net Operating Losses: What's So Bad?

By Mark Hoenig


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Hoenig examines the almost century-long history of Congress's efforts to allow tax losses and limit their transfer. He explores the rationale for those efforts, assesses the system now in place, and asks whether an alternative set of rules might better serve policy and the economy.



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*On the loss carryover reform scene, we have a full plate of alternatives, including, of course, the possibility that we do nothing, on the grounds that at least we're reasonably familiar with what we currently have under the existing regime. Nobody is sure we can ever draft a statute that astute practitioners won't be able to get around pretty quickly. At least, we've had the benefit of 30 years of experience with the present version. It's far from perfect, but it's not the worst thing that could happen here*.

Written 30 years ago by professor James S. Eustice,[1] those words could just as well describe our loss carryover scene today. Shortly after Eustice wrote those words, the rules governing loss carryovers did in fact experience a seismic shift. And yet, his sentiments from long ago still resonate deeply.

## I. Introduction

I have worked for over three decades on the preservation of tax losses. In rare circumstances, a client is laser-focused on — has as its principal motive, we might say — just acquiring tax losses, and section 269 has never failed to serve its purpose. For the most part, however, my time in this area — and lots of it — has been spent navigating the maze of tax law constraints and limitations on the use of tax losses in transactions with many important commercial objectives. While tax planning through net operating loss preservation has been an important part of these transactions, it is fair to say, given what I do for a living, that tax planning is an important part of *any* transaction on which I spend meaningful time.

My professional experiences in this arena have often been both puzzling and eye-opening. This is particularly true of my earliest ones. Perhaps it was just my misfortune (or fortune) to enter the world of tax during the 1980s, a period during which the job

[1]Eustice, "Carryover of Corporate Tax Attributes," 22 *San Diego L. Rev*. 149 (1985).

of preserving tax losses presented extraordinary challenges. During most of that decade, the predecessor of today's section 382, a network of inconsistencies and traps, was a constant reminder of the difficulties and risks of being a tax adviser. And in 1986 (a little more than a year after Eustice wrote his piece), the area was totally overhauled when Congress introduced what was then known as ''new section 382,'' a framework that has endured and remains with us today. The new version of section 382 offered fewer inconsistencies than its predecessor but, then and now, never seemed anchored to a unifying and overarching set of policy or fairness principles other than ''it works.''

The lesson? For me, from early in my professional development, it was a valuable lesson about the somewhat unprincipled and occasionally even nonsensical way these tax loss limitation rules were designed. With no apparent comprehensive theory or foundational policy, the rules seemed plainly to reward those fortunate enough to have clever tax counselors (and some amount of luck). And so began my quest, trying to understand and rationalize the tax law's network of provisions all focused on preventing something referred to as ''trafficking'' in tax losses.

The dictionary offers that trafficking (at least in this context) means illegal or disreputable forms of commerce — like drug trafficking. This report explores the almost century-long history of Congress's efforts to allow tax losses and limit their transfer. It examines the rationale for those efforts, assesses the system we now have in place, and asks whether an alternative set of rules might better serve policy principles and our economy.

## II. NOLs — Why Do They Exist?

### A. Statutory Framework

Under section 172, a taxpayer that incurs an NOL[2] in a tax year is permitted to carry back that loss to the taxpayer's two tax years immediately preceding the tax year in which the loss is incurred, or carry forward the loss to the taxpayer's next 20 tax years, in either case to be used as a deduction against the taxpayer's taxable income in those years.[3] Any NOL that cannot be used by the taxpayer during that period expires. Although the ability to carry over losses from one tax year to another now appears to be a permanent structural fixture of the tax law,[4] this benefit has not always been provided to taxpayers.

Following the ratification of the 16th Amendment in 1913, Congress quickly enacted an income tax on both individuals and corporations.[5] At that time, net losses realized in any given tax year could not be carried over to an earlier or later tax period to offset income and reduce tax liability. This changed in 1918 with the enactment of a temporary congressional relief measure to aid manufacturers that suffered losses as a result of decreased production following World War I.[6] In 1921 Congress enacted a new form of deduction, an NOL deduction, which permitted losses to be carried forward for two years.[7] This provision was in effect until 1932 when Congress limited the carryover period to one year. A year later, in 1933, given the massive losses suffered during the Great Depression, Congress repealed the NOL deduction entirely to ensure sufficient governmental revenue collection.[8] The allowance for taxpayers to carry over and deduct losses was restored in 1939[9] and has remained in the tax code since then, although (as indicated above) the permitted periods for carrybacks and carryforwards have fluctuated over time.[10]

One could envision a tax code in which a taxpayer simply tallied his items of income and deduction for the applicable tax year and paid tax on any resulting net income. If the taxpayer suffered a net loss during the tax year, he would owe nothing and pay nothing, and no carryover to earlier or later years would be permitted. The fairness of such a

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[2]Section 172(c) defines an NOL as the excess of the deductions allowed by the code over the taxpayer's gross income.

[3]Section 172(a), (b)(1)(A). Throughout this report, the terms ''NOL carryover'' or ''loss carryover'' (and derivatives thereof) refer to an NOL arising in one tax year that may be claimed as a deduction in a different tax year. The terms ''carryback'' and ''carryforward'' refer to losses that may be claimed as a deduction in a tax year preceding the loss year, or in a tax year after the loss year, respectively. In some cases, an NOL may be carried back more than two years. These carryback and carryforward

**(Footnote continued in next column.)**

periods have varied over the decades. For individual taxpayers, section 172 primarily applies to losses incurred in connection with the conduct of a trade or business, rather than losses attributable to investments or personal items. Section 172(d)(4). Capital losses are subject to a separate limitations regime and therefore are not addressed by section 172. *See* section 1212.

[4]References to the ''tax law'' are to the U.S. income tax law, meaning the Internal Revenue Code currently in effect or, as the context indicates, its predecessors, as well as authoritative administrative and judicial interpretations and applications thereof.

[5]Section II, Revenue Act of 1913.

[6]Section 204, Revenue Act of 1918; S. Rep. No. 65-617 (1919).

[7]*See* section 206(a), Revenue Act of 1924; section 206(a)(5), Revenue Act of 1926; and section 117(a)(1), Revenue Act of 1928.

[8]Section 117, 1932 Revenue Act; section 218(a), National Industrial Recovery Act of 1933.

[9]Section 211, Revenue Act of 1939.

[10]Under prior versions of section 172, the carryback period was three years and the carryforward period was five years for tax years beginning before 1975, and three years and 15 years, respectively, for later tax years beginning before August 6, 1997.

system could certainly be debated, but that is not the focus of this report. Rather, this report focuses on the underpinnings and fairness of legislative limitations on the breadth and extent of provisions permitting loss carryovers to prior and later tax years. Of course, it is the legislative permission given to taxpayers to carry over net losses that sets the stage for limiting those carryovers. Thus, to understand those limitations, it is important to first understand the underpinnings of the tax loss carryover allowance.

### B. The Rationale for Permitting NOL Carryovers

The tax law raises revenues for the federal government by taxing income.[11] Both within and outside the field of taxation, many economists have attempted to define income. For purposes of developing and refining tax policy and implementing tax legislation, one widely accepted definition of income is the Haig-Simons definition.[12] Under the Haig-Simons definition, income is equal to the sum of (1) the market value of the taxpayer's consumption during the period and (2) the net increase in the taxpayer's wealth during the period (whether from the accumulations of savings or the increase in the value of property held).[13] Under the Haig-Simons definition, costs that are incurred to generate income are subtracted before coming to a calculation of income because those costs neither reflect personal consumption nor represent an increase in the taxpayer's wealth.

The determination of taxable income under the tax law diverges from the Haig-Simons approach. The tax law first requires a taxpayer to determine his gross income and then permits the taxpayer to subtract specified costs or expenses incurred to generate that gross income.[14] The Supreme Court has stated that the allowance for deductions for costs incurred to earn income is not required by the U.S. Constitution;[15] thus, the allowance reflects a fundamental decision by Congress to tax net, rather than gross, income.[16] While the computational approaches may vary, both the tax law and the Haig-Simons approach seek to tax income net of costs incurred to generate the income.

Once the decision has been made to tax net income, there arises a decision regarding the proper time horizon over which to measure net income; as a matter of temporal proximity, which costs and expenses should be allocated to which period in determining net income of a given period?[17] For purposes of their theory of economic income, which was not overly concerned with any arbitrary temporal cutoff date, Messrs. Haig and Simons were not focused on an appropriate period for determining tax liability.[18] To the extent that an annual accounting period was to be used, Simons thought it should be ''tentative and provisional.''[19] From a theoretical perspective, the determination of an individual's economic income could (and probably should) be judged over an individual's or a business entity's lifetime, because it is only over that period that economic income could be definitely measured and fixed. However, the crafters of our income tax law could not take such a long view, regardless of the compelling underlying arguments to do so. For administrative purposes and to ensure that the government has revenues to carry out its functions, the tax code requires taxpayers to calculate and pay tax on their income annually.[20]

The tax code generally does not provide for payments *from* the government to taxpayers who experience negative taxable income for a tax year.[21] Consequently, the annual accounting period can

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[11] 16th Amendment (''The Congress shall have power to lay and collect taxes on *incomes*, from whatever source derived'' (emphasis added)); *see also Eisner v. Macomber*, 252 U.S. 189 (1920); section 61; and section 62(a)(1).

[12] Boris I. Bittker and Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts*, para. 3.1.1. This definition is named for American economists Robert M. Haig and Henry C. Simons.

[13] Simons, *Personal Income Taxation*, 50, 61-62, 206 (1938). Because a corporate entity itself cannot consume, as meant for purposes of this definition of income, its income would be limited to the increase in its savings during the period.

[14] Sections 61 and 62(a)(1).

[15] *White v. United States*, 305 U.S. 281 (1938) (''Moreover, every deduction from gross income is allowed as a matter of legislative grace''); *see also* Bittker and Lokken, *supra* note 12, at para. 20.1.1.

[16] *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

[17] To be sure, the decision to tax net income gives rise to or affects several issues regarding time. For example, often (if not usually) costs are incurred well before the realization of associated income, and so emerges the challenge of matching (or not) items of cost and income to determine the proper measure of net income. Along these lines, questions arise about the proper time of income and expense recognition. Accelerated expense recognition, such as through accelerated depreciation, tends to exacerbate the mismatching of expense and associated income, while accelerated income recognition, such as through mark-to-market rules, tends to enhance the matching process. For the sake of discussion, this report assumes the validity of those timing rules through which NOLs emerge, and instead focuses on the legislative need and decision to create discrete tax periods over which net income would be measured.

[18] Bittker, ''A 'Comprehensive Tax Base' as a Goal of Income Tax Reform,'' 80 *Harv. L. Rev.* 925, 935 (1967).

[19] Simons, *Federal Tax Reform* 58-60 (1950).

[20] Section 441.

[21] Some, however, have argued that taxpayers who experience net losses in a tax period should be reimbursed for those losses in what essentially amounts to a negative income tax. *See, e.g.*, Mark Campisano and Roberta Romano, ''Recouping Losses: The Case for Full Loss Offsets,'' 76 *Nw. U. L. Rev.* 709, 717 (1981).

create disparities between the tax treatment of businesses whose income is relatively constant versus businesses whose income fluctuates from year to year.[22] For example, consider two businesses: Business A earns $100 of net taxable income in both year 1 and year 2, and Business B suffers a $100 net taxable loss in year 1 and earns $300 of net taxable income in year 2. At a 35 percent tax rate, Business A would pay $70 of total tax ($35 in both years 1 and 2), but Business B would pay $105 of total tax ($0 in year 1 and $105 in year 2). Although Business A and Business B both earn $200 of net taxable income over the entire two-year period, Business B pays more tax because of the annual accounting period. Given that the annual accounting period is an arbitrary convention devised and adopted merely to satisfy administrative and other governmental conveniences, the different results for Business A and Business B seem unjustifiable other than to say, ''Too bad, we had no other better choice.''

This lack of symmetry between the taxation of two taxpayers that each enjoyed the exact same accession to wealth is at least partially alleviated by permitting loss carryovers, which was the avowed purpose for the enactment of the original NOL carryover provision in 1921.[23] Loss carryovers essentially enable a taxpayer to average its tax liability by recouping or reducing taxes paid in high-income years with the application of losses sustained in down years to reduce the amount of income taxed in the profitable years.

The conceptual foundation of this averaging solution is fairly straightforward in the context of an individual taxpayer, but, at least in the view of some, becomes murkier when applied to corporations. For federal income tax purposes, corporations are treated as taxable entities separate from their owners. As separate tax ''persons,'' corporations calculate their taxable income on a stand-alone basis and pay the resulting tax liabilities out of their separate corporate assets. Accordingly, under the averaging concept embodied in the allowance to carry over tax losses, if a corporation incurs net losses during a tax year, it registers a loss carryover that can be used against the corporation's future taxable income. And yet, some have observed that corporations are mere legal fictions without the ability to consume; thus, corporations do not reap the rewards of their success or suffer the economic consequences of their losses. Those benefits and burdens are borne by their shareholders (and creditors).

[22]Bittker and Lokken, *supra* note 12, at para. 3.1.1.
[23]H.R. Rep. No. 65-619, at 7 (1919).

This disconnect raises the question of how loss carryovers of a corporation should be treated under the tax law, because the entity that possesses the loss carryover (the corporation) is not the same person who bore the corresponding economic loss (the corporation's shareholders). This disconnect has implications in any exploration of how and whether corporate tax losses should be allowed and limited.

## III. Trafficking in NOLs — A Problem Emerges?

A corporation with accumulated tax loss carryovers is more valuable than an otherwise similarly situated corporation without loss carryovers, because the loss carryovers can be used to offset future tax liabilities. Assuming each of the two corporations projects the same future stream of pretax income, the corporation with loss carryovers will anticipate higher after-tax yields. At least in theory, an acquirer should be willing to pay an additional amount for the loss corporation up to the present value of the projected future tax savings resulting from the anticipated use of loss carryovers to offset future income.

Is there anything wrong with that? Does an acquirer's payment of incremental purchase price for this type of tax asset result in some distortion or unfairness that cannot be tolerated by our tax system? Are there important differences between the purchase of a tax asset as compared with, say, the purchase of a machine or a parcel of real estate?

A review of the legislative history and related literature over decades of congressional efforts to curb trafficking in tax losses clearly reflects a widespread view that there is in fact a difference, a view that third parties should not be permitted to simply purchase — ''traffic in'' — tax losses. The emerged wisdom among the tax community is that a loss corporation's ability to use pre-acquisition loss carryovers should be limited to prevent so-called trafficking in loss corporations.

But why? Several rationales are offered. Trafficking is often presented as a self-evident evil, generally defined by reference to a motive to engage in a transaction primarily to acquire a loss corporation's tax attributes. This, however, merely begs the question: Why is that bad? If it is acceptable for a purchaser to acquire a machine, for example, why not a tax attribute?

One answer often provided: The tax law cannot abide by an acquisition undertaken solely with a tax-driven motivation. The tax law, under this way of thinking, cannot be driving transactions and should ''allow'' only transactions that would have been undertaken even in the absence of tax loss carryovers. Under this view, a transaction whose sole result is a net decrease in tax revenue to the

Treasury can have no place within our tax system. This violates the principle of tax neutrality, which posits that tax implications should neither impede nor induce business transactions. As will be explored below, not only are the ethical, moral, and practical underpinnings of this principle unclear, it is even debatable whether this principle is followed with sufficient consistency within the tax law to cloak it with respectability.

Another theory for limiting loss trafficking is based on the principle that only the historic owners of a loss corporation who have borne the underlying economic loss should be permitted to realize the tax benefit associated with that loss carryover. Again, however, this merely begs the question: Why should the tax benefit, unlike other assets, be usable exclusively by these shareholders? And why, even under this view that the shareholders who bore the economic loss should be able to enjoy the associated tax benefit, should these shareholders be precluded from realizing that value through a sale of the benefit?

Some have offered a corollary to the idea that only the historic owners should get the tax benefit associated with having endured the economic loss: According to this notion, the reason to constrain trafficking in tax losses is to protect these historic owners from the eventuality that acquirers will not adequately compensate selling shareholders for the tax attribute. Under this theory, it is argued that acquirers will discount their payment to account for uncertainty regarding the potential acquirer's ability to use a loss carryover, and so selling shareholders will simply be unable to obtain adequate compensation for the underlying tax benefit. Consequently, the selling shareholders would be underpaid and the acquirer might accede to a windfall if it can use more of the loss carryover than it anticipated at the time of the acquisition. This concern, further examined later, has the hallmarks of a rationale concocted after the fact to explain a rule that may simply have no good underlying purpose.

Finally, some object to the possibility that losses incurred in one business line will be used to offset profits arising from another, unrelated business. This is a particularly strict application of the concept that loss carryovers are intended to facilitate income averaging. This rationale at least presents a valid policy question: In our system of annualized reporting, if we are to permit an averaging convention across tax periods to smooth out profitable years with loss years and thereby achieve greater parity between similarly situated taxpayers, should the averaging be done at the taxpayer level or the business level?

These are the main rationales offered for our web of tax law provisions that constrain and penalize trafficking in tax losses. They are explored later in this report. At this point, it merits observation that quite (if not most) often the tax community simply takes for granted that trafficking in tax attributes is an evil that should be eliminated wherever possible, with no effort to articulate the "evil." While some have paused to examine a particular negative associated with trafficking, such as its potential to violate the goal of tax neutrality, these efforts generally fail to satisfactorily examine the potential undesirable consequences resulting from the constraints and limitations imposed or the lack of consistency or conformity with other areas of the tax law. Importantly, however, these are the rationales and justifications that have, over all these many decades, been handed down and become our "received wisdom" on the subject, a wisdom that has frequently been invoked in both legislative and judicial approaches to the treatment of loss carryovers, and a wisdom that perhaps deserves a second look.

## IV. Limits on NOL Use Following Acquisitions

As discussed earlier, a principal reason for permitting NOL carryovers was to enable averaging of income and losses across tax years so as to reduce at least some of the unfairness resulting from adoption of an annual accounting period to measure income. Initially, when confronting the case of corporate taxpayers, courts applied this averaging concept strictly and permitted NOLs to be used only by the specific corporate taxpayer that incurred the loss. In *New Colonial Ice Co. v. Helvering*, the Supreme Court held that a corporation newly formed to acquire all the assets and liabilities of an existing corporation could not inherit the NOLs of the existing corporation, even though the business conducted by the existing corporation was continued in the new corporation and the shareholders remained the same.[24] The taxpayer argued that the losses should be transferred to, and available for use by, the new corporation because after the transaction the stockholders and creditors of the new corporation were the same as the existing corporation. The Court rejected the taxpayer's argument because the two corporations were in fact two distinct legal entities and the new corporation should not and could not be viewed as the same entity for tax purposes. Consequently, the Court held that the new corporation could not use the tax losses incurred by its predecessor.

[24] 292 U.S. 435, 437-438 (1934) (applying the two-year NOL carryover allowed under the Revenue Act of 1921, ch. 136, section 204(b)).

A few years later, in *Helvering v. Metropolitan Edison Co.*,[25] the Court moved away from this strict entity approach and permitted the surviving corporation in a merger to use the other corporation's deduction for unamortized bond discount, a favorable tax attribute. The distinction between *Metropolitan Edison* and *New Colonial Ice* apparently was that the *Metropolitan Edison* transaction took the form of a merger rather than an actual sale of all of one corporation's assets to another. This formalistic distinction enabled taxpayers to effect tax-motivated acquisitions of loss corporations so long as they were structured correctly.

**A. Section 269 and Its Predecessor**

To combat these tax-motivated transactions, Congress enacted section 129 of the Revenue Act of 1943 (the predecessor to current section 269), which provided that if any person acquired control of a corporation, or any corporation acquired the assets of another corporation not controlled by the acquiring corporation before the acquisition, ''and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income or excess profits tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed.''[26]

Section 129 of the 1943 Act was intended ''to put an end promptly to any market for, or dealings in, interests in corporations or property which have as their objective the reduction through artifice of the income or excess profits tax liability.''[27] It had come to Congress's attention that some corporations with large excess profits were purchasing corporations with large current, past, or projected losses to reduce or offset those taxable profits. Congress took action to close this ''loophole'' so as not to undermine the position of ''honest'' taxpayers.[28] The legislative history in the Senate report also notes that more specific (meaning less vague) statutory language was considered but rejected in favor of the general (meaning vague) principle because specific descriptions place too much emphasis on the form and technical character of the tax avoidance scheme, rather than on the substance.[29] Interestingly, the original House proposal would have applied to a transaction if ''*one* of the principal purposes'' was tax avoidance, but the Senate narrowed this statutory antiabuse rule to apply only if ''*the* principal purpose'' was tax avoidance; the Senate Finance Committee thought that the provision should be operative only if ''the evasion or avoidance purpose outranks or exceeds in importance, any other one purpose.''[30] However, in its application, section 129 was not up to the task.

The inadequacy (real or perceived) of section 129 was highlighted in dicta offered by the Tax Court in *Alprosa Watch Corp. v. Commissioner*,[31] which focused on a transaction that preceded the enactment and effectiveness of section 129. In *Alprosa Watch*, the purchasers of the stock of a loss corporation were able to preserve NOL carryovers even though the corporation immediately disposed of its historic business, changed the location of its place of business, and changed its name. The Tax Court, relying on the principle that a corporation and its shareholders are separate entities for tax purposes, concluded that the change of ownership did not affect the tax identity of the corporation, so the corporation could continue to use its historic NOLs to reduce its taxable income following the ownership change.

Although the transaction in *Alprosa Watch* occurred before the effective date of section 129, the Tax Court expressed ''considerable doubt'' that section 129 would have applied to the transaction because ''that section would seem to prohibit the use of a deduction, credit, or allowance only by the acquiring person or corporation and not their use by the corporation whose control was acquired.''[32] The Tax Court also stated that because the purchasing shareholders had a business purpose for the transaction apart from any potential tax benefits, section 129 (had it been in effect for the transaction at issue) would not apply because tax avoidance was not the dominating motive.

Thus, in *Alprosa Watch*, the Tax Court signaled a perceived deficiency of the subjective intent-based approach, an approach later and still relied on by

[25]306 U.S. 522 (1939).

[26]Revenue Act of 1943, section 129. The triggering language of current section 269(a) is virtually the same. The provision was amended in 1963 to give the Treasury secretary discretion to disallow deductions or credits. Revenue Act of 1964, section 235(c)(2).

[27]H.R. Rep. No. 78-871, at 49 (1944).

[28]*Id.*

[29]S. Rep. No. 78-627, at 49 (1944).

[30]*Id.* (emphasis added).

[31]11 T.C. 240 (1948).

[32]As indicated, the Tax Court actually said that the statutory language of section 129 — the predecessor of section 269 — would disallow use of the tax losses by the acquirer but *not* by the corporation in which the losses arose. This interpretation of the statute has been rejected by courts in subsequent cases, such as in *Commissioner v. British Motor Car Distribs. Ltd.*, 278 F.2d 392 (9th Cir. 1960) (''We should be closing our eyes to the realities of the situation were we to refuse to recognize that the persons who have acquired the corporation did so to secure *for themselves* a very real tax benefit to be realized *through* the acquired corporation and which they could not otherwise have realized'') (emphasis added).

section 269. This statutory antiabuse rule relies entirely on a taxpayer's intention, which in the best of circumstances is hard to determine, much less prove. Thus, the emerging and later prevailing view was that a subjective antiabuse rule simply would not suffice. As long as a taxpayer could demonstrate a business purpose as a primary motivation for a transaction, this type of statutory constraint would not serve as an effective limitation on trafficking in loss carryovers. Under this view, the IRS's burden to prove a subjective primary intent of tax avoidance renders the provision too difficult to successfully invoke in transactions if they are not completely devoid of economic substance.

**B. The 1954 Code — Section 382**

And so, the legislative effort to address the problem of trafficking in tax losses persisted. In 1954 Congress completed a major overhaul of the Internal Revenue Code, and some of the changes had a significant impact on the treatment of loss carryovers. First, section 381 was added, which permitted the carryover of specified corporate tax attributes, including NOL carryovers, for liquidations of 80 percent-owned corporate subsidiaries and other transactions that qualify as asset-type reorganizations under section 368.[33] New section 381 enabled a successor corporation to step into the tax shoes of the predecessor corporation even though it is not the same legal entity. Accordingly, new section 381 effectively overruled the holding of *New Colonial Ice* for tax-free asset reorganizations and expanded the range of transactions in which loss corporation shareholders could ''transfer'' loss carryovers.

To address loss trafficking, Congress concurrently added section 382. Congress thought that the subjective intent test of then-section 129 (the predecessor of section 269) increased the chance of litigation and hampered a taxpayer's ability to conduct legitimate business transactions.[34] Accordingly, the 1954 version of section 382 enumerated objective criteria in an attempt to add certainty to the determination of when loss carryovers would be limited.[35]

Newly enacted section 382 provided two separate sets of rules: one for purchases of stock of loss corporations (under then-section 382(a)) and one for specified types of reorganizations involving loss corporations (under then-section 382(b)). Section 382(a) provided that a loss carryover was disallowed in full if there was a 50 percent change of stock ownership of a loss corporation within a two-year period *and* the loss corporation did not continue its historic business. For purposes of this test, only increases in stock ownership by the loss corporation's 10 largest stockholders were considered.[36] Under section 382(b), following a reorganization, the amount of a loss carryover was reduced proportionately, depending on the degree to which the shareholders of the loss corporation received less than 20 percent of the acquiring corporation's stock in the reorganization.[37]

Many of the inconsistencies between the treatment of stock purchases on the one hand and the treatment of reorganizations on the other were unprincipled.[38] For example, (1) the continuation of a historic business was irrelevant for reorganizations but required for stock purchases; (2) loss carryovers under the reorganization rules were permitted in full following as much as an 80 percent ownership change but were entirely eliminated upon only a 50 percent ownership change under the

[33]Codified at current section 381(a). In reorganizations treated as stock sales for U.S. federal income tax purposes, such as B reorganizations, the target corporation remains in existence and retains its tax attributes.

[34]*See* S. Rep. No. 83-1622, at 53 (1954) (section 269 ''has been so uncertain in its effects as to place a premium on litigation and a damper on valid business transactions'').

[35]IRC of 1954, section 382(a)(1)(A) and (C). *Cf.* S. Rep. No. 83-1622, at 53 (1954) (stating that the rule is to prevent the use of NOL carryovers against the income of an unrelated business and that the limitation will apply if ''the corporation engages in a different type of business''). Under the new provision, existing

**(Footnote continued in next column.)**

loss carryovers would be eliminated if, in addition to changing ownership beyond a specified threshold, the corporation did not continue its historic business. Despite the articulated goal in the Senate report, the statute clearly permitted complete survival and use of the loss carryovers as long as some part of the old loss corporation business was continued, and it permitted the use of those surviving losses to offset not only the historic business's income, but also to offset income from new businesses. (The regulations prohibited more than a minor change in business. Reg. section 1.382-1A(h)(7).) The statements in the Senate report — which did not appear to guide the actual formulation of the new statutory provisions — resemble the principle and holding later enunciated by the Supreme Court in *Libson Shops Inc. v. Koehler*, 353 U.S. 382, 382 (1957) (discussed below).

[36]IRC of 1954, section 382(a)(2) (repealed in 1986).

[37]IRC of 1954, section 382(b) (repealed in 1986). If the loss corporation shareholders owned less than 20 percent, the allowable NOL carryover was reduced. IRC of 1954, section 382(b)(1) and (2). The continuing ownership taken into account for this purpose was only that ownership which was attributable to interests previously held in the loss corporation. IRC of 1954, section 382(b)(1)(B). The limitation on NOL carryovers following a tax-free reorganization extended to reorganizations to which section 381 applied regardless of whether the loss corporation was the acquired or surviving entity. IRC of 1954, section 382(b)(1). The limitation on loss carryovers was not extended to B reorganizations, in which the loss corporation remains wholly intact (albeit owned by a new corporate shareholder).

[38]George K. Yin, ''Of Diamonds and Coal: A Retrospective Examination of the Loss Carryover Controversy,'' 2 *NYU Proceedings of the 48th Inst. on Fed. Tax'n*, ch. 41 (1990).

stock purchase rules; and (3) reductions of the tax loss carryovers were proportionate under the reorganization rules but all-or-nothing for stock purchases. Further, the statute left important gaps. For example, many believed that neither the rules applicable to stock purchases nor the rules applicable to reorganizations applied to B reorganizations or section 351 transactions.

Interestingly, despite the perceived inadequacy of then-section 129 or the stated congressional concern regarding the tendency of section 129 to foster excessive litigation and hamper otherwise valid commercial transactions, Congress reenacted former section 129 as section 269, which the legislative history made clear could be applied regardless of whether section 382 applied to a transaction.[39]

### C. The *Libson Shops* Doctrine

In 1957 the Supreme Court again waded into the discussion regarding NOL carryovers. *Libson Shops Inc. v. Koehler*[40] involved the survival and transferability of loss carryovers in a transaction that preceded the enactment and effectiveness of the 1954 legislation. The taxpayer, Libson Shops Inc., was the surviving corporation in a transaction in which 16 sales corporations were merged with and into it, with the shareholders of the 16 corporations receiving stock in Libson Shops as consideration. The same persons who, directly or indirectly, owned stock of the merged sales corporations owned the stock of Libson Shops in the same proportions as a result of and following the mergers. Three of the sales corporations had historic NOLs before the merger, which the combined entity attempted to claim against its combined taxable income in the year following the merger. The applicable statute provided that ''if for any taxable year beginning after December 31, 1947, and before January 1, 1950, *the taxpayer* has a net operating loss, such net operating loss shall be a net operating loss carryover for each of the three succeeding taxable years.''[41] The question presented was whether Libson Shops should be considered the taxpayer regarding the pre-merger NOLs of the three loss corporations.

Based on the applicable (pre-1954 law) statutory construct and judicial precedent, the Court faced several possible outcomes. The IRS relied heavily on *New Colonial Ice* to argue that no carryover should be permitted because Libson Shops had its own corporate charter and therefore was not technically the same corporate taxpayer that incurred the tax losses. The taxpayer in turn relied on *Metropolitan Edison* to argue that a surviving corporation in a statutory merger should be treated as the same taxpayer and therefore permitted to inherit and use the predecessor corporation's tax loss carryovers. Further, it argued, the fact that the same persons ultimately owned the loss corporations and Libson Shops in the same proportions could have been relied on to conclude that the losses should be inherited and usable by the surviving corporation in the mergers.

Ultimately, the Supreme Court decided that the surviving entity, Libson Shops, could not use the pre-merger NOLs to offset post-merger income because there was not a sufficient continuity of business enterprise between the activity that generated the loss and the income that Libson Shops sought to offset with the NOLs. The Court found support for a continuity of business requirement in the legislative history of the applicable NOL carryover provisions (section 122 of the IRC of 1939). Based on the Court's reading of the legislative history, the then-applicable provision allowing carryover of NOLs was enacted to remedy the ''unduly drastic consequences of taxing income on an annual basis,'' but there was no indication that Congress intended for that averaging to permit pre-merger losses of one business to offset post-merger income of some other business that had previously been taxed separately.[42] Finally, the Court noted that because the businesses of the three loss corporations that generated the NOLs continued to generate losses on a stand-alone basis after the merger, they would have been unable to use the NOLs (within the applicable three-year carryforward period) absent the merger.[43]

The Supreme Court's holding in *Libson Shops* had the potential to significantly affect the treatment of loss carryovers in corporate acquisitions. However, because the transaction in *Libson Shops* occurred before the effective date of the 1954 code, there was uncertainty whether the holding's constraints on the use of tax losses had been superseded by the 1954 legislation, given that Congress had created a statute specifically addressing the treatment of loss carryovers in acquisition transactions.

The rationale underlying the *Libson Shops* holding is consistent with the Senate's stated purpose for enacting the continuity of business requirement for stock purchases in section 382(a) of the 1954 code. The Senate report stated, ''Abuse has most

[39]*See* S. Rep. No. 83-1622, at 284 (1954) (stating that ''the fact that a limitation under [IRC of 1954, section 382] does not apply shall have no effect upon whether section 269 applies'').

[40]353 U.S. 382 (1957).

[41]IRC of 1939, section 122(b)(2)(C) (emphasis added).

[42]353 U.S. at 386.

[43]Before the merger, the 16 sales corporations had not elected to file a consolidated return.

often arisen [in] the purchase of the stock of a corporation with a history of losses for the purpose of using its loss carryovers to offset gains of a business unrelated to that which produced the losses.''[44] The continuity of business requirement actually enacted in 1954, however, was less stringent than the holding in *Libson Shops* because it only required the loss corporation to continue ''to carry on *a trade or business* substantially conducted'' before an ownership change in order to preserve its loss carryovers.[45] Thus, under the new legislation at the time, a taxpayer with multiple lines of business was not required to continue conducting the trade or business that generated the loss; rather, only one of its historic lines of business needed to be continued. Further, as long as any historic line of business was continued, the 1954 version of section 382 did not prevent a loss corporation from using losses against any of its income (even income attributable to a line of business that was acquired in the transaction), which is exactly what the Supreme Court proscribed in *Libson Shops*.[46]

For transactions occurring after the 1954 enactment of section 382, courts generally concluded that the holding in *Libson Shops* was superseded and that post-1954 transactions would be tested only under section 382.[47] The IRS, however, not yet willing to throw in the towel and concede that *Libson Shops* was no longer relevant, continued to assert that *Libson Shops* could apply to transactions with similar facts if section 382 did not impose a loss carryover limitation.[48]

The ambiguity regarding the continued relevance of the *Libson Shops* doctrine was not put to rest until 1986 when Congress, in connection with its overhaul of section 382, affirmatively stated its intent that the *Libson Shops* doctrine was no longer applicable. At long last, *Libson Shops* was, according to everyone, ''dead.''

### D. The Tax Reform Act of 1976

In 1976 Congress again took up the issue of constraining the ability to traffic in tax loss carryovers. The Tax Reform Act of 1976 included adjustments to section 382 intended to create better symmetry between the rules applicable to stock purchases and those applicable to reorganizations.[49] Under the proposed 1976 revisions (1) the business continuation requirement was eliminated from section 382(a); (2) both sets of section 382 rules — for stock acquisitions and for reorganizations — were revised so that there was no disallowance of loss carryovers until there was at least a 60 percent ownership change; and (3) the loss use limitation, once triggered, effected only a partial disallowance of carryovers under both provisions.[50] The changes proposed under TRA 1976 were the subject of much criticism, in part because the amendments were hastily drafted and Congress did not permit an adequate opportunity for industry comment.[51] Congress repeatedly delayed the effective date of the 1976 changes; a portion of the 1976 changes finally became effective in 1984 only to be followed shortly by a full repeal of the 1976 changes in 1986.[52]

### E. The Tax Reform Act of 1986

Persistent concerns with and criticism of the 1954 rules, together with the strong and vocal dissatisfaction with the (enacted but never fully effective) 1976 revisions, compelled Congress to revisit the treatment of tax loss carryovers in the 1980s. Apparently, given the long history of criticism and dissatisfaction, Congress was finally moved to look at the entire set of rules through a different part of the prism, willing to address the problem — whatever it was — by fashioning a brand-new approach, an approach unlike previous efforts. Hence, the overhaul of section 382 in TRA 1986.

With the 1986 approach, Congress introduced several new concepts. As with the original section 382, the new rules only applied following a large change in the ownership of a loss corporation, but the consequences of such an ownership change were significantly altered. Instead of an ownership change resulting in the *reduction* of the pre-ownership change amount of loss carryovers, the

[44]S. Rep. No. 83-1622, at 53 (1954).

[45]IRC of 1954, section 382(a)(1)(C) (emphasis added).

[46]Also, section 382(b) did not specifically require a continuity of business enterprise at all in a reorganization.

[47]*See Maxwell Hardware Co. v. Commissioner*, 343 F.2d 713 (9th Cir. 1965).

[48]Indeed, while the courts generally signaled that *Libson Shops* had no continuing relevance or application in the face of IRS assertions to the contrary, the legislative branch did its part in keeping the intrigue alive; when Congress amended section 382 in the Tax Reform Act of 1976, it specifically stated that it was not superseding *Libson Shops* for tax years before the effective date of the 1976 changes.

[49]Also, Congress sought to correct several technical deficiencies with the prior statute.

[50]There were also several other minor changes, such as measuring an ownership change by reference to the 15 largest shareholders instead of 10, and over a three-year period rather than two years.

[51]*See generally* Eustice, ''The Tax Reform Act of 1976: Loss Carryovers and Other Corporate Changes,'' 32 *Tax L. Rev*. 113 (1977).

[52]TRA 1986, section 621(e). Because of a delay in the enactment of TRA 1986 until October 1986, some taxpayers may legitimately have assumed that the 1976 amendments, due to take effect on January 1, 1986, actually went into effect. Congress was aware of this potential problem and provided transitional relief by permitting application of the 1976 amendments in some cases. TRA 1986, section 621(f)(2).

new provision generally left intact and unreduced the amount of loss carryovers and instead imposed a limit on the amount of post-ownership change income of the loss corporation that could be offset by its pre-change losses.[53] The enunciated goal of the new rules was to limit use of loss carryovers following an ownership change to the amount of losses that would have been used by the loss corporation had no ownership change occurred.[54]

The basis for this new approach was a study conducted by the American Law Institute and reported in 1982. The loss use limitation proposal in the ALI report included several components, not all of which were adopted by Congress in new section 382. The ALI report made two proposals, one for mergers and one for purchases of shares. Both proposals were based on a ''pool of capital'' concept: A loss corporation's tax loss carryovers following an acquisition transaction should be allowed to offset only income from that loss corporation's pool of capital existing on the date of the acquisition transaction.

Under the ALI report's primary proposal, applicable to mergers and some other business combinations, a loss corporation could apply its losses to offset post-merger profits only to the extent of profits allocable to shares of the loss corporation outstanding when the loss was incurred. For example, if in a merger the target loss corporation's shareholders receive 10 percent of the total outstanding shares of acquirer common stock (suggesting that the loss corporation represents 10 percent of the combined entity), the tax loss carryovers of the loss corporation could be used to offset only 10 percent of the acquiring corporation's post-merger earnings. This is consistent with the pool of capital concept because only the portion of the future earnings attributable to the loss corporation can be offset by the tax loss carryforward, with the percentage of acquirer stock received by the loss corporation shareholder's acting as a proxy for the relative value of the loss corporation. This first and primary proposal offered by the ALI report also required a proration of future earnings that could be offset by prior loss carryovers when shareholders make additional capital contributions to a loss corporation in exchange for new loss corporation stock.[55]

The ALI report proposal included a second component, a backup rule that would apply when stock of a loss corporation was purchased outside a merger. Under the primary rule, in a situation in which there is a purchase of loss corporation stock (involving no combination with any second corporation), there would be no limit on the loss corporation's ability to use its loss carryforwards. In that case, under the arithmetic application of the primary rule, there would have been no change in its pool of capital and thus no limitation. There was concern, however, that following such a stock acquisition, the new shareholders could make capital contributions to the loss corporation in a way that could thwart the intended operation of the primary rule. Therefore, the proposal also included a secondary purchase rule, which would limit the use of any loss carryforwards following an acquisition of loss corporation shares. Under this rule, loss use would be limited to an objective rate of return multiplied by the price paid for the purchased stock. This method was based on the theory that the value of the loss corporation's equity — the value of its outstanding stock at the relevant time — represented a good measure of the pool of capital amount. This purchase rule, intended as a backstop, would apply only if the primary rule did not apply.

In fashioning the 1986 version of section 382, Congress adopted the ALI report's underlying pool of capital theory but chose to enact only the purchase rule. It felt that the primary rule was too complex. Section 382 of the 1986 code limits the amount of taxable income of the loss corporation that may be offset by loss carryovers following an ownership change. The ownership change trigger serves as a cliff; until the threshold is met there is no limit on continued use of the tax loss carryovers, but once the ownership change threshold is reached, the loss limitation rule applies in full force.

Under the new 1986 formulation, an ownership change generally is any increase greater than 50 percentage points in a corporation's stock ownership over a three-year period by shareholders (or shareholder groups) who own 5 percent or more of the stock of the loss corporation. If an ownership

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[53]Under the 1986 version of section 382, Congress retained an element of the prior law's focus on tying the NOLs to the ''same business.'' Under the new version (section 382(c)), a discontinuation of the loss corporation's business within two years of the ownership change would result in elimination of the NOLs (and not merely a limitation on their use). This continuity of business requirement was, however, considerably more relaxed than the continuity required under the prior version of section 382.

[54]*See also* H.R. Rep. No. 99-426, at 257 (1985); S. Rep. No. 99-313, at 232 (1986); and American Law Institute, ''Federal Income Tax Project — Subchapter C: Proposals on Corporate Acquisitions and Dispositions,'' at 239-242 (1982) (ALI report).

[55]The ALI report allowed exclusions from this requirement to prorate future income for pro rata capital contributions as well as contributions of preexisting debt (meaning debt already in place when a loss was incurred) in exchange for loss corporation equity. The ALI report also contained special rules for situations in which the loss corporation shareholders receive plain vanilla preferred stock or equity with characteristics of both common and plain vanilla preferred stock.

change occurs, the amount of the limitation — the amount of income that can be offset each year following the ownership change — is generally equal to the value of the loss corporation at the time of the ownership change multiplied by the long-term tax-exempt interest rate (updated and published monthly by the IRS). The limitation formula is a rough attempt to impute a rate at which the loss corporation could have used its losses if the transaction had not occurred and the corporation had instead sold all its assets and used the proceeds to purchase Treasury bonds. By limiting the amount of the tax benefit in this way, Congress hoped to eliminate any tax-motivated incentive for a third party to acquire and gain the benefit of tax losses — at least any tax benefit exceeding what the loss corporation would itself enjoy in the hypothetical liquidation scenario — in acquisitions of loss corporations.

Section 382 also was expanded to include a new concept of built-in losses. In 1986, for the first time, Congress sought to curb not only acquisitions of existing loss carryovers but also acquisitions focused on the existence of an overall built-in tax loss within the target corporation, meaning assets that on the whole have a tax basis in excess of their value. This expanded focus even on built-in losses was driven by a concern that the new section 382 rules could be circumvented by a loss corporation that timed sales of assets with built-in losses to occur after an ownership change.[56]

### F. Other Limitations

In addition to sections 382 and 269, there are rules in the code (and regulations) that can restrict a loss corporation or acquirer's ability to use loss carryovers after corporate acquisitions.

**1. SRLY rules.** Under the consolidated return rules, if a loss corporation is acquired by a corporation that is a member of a group of corporations filing a consolidated federal income tax return, the loss corporation's tax losses (including its built-in losses) are subject to the separate return limitation year (SRLY) rules. Under the SRLY rules, the loss carryovers and recognized built-in losses may be applied to offset consolidated taxable income only to the extent that the income is attributable to the loss corporation.[57]

Thus, the SRLY rules operate in a manner that calls to mind the Supreme Court's holding and rationale in *Libson Shops*. Like *Libson Shops*, pre-transaction losses generally could be used to offset income only from the businesses conducted by the loss corporation before the transaction. Unlike *Libson Shops*, however, the SRLY rules permit (subject to some antiabuse rules) the pre-acquisition losses (and built-in losses) to be applied against income of the acquired loss corporation even if generated by an entirely new business. Another difference from the *Libson Shops* concept is that in applying the SRLY limitations, the IRS has ruled that if a member of a consolidated group acquires an unaffiliated loss corporation in an asset-type reorganization — meaning the assets or operations of the loss corporation are themselves acquired by and held inside the consolidated group member — the consolidated group member that acquired the loss corporation is treated as the successor of the acquired corporation. The losses acquired by the successor (under section 381) remain intact and available for use under the SRLY rules to offset income of the successor corporation. Consequently, in that situation, the acquired losses may be applied against not only income of the acquired loss corporation but also income of the acquiring corporation (whether generated by the acquiring corporation's historic business or — subject to antiabuse rules — a new business).[58]

The SRLY rules reflect an effort to reconcile single- versus separate-entity treatment of consolidated group members regarding their losses when they join or leave a group, in addition to addressing loss trafficking concerns.[59] The Supreme Court first imposed a SRLY-like limitation in *Woolford Realty Co. v. Rose* because it determined that Congress could not have intended consolidated returns to permit manipulation of net taxable income through the absorption of separate return losses on a consolidated basis.[60] In his opinion, Justice Benjamin N. Cardozo stated:

> Doubt, if there can be any, is not likely to survive a consideration of the mischief certain to be engendered by any other ruling. A different ruling would mean that a prosperous corporation could buy the shares of one that had suffered heavy losses and wipe out thereby its own liability for taxes. The mind rebels against the notion that Congress in

[56]H.R. Conf. Rep. No. 99-841, at II-190 (1986).

[57]Reg. section 1.1502-21(c)(1). To be sure, the SRLY rules contain computational rules more complex than articulated here, which are beyond the scope of this report. Also, if an entire subgroup is acquired, the SRLY rules are applied on a subgroup basis (*i.e.*, the losses of any subgroup member may be carried forward to offset the income of any subgroup member). Reg. section 1.1502-21(c)(2).

[58]LTR 8851017.

[59]Andrew J. Dubroff et al., 2 *Federal Income Taxation of Corporations Filing Consolidated Returns*, section 42.02[1][a], at 42-8 and section 42.02[1][d], at 42-36 (2012).

[60]286 U.S. 319 (1932); *see also Planters Cotton Oil Co. v. Hopkins*, 286 U.S. 332 (1932) (same).

> permitting a consolidated return was willing to foster an opportunity for juggling so facile and so obvious.[61]

The consolidated return regulations first imposed a limitation on the use of carryovers from separate return years for tax years beginning in 1929. This first SRLY[62] limitation was based on the cost or basis of the stock of the acquired loss corporation.[63] Under this earliest articulation of the SRLY rule, a new member's losses from preconsolidation periods could be used only to the extent ''of the cost or the aggregate basis of the stock of such [member] owned by the members of the group.''[64] The theory behind limiting the deductions to the cost or value of the stock was to eliminate any incremental tax benefit associated with the purchase of stock of a corporation with tax loss carryforwards. The regulations were later changed to the current approach, which calculates the limitation based on the acquired loss corporation's separate income as a member, which is more consistent with preserving separate-entity treatment in determining the amount of the loss corporation's tax losses that could offset post-acquisition income.[65]

In cases in which both section 382 and the SRLY rules would apply, section 382 generally controls and the SRLY rules do not apply.[66] Under this overlap rule, if a loss corporation becomes a member of a consolidated group as part of a transaction that results in an ownership change under section 382, the SRLY rules will not apply. The rationale given for this rule is that section 382 is the more restrictive of the two limitation regimes and so it more comprehensively addresses the underlying loss trafficking concern. As a result of the overlap rule and its underlying rationale, commentators have argued that the SRLY rules are superfluous and should be repealed.[67] Others have argued that the SRLY rules should be preserved for non-overlap transactions.[68] For the time being, however, we must deal with both of these somewhat duplicative sets of rules. The legislative history of section 382 clearly signals that SRLY principles will continue to apply even after the 1986 enactment of section 382.[69]

**2. Section 384.** Enacted in the Revenue Act of 1987, section 384 limits use of the loss carryovers and certain built-in losses of one of the two corporations to offset gain built into the assets of the other when one corporation acquires another or one corporation acquires the assets of another in an A, C, or D reorganization. Under this statutory construct, the limitation rules can apply whether the loss corporation acquires the gain corporation or vice versa.[70] In either situation, if the acquisition — either by the loss corporation or by the gain corporation — results in shifting ownership of the loss corporation, section 382 can apply as well.[71]

Once section 384 is triggered, the loss carryovers from pre-combination periods are not allowed to be used to offset gain on the disposition of assets for five years if the assets were held by the gain corporation on the date of the combination, and to the extent the assets had built-in gain as of the date of the combination. Unlike section 382, section 384 is not limited to changes in ownership of the loss corporation. Rather, it is focused on the combinations of gain corporations and loss corporations in order to prevent the blending of gain-corporation gain and loss-corporation losses to produce a combined tax liability lower than the aggregate tax liability of the two corporations absent the combination.

But what problem, exactly, was section 384 addressing? The legislative history indicates that Congress intended to prevent the losses of a loss corporation from sheltering the built-in gains of a gain corporation, such as phantom gains on property for which depreciation had been taken before the acquisition and the built-in income of a ''burnt-out'' leasing subsidiary whose property has a fair market value ''less than the present value of the taxes that would be due on the income associated with the property.''[72]

Again, however, what is the underlying abuse or policy goal? The section 384 construct, which disallows use of the existing losses (and built-in losses)

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[61]*Woolford Realty*, 286 U.S. at 329.

[62]The term SRLY was not used until the 1966 regulations. New York State Bar Association Tax Section comment letter (Dec. 10, 1996) (summarizing the history of the SRLY rules).

[63]Reg. 75, Art. 41(c) (1929).

[64]*Id.*

[65]Reg. 102, Art. 31 (1938).

[66]Reg. section 1.1502-21(g) (the overlap rule).

[67]*See*, *e.g.*, NYSBA tax section comment letter (Nov. 24, 1998); Association of the Bar of the City of New York comment letter (June 5, 1997).

[68]*See*, *e.g.*, Lee A. Sheppard, ''The Camel's Nose of Partial SRLY Repeal,'' *Tax Notes*, June 21, 1999, p. 1678; Tax Executives Institute, comments on Notice 98-38 regarding SRLY (Apr. 15, 1999).

[69]H.R. Conf. Rep. No. 99-841, at II-194 (1986).

[70]Under section 384(b), the combination of a loss corporation and a gain corporation that were part of the same controlled group (based on a 50 percent vote and value test) for five years before that combination will not trigger section 384(a).

[71]Sections 382 and 384 are meant to apply cumulatively, and presumably section 382 applies first. Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, para. 14.45. The detailed mechanics of section 384 are uncertain in many cases because no regulations have been promulgated thereunder.

[72]H.R. Conf. Rep. 100-3841 (1987).

against income and gain built into the assets of another corporation, runs counter to the idea that the owners of the loss corporation who bore the economic loss should be able to benefit from the loss carryovers generated by those economic losses. And while section 384 on its surface seems like it seeks to limit the tax losses generated by a particular business activity to that activity only — à la *Libson Shops* — the reality is that section 384 imposes limitations considerably more sweeping than would be required under that principle. The legislative history hints that Congress may again have been targeting tax-motivated transactions,[73] but section 384 is triggered with no ''evil'' tax-motivated purpose and certainly covers significantly more ground than transactions undertaken with tax avoidance as a driving (or even relevant) factor. Thus, the enactment of section 384 could be thought of as (yet another?) minor piece in a hodgepodge of legislative lurches aimed at an uncertain target.

## V. Legislative Intent in Limiting NOL Use

As mentioned above, the received wisdom is that trafficking in tax losses must be curtailed to prevent several ''evils'' — real, imagined, or manufactured. Over the many decades during which these legislative, administrative, and judicial efforts to curb trafficking have been undertaken, a variety of rationales and objectives have been advanced. The following are those most consistently or frequently offered:

- tax law must not encourage or permit transactions that have no nontax purpose and are driven entirely with a goal to reduce or eliminate tax liability (tax avoidance);
- the benefits that can be derived from tax losses must be enjoyed exclusively by the person that suffered the economic loss that gave rise to the benefit (same person);
- if the tax law permitted the sale of tax losses, sellers would almost certainly be inadequately compensated (inadequate compensation); and
- the tax benefits that can be derived from tax losses should be available only through offsetting the income generated by the same business activity from which the underlying tax losses arose in the first place (same business).

The discussion below examines whether and the extent to which these articulated concerns are in fact compelling. It also explores whether current law is effective at achieving its stated goals and whether alternative approaches might be better from a tax policy standpoint.

[73]*Id.* (''No inference is intended that such situations are not subject to section 269 of present law.'')

### A. Tax Avoidance

As enunciated in 1944, the primary factor driving Congress's effort to limit loss carryovers following changes in corporate ownership was that taxpayers were buying shell companies solely to acquire and take advantage of loss carryovers.[74] Congress concluded that this so-called trafficking in losses had no purpose other than tax reduction and should therefore be restricted.[75]

At least theoretically, section 269 (or its predecessor) should have curtailed this type of tax-motivated transaction. However, because the application of section 269 requires a finding that a taxpayer engaged in a transaction with the principal purpose of tax avoidance, it proved to have limited effectiveness in practice. Taxpayers have often been and continue to be able to marshal evidence of a legitimate business purpose complementing the desire to acquire tax attributes. This perceived deficiency — the statute's reliance on a taxpayer's subjective state of mind — was a primary driver for Congress when it enacted section 382, anchored with its focus on objective triggers. It is noteworthy, however, that section 382 clearly applies to a spectrum of transactions far broader than merely those undertaken with a tax avoidance motive. Indeed, given the mechanics of section 382, it is difficult to believe that curbing tax avoidance was even a significant consideration.

But what is wrong with transactions having as their sole motivation the reduction of taxes? We have come to understand and acknowledge that taxpayers are permitted to take steps to reduce taxes, that tax avoidance is not per se a bad thing. Courts have long held that a taxpayer ''may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury.''[76] Apparently, while there is nothing inherently objectionable about what we now commonly call ''tax planning,'' that kind of planning becomes unacceptable if it is not somehow connected with other objectives. Why?

The answer seems to be that purely tax-motivated transactions are undesirable because they violate the principle of tax neutrality, which

[74]At the time, shareholders placed advertisements in newspapers touting their corporations as having nominal assets and significant losses. *See* Richard H. Nicholls, ''Net Operating Loss Carryovers and Section 382,'' *Tax Notes*, Feb. 13, 1984, p. 609, at p. 610; and comment, ''Net Operating Loss Carryovers and Corporate Adjustments: Retaining an Advantageous Tax History Under *Libson Shops* and Sections 269, 381, and 382,'' 69 *Yale L.J.* 1201 (1960).

[75]H.R. Rep. No. 83-1337, at 42 (1954).

[76]*Gregory v. Helvering*, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

holds that the tax law should neither induce nor impede business transactions. On hearing this answer, a bit of skepticism takes hold and one is tempted to list the many ways our tax law is intentionally and incontrovertibly designed to encourage or discourage different types of activity and conduct, calling into severe question the validity of any argument relying on this imagined principle of tax neutrality. However, this weakness in the very premise of tax neutrality as a principle can be significantly or fully discounted by merely acknowledging that there are in fact many situations in which the tax law is clearly designed to cause or inhibit specified conduct, and that in the absence of a congressional desire to cause or inhibit targeted conduct, the principle of tax neutrality fills the vacuum.

Thus, despite the many provisions within the tax law that reflect a spotty adherence to the principle of tax neutrality, we can accept as a given that there exists a congressional view that unless there is some kind of legislative goal to be achieved, the tax laws should be designed to stay out of the way of ''normal'' commercial conduct. We should remain mindful, however, that the mere articulation of that view — ''we need tax neutrality'' — still fails to explain the why: What is wrong with transactions pursued entirely to reduce taxes?

Congress's century-long failure to answer this question — which leaves us no clear explanation of how pursuit of and adherence to the principle of tax neutrality advances any important national interest or policy — invites us to explore whether clinging to this principle in the area of tax loss trafficking has any negative consequences (unintended or otherwise).

The focus on tax neutrality in this context seems to ignore other important considerations. Imagine a particularly egregious example in which a profitable corporation acquires a shell corporation with significant tax loss carryovers. The acquiring corporation's sole objective is to acquire the loss carryovers to offset income from its own successful operations. Assume the shareholders of the loss corporation receive cash in exchange for their stock. In that transaction, the acquirer is paying an amount upfront for the ability to reduce future tax. The selling shareholders, who otherwise would have been unable to benefit from the loss carryovers, receive value for the tax losses from a party able to make use of them. In this way, selling shareholders who had suffered the economic loss and, through that loss gained ownership of a tax asset, would be permitted to realize at least some portion of the value of that asset.

If one believes that a loss corporation, and derivatively its shareholders, should be entitled to a reduction in taxes because of the prior economic losses, all that has occurred is that the shareholders have received that benefit in the form of purchase price for their loss corporation shares. Some have insisted that this is actually a good result, the *fair* result, asserting that the taxpayers who have suffered an economic loss should be permitted to recoup, through tax reduction or through the sale of tax benefits, some portion of that economic loss. But why? Why is it fair to facilitate such a recoupment?

Recoupment proponents fall within (at least) two camps. One camp focuses on the need to create, and the societal benefit attendant on, a tax system that helps those who have suffered loss or encountered hardship.[77] This is something of a welfare view of our tax system, whose adherents stress our communal obligation to prop up those less fortunate. The second camp is less ''socialist'' (for lack of a better word) and simply wants fairness within the four corners of the tax system. This group, recognizing the completely arbitrary nature of our annual reporting system, bristles at the notion that taxpayers who (directly or indirectly) have net losses in a given tax period might have paid tax in an earlier period or may pay tax in a future period with no offset for those losses.

In our ''egregious'' scenario, the members of these two recoupment camps may have differing views about the right answer. Perhaps one of the recoupment camps would argue that loss corporation shareholders should be permitted to monetize value any way they can, and the other camp would condition the ability to sell tax losses on a showing that taxes were paid in the past or would be paid in the future. Generally, however, the fact that the payment came indirectly from a third party and not directly as a reduction of future taxes should not matter to the members of either recoupment camp.

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[77]Some commentators argue against recoupment on the grounds that it merely subsidizes failure. *See* Daniel L. Simmons, ''Net Operating Losses and Section 382: Searching for a Limitation on Loss Carryovers,'' 63 *Tul. L. Rev*. 1068-1069 (1989):

> The principal argument against a recoupment policy is that the recoupment of losses is a government subsidy to failing businesses. Free transferability of loss carryovers provides a partial recoupment when the seller who incurred the loss receives payment for the value of its loss carryover discounted for the risk that the purchaser will be able to generate sufficient income to absorb the loss. The purchaser of loss carryovers is reimbursed with future tax reductions for its purchase price plus whatever profit is negotiated in the transaction. The subsidy concept diverges significantly from the averaging rationale for carryovers. Recoupment frees the loss corporation from the requirement that it produce income to offset its losses in order to realize the benefit of net operating loss carryovers.

But even proponents of recoupment would probably pause in the case of a corporation and its shareholders, asking whether the shareholders ought to be entitled to any form of recoupment at all. After all, the corporation is itself an entity, and so maybe the juridical entity only, and not its owners, should be the focus of our recoupment efforts. If (under either of the prevailing recoupment views) the benefit to the loss corporation shareholders must be in the form of reduced tax on future (or past) income of this particular corporation, there need not be accommodation in the tax law to permit these shareholders to secure the benefit of the tax losses through a sale of loss corporation stock.

Such a constricted view of how these shareholders should be allowed to realize value from the tax losses may be unduly harsh. The value of the shareholders' stock is inextricably linked to the corporation's tax history and profile, which are harmed (in this case) by a tax system that — for administrative convenience only — creates an arbitrary annual cutoff for tax calculations. Arguably, then, it is simply unfair to hamstring the shareholders' ability to realize value as they dispose of their investment. Permitting a loss corporation or its shareholders to freely transfer loss carryovers therefore enables that corporation's shareholders to recoup a reduction in value of their investment resulting from the tax law's annual accounting convention.

Who loses in that scenario? The Treasury. In the absence of this transaction, the government would have otherwise collected tax from the profitable acquiring corporation in future tax years, while the tax losses would have ultimately expired unused at no cost to the government. Clearly, if tax policy is driven by how to get the most tax dollars, the rules curbing this type of transaction serve that goal. But we should recognize that even in this kind of egregious transaction, the acquiring corporation is simply taking steps to reduce total tax payments and the seller is merely recouping at least some value from previously suffered economic losses. Evil? Hard to find any, unless you first define a motivation to reduce taxes as evil. There is no question, however, that the selling shareholders here are hurt by a policy with questionable validity and no articulated underpinning.

### B. Same Person

A prevailing rationale underlying the allowance of loss carryovers is to permit a taxpayer to average its tax liability over loss years and gain years. Given this underlying rationale for the very existence of loss carryovers, some insist that the tax law should not permit tax losses incurred by one taxpayer to be acquired and used by a different taxpayer.

For a corporation that incurs tax losses, this "same person" principle is applied at the shareholder level. The shareholders of a corporation are the parties who ultimately enjoy or suffer the corporation's economic performance, and so, the argument goes, it is a loss corporation's shareholders at the time the losses were incurred, and only those shareholders, who should be entitled or permitted to benefit (through the corporation's use of those tax losses) and thereby achieve the desired averaging.[78] Thus, if and to the extent there has been a significant change in a corporation's ownership base, under this argument the corporation's ability to offset future income with loss carryovers — which would inure to the benefit of a different group of shareholders — should be curtailed. Otherwise, the loss carryovers are not furthering the purpose of averaging, because the shareholders who bore the loss are not the ones receiving the corresponding tax benefit.

Current section 382's limit on the ability to offset post-change income with pre-change losses following a 50 percent ownership change partially addresses this concern. After all, if a section 382 ownership change occurs, the corporation's tax losses become subject to use limitation. In important respects, however, section 382 does not or cannot address the concern or achieve the same-person objective. For example, given the section 382 rules that lump together small shareholders of a public company and effectively ignore sales of shares between these small shareholders, the ownership of a publicly held loss corporation can change dramatically with zero impact on the corporation's ability to use its tax losses. Arguably, designing a rule to achieve the same-person objective in the context of "invisible" stock trading by small shareholders of a public corporation is simply impossible. So this example merely reflects an inability to fully realize the same-person objective, not that the objective is unworthy or that Congress wasn't concerned with it.

Section 382 has other elements inconsistent with a desire to pursue the same-person objective. For example, following a change of ownership under section 382, the tax loss carryovers are limited, not eliminated. If the goal is to adhere to and pursue the

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[78]"As an equitable matter, the answer seems rather plain: When one looks past the legal fiction of corporate entity, he finds human beings bearing corporate losses through decline in value of their stock. As a number of courts have clearly recognized, the stockholders — not the business activity or the loss entity — deserve and need the averaging device, for they are in the final analysis the true sufferers of the loss." Michael R. Asimow, "Detriment and Benefit of Net Operating Losses: A Unifying Theory," 24 *Tax L. Rev*. 4 (1968).

same-person objective, why permit continued use of the tax losses? And why does section 382 include the convention of a three-year testing period, which allows new shareholders — meaning shareholders who acquire shares of a loss corporation after the incurrence of tax losses — to be treated as old shareholders after three years? How is that consistent with a goal to ensure the same-person objective?

Clearly, current section 382 was not fashioned with a singular or overarching focus on the same-person objective. Perhaps more likely, the same-person principle is only an ingredient in the mix, an additional — but not primary or guiding — factor driving legislative efforts to curtail loss trafficking. Most likely, when invoked at all, the same-person principle serves as a backstop to the tax avoidance concern discussed above. If so, the plumbing of section 382 seems more rational: Congress was largely (but not entirely) focused on stopping acquisitions having tax avoidance as their primary goal; it recognized that section 269, with its purely subjective test, never has and never will be sufficiently effective; and so crafted current section 382 with its objective test but also with allowances for situations in which tax avoidance is almost certainly not at play. In any event, this exploration of section 382 clearly suggests that even assuming the same-person objective has any validity, it is not a principle that has driven or should drive legislative action without also balancing important countervailing considerations.

The argument that the same-person objective supports the imposition of tax legislation that precludes or impedes transfers of loss corporation stock also appears to ignore (or remain indifferent to) the very outcome that is achieved by that legislation. As a result of the rules limiting or disallowing transfers of loss carryovers, shareholders of the loss corporation become unable or less able to receive an incremental purchase price attributable to the value of the tax loss carryovers and thereby are rendered unable to secure the very tax benefit that the same-person proponents believe is and should be theirs. Allowing these shareholders to realize value upon a sale of the loss corporation would itself represent an indirect recoupment of the tax benefits attributable to the prior losses.

For example, assume that a loss corporation has business assets that are expected to generate future cash flows with a present value equal to $1,000 and also has a loss carryover of $200. Absent the loss carryover, a potential acquirer would be willing to pay up to $1,000 to acquire the corporation. However, if the loss carryover can be used post-acquisition, the acquirer would, at least in theory, pay a higher price based on its determination of the ability to use the tax losses to reduce future tax liability. This additional purchase price would compensate the selling shareholders, at least in part, for the tax benefit associated with their economic loss.

Oddly, then, the example presents a difficult challenge for those who say the same-person objective supports the curtailing of this type of trafficking. After all, if we imagine a case in which an acquirer pays 100 percent (discounted to take account of present value considerations) of the expected tax savings, only by allowing this kind of transaction will the ''same person'' be in a position to recoup the benefit associated with the economic loss. Why, then, should the tax law impede such a transaction?

### C. Inadequate Compensation

Some have argued that loss carryovers should not be freely transferable because selling shareholders would not receive adequate compensation in exchange for those attributes.[79] On its face, this argument seems both overly paternalistic and fairly archaic. In today's economic system, which permits and encourages the sale of just about any kind of asset — real or imagined, contingent or otherwise — it is difficult to understand a concern that the shareholders of the loss corporation won't get paid enough for the transfer of their tax asset. Indeed, our economies and our sophisticated markets have little difficulty placing a value on just about anything; surely they could figure out a proper value for these tax assets.

Ironically, the fact that loss carryovers are not freely transferable is probably the only real barrier precluding an efficient system in which tax losses are evaluated, bought, and sold with facility, a

[79]Robert P. Harrill, ''The Limitations on Loss Carryovers: Hindering Legitimate Business Transactions,'' 15 *Tax Mgmt. Wkly. Rpt.* 1410 (1996) (Congress believed ''that the full value of net operating losses is never properly reflected in the purchase price of a loss corporation. A windfall is realized by the acquiring corporation when it obtains an asset worth much more than its purchase price. Congress believed that free transferability of net operating losses would not solve this problem; buyers would continue to take advantage of superior bargaining positions to negotiate a purchase price which did not adequately reflect the value of the attributes''). *See also* Joint Committee on Taxation, ''General Explanation of the Tax Reform Act of 1986, 100th Cong., 1st Sess., Special Limitations on Net Operating Loss and Other Carryforwards,'' at 294 (1987) (a ''prospective buyer of a loss corporation might be a less efficient operator of the business than the current owner, but the ability to use acquired losses could make the loss corporation more valuable to the less efficient user and thereby encourage a sale'').

system in which shareholders selling a loss corporation could realize full value for their loss corporation shares.[80] In today's environment, encumbered by (among many things) tax law constraints like sections 269 and 382, when a potential acquirer is trying to determine the expected value of a tax attribute, it must not only take into account the economics of the underlying businesses, but it also must sort through and analyze the overlay of tax law constraints on the ability to use the tax losses. Of course, to the extent that as a result of these tax law provisions the amount of a loss carryover is reduced or the amount of future income that a loss carryover can offset is capped, the tax loss carryovers hold less or little value to the potential acquirer and, consequently, the price offered to the selling shareholders is even lower than it would otherwise be. And so, ironically, a concern that selling shareholders would receive inadequate consideration for the tax losses is offered to support a system of rules that in the final analysis results in a diminution of the amount that an acquirer will pay for those very losses.

Finally, some have argued that selling shareholders of loss corporations as a general matter have less bargaining power than acquirers, which will result in those selling shareholders receiving less than they should for tax attributes. Given that each transaction has its own particular dynamics, it is unclear why this would be the case and particularly doubtful that this could be characterized as the norm. Further, acquisition transactions are voluntary, so if selling shareholders do not believe that they are receiving adequate value, they can always decide not to proceed with the sale transaction.

**D. Same Business**

The fourth main objection to trafficking is that loss carryovers attributable to one particular line of business should be permitted to offset only income from that same line of business. This reasoning formed the basis for the Supreme Court's holding in *Libson Shops*; given that loss carryovers are only permitted to facilitate the averaging of tax liability, use of the losses must be limited to the business activity that generated the loss. Under this theory, the averaging convention enabling the leveling of net profit years and net loss years was not contemplated in the context of a corporate transaction in which pre-transaction losses would be used to offset post-transaction income from a new line of business. This "same business" concern also seems to represent the underpinning of the SRLY limitation,[81] although the SRLY rules represent at best a loose adherence to this approach because they apply on an entity-by-entity basis and do not limit use of an entity's SRLY losses against income of that same entity from a different or even brand-new venture.

One significant shortcoming of this "same business" approach is that if our limitation rules actually restricted use of tax losses to the same business, a loss corporation would be compelled (or at least encouraged) to continue a losing business line in order to realize value from its loss carryforwards, which is both economically inefficient and poor tax policy.

Moreover, the same-business principle is simply not in any way a staple of our tax law. There are many provisions within the code that explicitly permit a taxpayer to average its tax liability across multiple lines of business. For instance, a corporate taxpayer calculates its net taxable income based upon *all* of its activities, with losses generated in one line of business applied to reduce total net income, effectively offsetting the losses from one business against profits from another. Similarly, the ability to file consolidated returns also allows a consolidated tax group to calculate net taxable income across all the members of the group, permitting losses from one business to offset profits from another. Thus, the notion that use of tax loss carryovers must be limited to the very business in which the losses were generated is simply inconsistent with important elements of our existing tax system and, in that way alone, if applied in the anti-trafficking regime, would represent an arbitrary and inappropriate delineation.

Further, if, as a policy matter, we do not want to permit taxpayers to offset income and loss across business lines, the focus of our trafficking rules should shift away from ownership changes, which do not necessarily result in changes to the business activities of a loss corporation, and focus instead on

[80]It is not difficult to imagine a system — unencumbered by sections 269, 382, or other tax loss limitation provisions — in which acquirers would routinely assess a value on loss carryovers embedded within a target corporation. An acquirer would project the amount and timing of future income and calculate the amount and timing of projected reductions in tax liability. In this way, an acquirer would set a value and be inclined to pay for the tax losses. One could expect discounting for time value of money and for the risks of whether the assumptions concerning future income, tax rates, and other elements actually materialize. This form of tax loss valuation occurs today in many scenarios, so the process described here is hardly novel or fanciful. Ultimately, the price offered by the acquirer and accepted by the seller would represent the truest measure of the value of the tax asset.

[81]*See* Dubroff, *supra* note 59, section 42.02[1][a] at 42-8 (2012) (stating that the SRLY rules represent an effort to reconcile the single- versus separate-entity treatment of consolidated group members when a member join or leaves the group).

the *activities* of the loss corporation. However, any system implementing that policy would be complex from an administrative and compliance standpoint. There would be a definitional question about what activities of a corporation should constitute a line of business; taxpayers would need to begin tracking their taxable income on a business-by-business basis (rather than on an aggregate basis); and the IRS would need to have some method to determine when a corporation with losses shifted its business lines in a manner that should trigger a loss use limitation. All in all, not only does the same-business approach lead to bad economic and tax policy, and not only is the approach inconsistent with many other elements within our tax system, but the underlying goal would be quite difficult to achieve.

## VI. Is There No Better Mousetrap?

### A. Lessons From the Past Century

So what have we learned? And what shall we do? Looking back over just about 100 years, we can draw several conclusions:

- while there is a strong sense that there is a problem — trafficking — that needs to be addressed, there is no clear articulation of what the problem actually is;
- the legislative, judicial, and administrative efforts to curb trafficking in tax losses have been inconsistent, jerky at times, and lacking a defining and fixed focus;
- the most prevalent reasons offered to curb trafficking appear to be either superficial or flawed in important ways; and
- there has never been, as far as one can tell, a genuine effort to explore the benefits to our economy and to the perception of fairness within our tax system that might result from eliminating or drastically altering the rules that disallow or discourage so-called trafficking.

So what? Maybe, despite the fits and starts over the decades and the absence of a unifying and coherent focus, the network of loss limitation rules within the tax law has finally gotten to an acceptable place. Perhaps the current version of section 269 serves its purpose of discouraging the most abusive transactions, and section 382 (along with an assist from the SRLY rules) establishes a set of ground rules that has created a now-familiar system that seems to work reasonably well — even if we can't necessarily determine whether there is an evil or a goal of some sort. Sure, we continue to adjust section 382 around the edges, but it has endured largely intact now for almost 30 years and there appears to be no major industry-based complaint or effort at significant change or repeal. If that is our standard of successful tax law, maybe we have achieved it.

Or maybe we should step back and reexamine our assumptions, question whether the received wisdom is flawed, and explore whether a clearer understanding of our desired goals might help the conceptualization and implementation of a better system.

### B. Defining Goals

If we were to have a disciplined discussion to figure out what our tax system should be achieving regarding the transfer of tax loss carryovers, what would we decide? I'm guessing we would have difficulty finding common ground and that we would all agree on just one principle: The tax law should not respect transactions that are without substance. If a purported transaction changes nothing, the tax implications should correspondingly be nothing. This one principle already is a staple of our tax law in the form of judicial constraints such as the sham transaction, substance over form, and (to some extent) step transaction doctrines. And more recently, Congress, through its enactment of section 7701(o), has added a legislative constraint on transactions having no economic substance. This has given the IRS an additional tool to combat transactions with no substance.

Admittedly, these various tools are imperfect. The IRS's battle to identify and undo or disregard transactions without substance continues to be difficult and often unsuccessful. But, if we all agree that this is the principle that should be upheld, our focus ought to be on enhancing the effectiveness of these tools, not on creating different tools that address other, perhaps questionable, issues and objectives. The legislative and judicial constraints on NOL trafficking are not targeted narrowly — if at all — at addressing nonsubstantive transactions, and unquestionably apply to a broad range of transactions that are quite "substantive." Even section 269, with its focus on a taxpayer's subjective intent, really has, at best, only an incidental relationship with whether the underlying transaction has substance.

Aside from our universally agreed principle that doing nothing should not change the tax landscape, are there any other principles we would all agree on? I think not. Tax avoidance? Sure, many will reflexively say that transactions pursued entirely with tax avoidance as a goal should not be respected. As discussed earlier, however, there really is no compelling rationale for this position, other than arguing that those transactions are unseemly. Our tax law at times ignores and sometimes even encourages tax avoidance, so the real question is whether the area of NOL trafficking is unique somehow, an area in which we should impose limits? Is this kind of trafficking, unlike many other areas within the tax law, simply an area of tax avoidance we won't sanction? If so, why not?

Beyond tax avoidance, the ability to gain any kind of consensus on why and whether to limit transfers of NOL carryovers gets even more difficult. We have identified at least three different camps, each with its own view on how to think about NOL carryovers:

- The first camp, a subset of the recoupment proponents, believes that our tax system should help those who are struggling, those who have suffered economic losses. This camp would (or should) argue in favor of free transferability of NOL carryovers.
- The second camp, the other subset of the recoupment proponents, focuses on the arbitrariness of our annual cutoff for determining tax liability and believes that for our system to be fair, it must ensure averaging of income and loss over long stretches of time, perhaps even over the lifetime of a taxpayer. This camp would (or should) argue in favor of a system designed to ensure that no taxpayer (perhaps even shareholders of a corporation, who indirectly pay the corporation's taxes) involuntarily loses the potential tax benefit of economic losses to offset taxes paid in the past or (ever) to be paid in the future.
- The third camp, less focused on the fairness or arbitrariness of our annual accounting convention, appreciates that the system is set up as it is and will have winners and losers. This camp is not moved to reimburse taxpayers for unused tax losses or to facilitate taxpayers' ability to squeeze any value out of NOL carryovers. This camp would (or should) have no driving principle for whether and when to permit NOL trafficking, other than to insist that the rules work and that they don't create other negative consequences.

### C. Where Do We Go From Here?

And so, as we consider whether and how to limit transfers of NOL carryovers, we do so with no collective agreement on goals. After setting aside sham transactions, there is no real agreement on what, if anything, needs to be accomplished or should be avoided. Perhaps Eustice was right 30 years ago: What we have seems to work well enough, so why tinker?

Maybe we tinker because what we now have appears to be a patchwork of provisions with no overarching theory, no governing principle, and no singular goal. This patchwork arguably impedes free commerce and treats similarly situated taxpayers differently — while costing the public and private sectors uncounted dollars to maintain, monitor, and navigate.

What would tinkering look like?

**1. Maybe we should retain section 269.** At some level, one could argue that section 269 should be left in place, complementing the judicial and now legislative doctrines and rules designed to disallow nonsubstantive transactions. While some argue that section 269 is an imperfect tool, the reality may be that the tool is difficult to actually use but largely serves its purposes simply by existing.

**2. Or maybe we should repeal section 269.** Recognizing that section 269 is not targeted at transactions lacking substance and plays no important role in that arena, we might simply repeal (at long last) section 269 and instead permit the judicial and legislative doctrines and rules that are genuinely focused on substance versus sham to serve their intended function. Under this view, the tax law should not, in the absence of a compelling reason, disallow transactions with substance, even if motivated by a desire to reduce taxes. Thus, recognizing section 269's focus on tax avoidance and not on the economic substance of a given transaction, we should repeal it.

**3. Maybe we should repeal section 382.** Other than its service as a backstop to section 269, section 382 may have no purpose that most people would support. In its current form, section 382 is not in any way tied to tax avoidance. It is largely a permutation of the "same person" theory, a theory with questionable validity and not widely embraced as a compelling policy objective. Section 382 also represents, to a minor extent, a modest nod in the direction of the "same business" theory, a theory difficult to reconcile with important aspects of the tax law and a theory that has not been embraced with consistency over the decades of judicial and legislative activity in this area. If this is all true, maybe section 382 ought to be repealed.

**4. Or perhaps we should retain but amend section 382.** Alas, we seem to have an almost unbreakable bond with section 382, a bond that may be the product of the long and uncontested effort to convince ourselves (and the public at large) that there is something wrong with NOL trafficking, something unseemly. Consequently, those who argue — even without explaining why — that free transfer of NOLs is unseemly could prevail and insist that section 382 serves an important purpose and should be retained. Even in that case, however, we still should consider an element of current section 382 that arguably is unfair.

Most or all of us would agree that a corporation's inability to carry back NOLs more than two years can result in unfairness (when the corporation paid tax in those earlier tax periods), an unfairness born of our arbitrary annual tax period convention. In normal situations, the allowance to carry forward NOLs to subsequent tax years reduces (but does not eliminate) this unfairness. Application of section 382, however, can significantly reduce (or even eliminate) the corporation's ability to approach an averaging through NOL carryforwards. In this way, the application of section 382 can stymie achieving greater fairness within our tax system. Perhaps, then, section 382 could be amended to permit an extended carryback period when a corporation undergoes a section 382 change of ownership, thereby mitigating this unfair result and permitting the shareholders who suffered the economic loss to recover at least some portion of the associated tax benefit.

Such an amendment to section 382 would, however, confront challenges. Allowing an extended carryback to secure otherwise unattainable tax refunds from prior years only in situations in which there has been a section 382 change of ownership likely would create some odd, perhaps inappropriate, results: The owners of a loss corporation facing little or no prospect of ever making a profit (against which its NOLs could be used) might be tempted to manufacture a sale of the loss corporation just to allow the extended carryback period and to secure tax refunds from earlier tax years otherwise out of reach. Some would argue that this is an unacceptable result. Further, allowing too long a carryback period could be viewed as an administrative difficulty or impossibility for the IRS. Perhaps these and other challenges to amending section 382 to allow a greater opportunity for averaging could be overcome with a carefully tailored amendment, but one gets the sense that we would then be slipping down the same type of slope that has gotten us to our current version of section 382.

**5. Maybe, then, we should retain section 382 as is.** Some might argue that section 382 serves an important purpose simply as a revenue raiser and should therefore be retained without substantial alteration. After all, in a tax system allowing unfettered transferability of NOLs, it would be unlikely that any NOL would expire unused. In that system, all of corporate America would be like a single taxpayer — something like one giant consolidated group — when it comes to making use of NOLs. If the corporation that generates an NOL cannot use it, another corporation surely would pay for and make use of the NOL. As a result, Treasury would collect less revenue than under our existing system.

We can debate of course whether a system with no section 382, a system that allows all of corporate America to be a single taxpayer when it comes to the use of NOLs, would represent a distorted and unacceptable expansion of the underlying goal of averaging to mitigate the unfairness of our annual accounting convention. Many would argue that an inviolable rule of our system is that everyone should pay their fair share of taxes, that those of us who earn or make profit should not be permitted to simply staple our tax return to the tax return of others who've been less successful and thereby avoid paying taxes. Under this view, permitting all of corporate America to share NOLs would represent an unacceptable expansion of the averaging principle. Others might argue that we find ourselves facing these difficult issues only because our current system picks and chooses when to respect the separate existence of a corporate entity and thereby creates some unfair results that beg to be addressed, perhaps even with this kind of expansion of the averaging principle.

Ultimately, then, we are back to a lack of consensus regarding which principles should prevail, and an appreciation that in the final analysis, the main driver of tax policy is that the government must establish a revenue-raising system that appears fair within the prevailing economic, social, and political environment. In a system with no section 382, in which NOLs are freely transferred and all of corporate America thereby shares NOLs, Treasury surely would lose revenue it otherwise would have collected. If raising revenue is the reason to retain section 382, then so be it, but we should say so openly; at least an honest admission that revenue-raising is the goal of section 382 would properly inform our focus on the proper application and modifications of section 382.

**6. Maybe we should repeal section 384.** Section 384 can be broken into two categories: (1) limitations imposed when a gain corporation acquires a loss company; and (2) limitations imposed when a loss corporation acquires a gain company. Transactions in the first category, involving an acquisition of NOLs (or built-in losses), are and should be governed (if at all) by other judicial and statutory constraints, with no need for a section 384 overlay. Judicial (and legislative) constraints on sham transactions, complemented if need be by sections 269 and 382, really ought to be sufficient to cover this ground.

Thus, in assessing the need for section 384, our focus should turn to transactions in the second category, involving an acquisition of built-in gain assets. The question becomes whether our tax law should permit a corporation with NOL carryovers (or anticipated tax losses) to use those losses to offset income and gains that are built into acquired assets. The underlying congressional concern relates to types of activity and assets for which the transferor would unfairly escape long-delayed gain recognition. This seems like an issue that should not be addressed by focusing on the acquiring corporation or its tax attributes; instead, the focus should be on when and whether to tax the transferor of gain assets rather than allow a tax-free transfer with a carryover of the low tax basis. Section 384's misplaced focus on the loss corporation acquirer — particularly given the sweeping application of section 384 to acquisitions well outside the underlying legislative concern — arguably represents just another inappropriate roadblock, stifling a loss corporation's efforts to use its NOLs to regain its footing or achieve greater profitability. Therefore, serious consideration should be given to repealing section 384 or at least significantly narrowing its application.

**7. What about the SRLY limitations?** Defining the role of the consolidated return rules in this one area of loss limitations is well beyond the scope of this report. While there is little doubt that the SRLY rules are somewhat subsumed by section 382, and there remain questions regarding the validity of the rationale underlying the continuation of the SRLY rules, one could argue that unique considerations present themselves in consolidated tax returns and that the SRLY rules should therefore be examined through a different prism. I defer to that notion, although I still maintain that a robust discussion concerning what the tax law should (and should not) seek to prevent or achieve would be a healthy first step in any such examination.

## VII. Conclusion

Where to go from here? My vote would be to permit free transfer of NOL carryovers as long as the underlying transaction has substance. Doing so would (1) allow the development of a rational market for the sale and purchase of NOLs; (2) render unquestionably aboveboard the arena of NOL preservation and use in corporate transactions; (3) permit greater fairness within a system that necessarily imposes arbitrary conventions; and (4) substantially reduce the high public and private sector cost of navigating through a system that has questionable value at best. Thus, I would repeal sections 269, 382, and 384. But after I retire, please.