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SECTION 384 OF THE INTERNAL REVENUE CODE OF 1986

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SECTION 384 OF THE INTERNAL REVENUE CODE OF 1986

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I. INTRODUCTION

A. Section 10226 of the Revenue Act of 1987, P.L. 100-203 ("OBRA"), added section 384 to the Code. The general purpose of section 384, as originally enacted, was to prohibit loss corporations from using their losses to shelter built-in gains of an acquired target corporation if such gains were recognized within the five-year period after the target's acquisition. See H.R. Rep. No. 391, 100th Cong., 1st Sess. 1093-94 (1987).

1. The original version of section 384 generally applied where a loss corporation became affiliated with a gain corporation as a result of the acquisition of gain corporation stock. In addition, the original version of section 384 generally applied to certain tax-free asset acquisitions by loss corporations (where built-in gain in the acquired assets was preserved).

2. An exception was provided where the loss corporation and the gain corporation were under common control.

B. However, the original version of section 384 was so seriously flawed that Congress substantially revised section 384 in the Technical and Miscellaneous Revenue Act of 1988, P.L. 100-647 ("TAMRA").

1. Revised section 384 now applies to: (1) stock acquisitions in which control of the target is acquired, and (2) certain tax-free asset acquisitions, regardless of whether the loss

corporation acquired the gain corporation (or its assets) or vice-versa.

2. The general thrust of revised section 384 is that, following such an acquisition, built-in losses (i.e., preacquisition losses) of one corporation cannot offset built-in gains of another corporation which are recognized within five years of the acquisition.

3. TAMRA offers taxpayers an election to have the old version of section 384, rather than the revised version, apply to transactions for which the acquisition date is before March 31, 1988. See TAMRA, § 2004(m)(5). For procedures to make this election, see Announcement 89-40, 1989-12 I.R.B. 95.

4. Accordingly, the old statute remains relevant for purposes of this election. For this reason, discussions of the old statute are retained in this outline.

C. Section 384 does not displace any of the current provisions limiting loss carryovers. Thus, for example, sections 172, 269, 382, and the consolidated return regulations (the SRLY and reverse acquisition rules) continue to apply. However, the interaction among section 384 and these other provisions is uncertain at this time.

1. Apparently, the limitations of section 384 are to apply independently of, and in addition to, section 382. See Staff, Joint Committee on Taxation, Description of the Technical Corrections Act of 1988 ("TCA 88"), at 421 (1988) ("Gen. Expl."). See also H.R. Rep. No. 795, 100th Cong., 2d Sess. 412 (1988) ("House Report"); S. Rep. No. 445, 100th Cong., 2d Sess. 436 (1988). Thus, for example, it is possible that both section 382 and 384 will apply as the result of a single transaction (e.g., gain corporation acquires loss corporation). Dual application of these sections creates enormous complexity.

2. Section 384 overlaps to some extent with section 269(a), except that section 269(a) may apply

where the loss corporation acquires only 50 percent control of the profitable corporation.

a. In contrast to section 269, however, section 384 is not dependent on the subjective intent of the acquiring corporation.

b. Also, losses may be disallowed if section 269 applies, whereas section 384 only prevents preacquisition losses from offsetting another corporation's recognized built-in gains.

3. As originally drafted, section 384 essentially was the converse of section 269(b) (profitable corporation makes a qualified stock purchase of a loss target without electing section 338 and liquidates target). However, revised section 384 now overlaps to some extent with section 269(b) except that no liquidation is needed to trigger this section.

4. Section 384 also overlaps with the SRLY rules where a gain corporation acquires the stock of a loss corporation (unless the acquisition is a reverse acquisition, in which case section 384 generally would apply but not the SRLY rules).

a. However, the SRLY rules extend to the gain corporation's operating income, whereas section 384 applies only to recognized built-in gains.

b. In addition, prior to the introduction of subgroup principles to the SRLY rules, the SRLY rules may have been more restrictive than the section 384 rules if the gain corporation acquires (not in a reverse acquisition) a consolidated group having both gain and loss members. Prior to 1997 (or 1991 if a retroactive election is made), the SRLY rules applied separately to each member of the acquired group. However, as discussed below, section 384 generally treats the acquired group as one corporation. This result has been mitigated by the SRLY subgroup rules. See Treas. Reg.

§§ 1.1502-15(c) and -21(c) (finalized in T.D. 8823, 1999-29 I.R.B. 34).

D. The alternative minimum tax ("AMT") must also be considered. A corporation's built-in gains and losses (including net operating loss carryovers) are likely to differ for regular and minimum tax purposes. Presumably, section 384 will be applied separately for AMT purposes. See Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 438 and 470 (1987) ("Blue Book"); Ltr. 9804013 (stating that section 384 will apply in the computation of alternative minimum taxable income in the same manner as it applies in the computation of taxable income). Cf. section 382(l)(7).

II. ACQUISITIONS SUBJECT TO SECTION 384

A. The Revised Statute

1. Stock Acquisitions

a. With respect to stock acquisitions, revised section 384(a) provides that:

(1) if a corporation "acquires directly (or through 1 or more corporations) 'control' of another corporation,"

(2) and either corporation is a "gain corporation,"

(3) then income for "any recognition period taxable year" (to the extent attributable to "recognized built-in gains") may not be offset by any preacquisition loss (other than a "preacquisition loss" of the gain corporation). Section 384(a)(1)(A).

b. Thus, the first requirement is that one corporation must acquire "control" of another corporation.

(1) The term "control" means ownership of stock in a corporation which meets the requirements of section 1504(a)(2) (80

percent vote and value). Section 384(c)(5).

i. Presumably, this standard incorporates section 1504(a)(4) so that "vanilla" preferred stock is ignored.

ii. It is unclear what effect the regulations under section 1504(a)(5) will have in a section 384 context. Cf. Notice 87-63, 1987-2 C.B. 375 (indicating section 1504(a)(5) regulations will apply, in general, prospectively for section 332 and 338 purposes).

(2) Control may be acquired in a taxable or tax-free manner. Also, there is no time limit as to the acquisition of control -- a creeping 20-year acquisition would become subject to section 384 once control was acquired.

(3) Since this term is different from "control" as used in the section 351 context, a section 351 exchange can fall outside revised section 384(a)(1)(A). But see section 384(f)(2).

(4) Further, it is unclear how a corporation may acquire control through “1 or more corporations” under Section 384(a)(1)(A) as neither Section 384 nor Section 1504(a)(2) expressly provides constructive ownership rules. However, the Service has advised that the stock of two acquiring corporations may only be aggregated for the purpose of determining control of an acquired corporation under Section 384(a)(1)(A) if one of the corporations controls the other by means of direct stock ownership determined under the Section 1504(a)(2) control test (80 percent vote and value). FSA 200125007.

(5) In contrast, old section 384 applied where the gain corporation became a "member of an affiliated group."

c. The second requirement is that at least one corporation must be a "gain corporation."

(1) Section 384(c)(4) defines a gain corporation as any corporation with a net unrealized built-in gain.

i. Note that under this definition, a corporation may be a gain corporation, yet still possess loss carryovers

ii. An example of such a case is a real estate concern that owns appreciated real property but has losses resulting from depreciation and interest deductions.

(2) The revised statute clearly would apply where a gain corporation acquires control of a loss corporation and vice versa; whereas the old statute seemed applicable only where a loss corporation acquires a gain corporation.

d. In addition, except as may be provided in regulations, section 384(c)(6) also provides that all corporations which are members of the same affiliated group (as defined in section 1504) immediately before the acquisition generally will be treated as one corporation.

(1) To the extent provided in regulations, section 1504 will be applied _without regard_ to the limitations in section 1504(b).

i. That is, once implementing regulations are issued, foreign corporations, certain insurance companies, _etc_. may be included as members of the gain corporation's affiliated group. _But_ _see_ H.R. Rep. No. 1104, 100th Cong., 2d Sess. 19 (1988).

ii. This rule apparently will apply on both sides of the transaction to aggregate members of the acquiring group and the acquired group.

(2) Thus, under the revised statute, where the loss corporation acquires the common parent of an affiliated group, all members of the acquired group generally would be treated as one corporation. Preacquisition losses attributable to one acquired member of the group apparently may be offset by recognized built-in gains of another member of such acquired group.

i. This change tends to correct the SRLY effect under the language of old section 384.

ii. Under old section 384, preacquisition losses of former members of the gain corporation's affiliated group who were also acquired by the loss corporation were technically limited under old section 384(a)(1).

e. Revised section 384(a) expressly allows built-in gains to be offset by preacquisition losses of the gain corporation. This reflects the fact that the statute is designed to prevent losses from one corporation from offsetting gains of _another_ corporation.

f. The other terms contained in revised section 384(a) will be defined in Part III., below.

2. Asset Acquisitions

a. With respect to asset acquisitions, revised section 384(a) provides that:

(1) if the assets of a corporation are acquired by another corporation in an (A), (C) or (D) reorganization,

(2) and either corporation is a gain corporation,

(3) then income for any recognition period taxable year (to the extent attributable to recognized built-in gains) may not be offset by any preacquisition loss (other than a preacquisition loss of the gain corporation).

b. The principles outlined in Part II.A.1.c. through e., above, with respect to stock acquisitions, apply here with respect to asset acquisitions.

c. In contrast to the old statute, a section 332 liquidation is not treated as an asset acquisition within the realm of section 384. According to the TCA 88 General Explanation, the reference to section 332 liquidations was deleted because the successor rule of revised section 384(c)(7) renders the liquidation rule unnecessary. See discussion below at Part III.D.

d. Section 384(a)(1)(B) does not apply, on its face, to F or G reorganizations. It is unclear whether section 384 would apply to a transaction that is both a G or an F, and an A, C or D reorganization as well.

B. The Old Statute

1. Stock Acquisitions

a. Old section 384(a)(1) provided that:

(1) if a corporation (the "gain corporation") became a member of an affiliated group,

(2) and the gain corporation had a net unrealized built-in gain,

(3) then the income of the gain corporation for any recognition period taxable year (to the extent attributable to recognized built-in gains) could not be off-set by any preacquisition loss of any other member of such group.

b. Old section 384(a)(1) essentially covered stock acquisitions -- whether taxable or tax-free. This provision conceivably was broad enough to encompass section 351 transfers (e.g., where "Newco" was formed by a consolidated group member and appreciated property was transferred to it).

c. Importantly, the language of old section 384(a)(1) would prevent recognized built-in gains from being offset by any other member of the acquiring corporation's affiliated group, including those members that were formerly included in the target gain corporation's affiliated group.

d. As will be discussed below in Part III.C.2. (the old definition of "acquisition date"), it was not clear precisely when a corporation became a "member of an affiliated group."

(1) Construed broadly, this language would cover the situation where a "stand alone" gain corporation acquired a loss corporation and the two corporations filed consolidated returns thereafter. In such a case, the gain corporation literally would have "become a member of an affiliated group."

(2) It was unclear from the original statute whether this was an intended result. As discussed above, revised

section 384 makes clear that the statute would apply where a gain corporation acquires a loss corporation.

2. <u>Asset Acquisitions</u>

a. Old section 384(a)(2) provided that:

-- if the assets of the gain corporation were acquired by another corporation (1) in a section 332 liquidation, or (2) in a reorganization described in section 368(a)(1)(A), (C) or (D),

-- and the gain corporation had a net unrealized built-in gain,

-- then the income of the acquiring corporation for any recognition period taxable year (to the extent attributable to recognized built-in gains of the gain corporation) could not be offset by any preacquisition loss of any corporation other than the gain corporation.

b. The effect of old section 384(a)(2) was to prevent recognized built-in gains attributable to the gain corporation from being offset by preacquisition losses of any other member of the acquiring group, including those members that formerly were included in the target gain corporation's group.

III. <u>DEFINITIONS</u>

A. <u>Recognized Built-in Gain</u>

1. Under section 384(c)(1), the term "recognized built-in gain" means any gain recognized during the "recognition period" on the disposition of

any asset, except to the extent that the taxpayer establishes that:

-- such asset was <u>not</u> held by the gain corporation on the "acquisition date," or

-- such gain exceeds the excess (if any) of: (1) the fair market value of such asset on the acquisition date, over (2) the adjusted basis of such asset on the acquisition date.

In other words, any gain recognized during the recognition period is presumed to be limited under section 384, unless the loss corporation can prove otherwise (presumably on the basis of a preponderance of the evidence).

2. Recognized built-in gains for any recognition period may not exceed the net unrealized built-in gain reduced by the recognized built-in gains for prior years (ending in the recognition period) which would have been offset by preacquisition losses but for section 384. <u>See</u> section 384(c)(1)(C).

3. Presumably, gain will be treated as being recognized under the corporation's usual method of accounting.

    a. Thus, if inventory is reported on the LIFO method, built in gain would not be recognized until the pre-acquisition LIFO layers are invaded. <u>Cf</u>. Announcement 86-128, 1986-51 I.R.B. 22 (applying a similar rule for section 1374 purposes).

    b. Query whether a corporation could successfully adopt the LIFO method after the acquisition date. <u>Cf</u>. S. Rep. No. 445, 100th Cong., 2d Sess. 66 (1988) (indicating that regulations under section 337(d) will prevent such maneuvers for section 1374 purposes).

4. The term "recognized built-in gain" also includes accrued income items. Section 384(c)(1)(B).

a. Accrued income items would include accounts receivable held by a cash basis corporation (a dying breed following section 448 enactment). Also, accrued income would include deferred gain inherent in installment obligations arising from pre-acquisition date transactions, and contract income earned but not reported under the completed contract method of accounting. Accrued income could also include section 481 adjustments from pre-acquisition date periods.

b. Although no offsetting provision for accrued deductions is expressly provided, section 382(h)(6)(B) (which treats accrued deductions as recognized built-in losses) apparently is incorporated into section 384 as part of the computation of net unrealized built-in gain and recognized built-in losses. _See_ section 384(c)(8).

(1) Thus, to the extent that section 382(h)(6)(B) treats accrued deductions as recognized built-in losses (with an adjustment to net unrealized built-in gain under section 382(h)(6)(C)), it appears that accrued deductions would operate to reduce the amount of net unrealized built-in gain.

(2) This in turn limits the amount of recognized built-in gains that can be subject to section 384. _See_ section 384(c)(1)(C).

(3) A better approach would be to provide a direct offset in section 384 for accrued deductions.

c. Operating and investment income (such as business income, rents and dividends) that accrues after the acquisition generally would not be captured by section 384.

5. The section 384 legislative history provides that built-in gains are to include "phantom" gains derived from depreciation deductions, as well as

any income recognized after an acquisition in which the fair market value of the property acquired is less than the present value of taxes that would be due on the income associated with the property (e.g., where a burnt-out leasing subsidiary with built-in income is transferred to a loss corporation). See House Report at 1094. The purpose or scope of this passage is not entirely clear.

6. The section 384 definition for built-in gain more closely follows the definition under section 382 for built-in loss. Compare section 384(c)(1) with section 382(h)(2)(B). Built-in losses under section 382 and built-in gains under section 384 are presumed to be limited under the respective provisions, unless the corporation can prove that such items are not limited.

7. Installment Sales

   a. If the gain corporation sells assets for an installment note payable after the close of the recognition period, such gain would not appear to be recognized built-in gain under section 384(c)(1) since no gain was recognized in the recognition period.

   b. However, the Service intends to issue regulations providing that if a taxpayer sells a built-in gain asset prior to or during the recognition period in an installment sale, the provision of section 382(h) will continue to apply to gain recognized from the installment sale after the recognition period. Notice 90-27, 1990-1 C.B. 336.

   c. The Service concluded that permitting installment sale treatment to avoid characterization as built-in gain did not carry out the purposes of section 384.

   d. This does not appear to be the correct result as a policy matter; the corporation has "complied" with section 384 by not offsetting such gains with preacquisition

losses within the five year recognition period.

e. Note: Installment method reporting has been eliminated for accrual basis taxpayers for sales or other dispositions occurring on or after December 17, 1999. Section 453(a)(2).

B. Preacquisition Loss

1. Under section 384(c)(3)(A), the term "preacquisition loss" means: (1) any net operating loss carryforward to the taxable year in which the acquisition date occurs; and (2) any net operating loss for the taxable year in which the acquisition date occurs, to the extent such loss is allocable to the period in the year on or before the acquisition date.

2. Also, if a corporation has a "net unrealized built-in loss," the term "preacquisition loss" includes any recognized built-in losses. Section 384(c)(3)(B).

3. This definition closely parallels the section 382(d)(1) definition of "pre-change losses." That is, losses incurred prior to the acquisition date, in general, are preacquisition losses.

4. Absent section 384 regulations stating otherwise, the net operating loss for the taxable year in which the acquisition occurs is allocated ratably to each day in the year. See section 384(c)(3). It is unclear whether the section 384 regulations will contain provisions similar to those described Treas. Reg. § 1.382-6(permitting a closing-of-the-books election for allocating income and losses under section 382). See also LTR 200238017 (allowing a parent corporation and each member of its affiliated group to allocate net operating losses for purposes of section 384(c)(3)(A)(ii) by treating their books as if they closed on the date of the merger of two subsidiaries of the affiliated group); LTR 9027008 (allowing a corporate group to allocate net operating losses for purposes of section

384(c)(3)(A)(ii) by treating their books as closed as of the acquisition date).

5. When a consolidated group acquires a gain corporation, it is unclear for purposes of section 384 whether the consolidated group (with the gain corporation as a member) determines its net operating loss, if any, for the taxable year in which the acquisition date occurs on a consolidated group basis (i.e., items of income and loss of both the consolidated group and gain corporation are aggregated except for recognized built-in gain) or on a separate return basis (i.e., items of income and loss of the consolidated group and the gain corporation are separately determined).

    a. For example, assume that a consolidated group (A Group) acquires a gain corporation (G) in 2004. G becomes a member of the A Group. After the acquisition, G sells assets resulting in a recognized built-in gain of $50. A Group includes G's recognized built-in gain and G's other allocable items of income and loss on its consolidated tax return for 2004. If A Group's items of income and loss were separately determined for 2004, A Group would have a loss of $100 and G would have a gain of $100 (not including $50 of recognized built-in gain).

    b. Under a consolidated group approach, the A Group would not have a net operating loss for 2004. See LTR 200447037 (stating that a preacquisition loss must be determined by first computing taxable income on a consolidated group basis).

    c. In contrast, under a separate return approach, the A Group would have a net operating loss of $100 in 2004. Thus, the portion of loss that was allocable to the post-acquisition period would offset the $50 of recognized built-in gain.

C. Acquisition Date

1. Revised Statute

a. The term "acquisition date" is defined as the date on which the acquisition of control occurs. *See* section 384(c)(2)(A). Query: What is the effect on the section 384 acquisition date if a 30-day election under Treas. Reg. § 1.1502-76(b)(5) is made?

b. In the context of an asset acquisition, the "acquisition date" is defined as the date of the transfer in the reorganization. Section 384(c)(2)(B).

2. Old Statute

a. With respect to stock acquisitions, old section 384(c)(2) defined the term "acquisition date" as the date on which the gain corporation became a "member of the affiliated group." It was unclear precisely what this phrase meant.

(1) First, this phrase could have meant the date when 80 percent of the vote and value of the gain corporation was acquired by the loss corporation or members of the loss corporation's group. *Cf*. section 338(d)(3) (definition of a qualified stock purchase).

(2) However, the phrase may also mean the first day when the gain corporation is included in the loss corporation's consolidated tax return. Under the consolidated return regulations, the gain corporation generally is included in such return on the day *after* the acquisition of 80 percent vote and value. *See* Treas. Reg. § 1.1502-76(b)(3).

b. With respect to asset acquisitions, old section 384(c)(2) included a reference to section 332 liquidations in defining the

acquisition date (consistent with old section 384(a)(2) that included section 332 liquidations as a section 384 trigger.

D. Corporation -- Predecessor and Successors

1. Section 384(c)(7) states that any reference to a corporation includes a reference to any predecessor and successor corporations.

2. This provision apparently is intended to ensure that the section 384 limitation applies to any successor corporation to the same extent that it applied to its predecessor. *See* Gen. Expl. at 421.

   a. For example, assume that loss corporation (L) acquires control of gain corporation (G). The two corporations subsequently file a consolidated return.

      (1) Under the stock acquisition rule, income attributable to G's recognized built-in gains may not be offset by L's preacquisition losses during the subsequent five-year recognition period.

      (2) If G is liquidated into L under section 332 within five years after the acquisition, income attributable to G's recognized built-in gains may not be offset by L's preacquisition losses during the remainder of the five-year period. Gen. Expl. at 421.

      (3) The TCA 88 General Explanation states that because of this successor rule, the reference to section 332 liquidations in the asset acquisition rules of section 384(a) was deleted. Gen. Expl. at 421.

   b. As another example, assume the same facts as above except that, three years after G was acquired by L, G merges into an unrelated gain corporation (X), with X surviving.

Assume that X thereafter files a consolidated return with L.

(1) Under the successor rule, during the two remaining years of the recognition period with respect to G, L is precluded from using its preacquisition losses -- those attributable to periods before it acquired control of G -- against income of X attributable to built-in gains inherited from G that would have been subject to such limitation prior to the merger.

(2) In addition, the general asset acquisition rule would prevent X's built-in gains that accrued prior to the merger with G but that are recognized during the 5-year recognition period following that merger from being offset by losses of L accruing before that merger. Id.

c. Further, suppose G were subsequently merged into a loss group member that was affiliated with G prior to the acquisition (e.g., where G has a subsidiary, GL-1, and G is merged into GL-1).

(1) The merger apparently would be ignored since revised section 384(c)(6) treats G and GL-1 as the same corporation.

(2) Apparently, under section 384(c)(7), L and GL-1 would be subject to section 384 to the same extent as before the merger.

3. One unfortunate by-product of the successor rule is that corporations will be forced to trace assets and the related built-in gain and losses through their various corporate incarnations.

E. Other Definitions

The terms "net unrealized built-in gain," "net unrealized built-in loss," "recognized built-in loss," "recognition period" and "recognition period taxable

year" have the same meanings as under section 382(h), except that the "acquisition date" will be taken into account instead of the "change date." Section 384(c)(8).

1. Net Unrealized Built-in Gain or Loss

a. Definition

(1) In defining the term "net unrealized built-in gain," section 382(h)(3) does not use the term "change date," but instead contemplates that the net unrealized built-in gain will be calculated immediately before the ownership change (unless a redemption occurs in connection with the ownership change). Presumably, Congress intended to measure net unrealized built-in gain immediately before the triggering acquisition.

(2) Thus, using this interpretation, a corporation will have a net unrealized built-in gain or loss if the fair market value of the corporation's assets immediately before the section 384(a) acquisition is more or less (respectively) than the aggregate adjusted basis of those assets. Section 382(h)(3)(A)(i).

i. Presumably, the gross value of assets, as opposed to net value, will be used in testing for unrealized built-in gain or loss.

ii. For example, assume that gain corporation (G) owns two assets. The first asset has a value of $200 and basis of $50 (built-in gain of $150). The second asset has a basis of $100 and a value of $20 (built-in loss of $80). G's net unrealized built-in gain is $70.

(3) The presence of contingent consideration may make the determination of the assets' fair market value difficult if such value is to be ascertained by reference to the purchase price of the business.

b. Special rule for redemptions

It is unclear whether the special rules contained in section 382(h)(3) apply for section 384 purposes.

(1) For example, under section 382(h)(3)(A)(ii), if a redemption occurs "in connection with" an ownership change, the redemption must be taken into account in determining whether a loss corporation has a net unrealized built-in gain or loss.

i. Thus, if built-in gain assets are distributed to a shareholder, this may cause the loss corporation to fail the threshold test discussed below, or it may result in a net unrealized built-in loss.

ii. Such a situation may occur in a *Zenz*-type boot strap purchase where appreciated, but unwanted, assets are distributed to the shareholder.

iii. However, if a shareholder receives a note in exchange for his stock in the redemption, the unrealized built-in gain or loss apparently would not be affected (unless value is determined on a net basis).

(2) If control for section 384 purposes is acquired in a *Zenz*-type transaction, it is unclear whether this rule will apply for section 384 purposes. Presumably, the net unrealized gain or loss would be computed *after* the redemption.

(3) If the target is acquired in a leveraged buyout, the acquisition debt may be treated as a redemption. _See_ section 382(h)(3)(A)(ii) (referring to corporation contractions). _See also_ Blue Book at 316. However, if built-in gain is determined on a gross basis, such debt should not affect the determination of built-in gain for either section 382 or 384 purposes.

c. _Special rule for computing net unrealized built-in loss_

(1) Section 382(h)(8) provides that, if 80 percent or more in value of the stock of the loss corporation is acquired during a 12 month period in one transaction (or a series of transactions), then for purposes of computing net unrealized built-in _loss_, the fair market value of the assets cannot exceed "the grossed-up amount paid for such stock properly adjusted for indebtedness of the corporation and other relevant items."

(2) Section 382(h)(8) appears to adopt a value calculation similar to the calculation of "adjusted grossed-up basis" under section 338. _See_ Treas. Reg. § 1.338-4T(j).

(3) It is unclear whether this rule would apply for purposes of section 384(c)(3)(B). Presumably, it does.

d. _Threshold test_

Section 384(c)(8) adopts the definition of “unrealized built-in gain” of section 382(h)(3). Thus, the threshold limitation in section 382(h) will apply in determining a corporation's net unrealized built-in gain/loss for section 384 purposes. _See also_ H.R. Rep. No. 495, 100th Cong., 1st Sess. 974 (1987) ("Conf. Report"). _See also_ Gen. Expl. at 421.

(1) If a corporation's net unrealized built-in gain or loss does not exceed the lesser of 15 percent of the fair market value of its assets or $10 million, the corporation's net unrealized built-in gain or loss will be treated as being zero. Section 382(h)(3)(B)(i). The 15 percent/$10 million threshold replaced an earlier 25 percent threshold that Congress considered too generous. See H.R. Rep. No. 247, 101st Cong., 2d Sess. 1231-1232 (1989).

(2) However, for section 382 purposes, section 382(h)(3)(B)(ii) states that any cash or cash item, and any marketable security which has a value which does not "substantially differ" from its adjusted basis, is to be excluded in making the threshold determination. For the definition of the term "cash item," see section 368(a)(2)(F)(iv).

(3) In the example in Part III.E.1.a., above, L would pass the threshold test since it has a built-in gain of 32 percent (70/220). If L also had $500 in a bank account, the result would be the same since such an item would be excluded in the calculation.

(4) As a result of TAMRA, Treasury has authority to prescribe regulations under which cash and cash items will not be excluded for section 382 purposes. In applying this threshold test, the legislative history states that cash and cash items "will continue to be excluded [for purposes of the section 382 threshold computation] in any case in which there is a variation from the taxpayer's past business practice, or in any other appropriate case with a result that causes the threshold to be met or not met in a

manner favorable to the taxpayer." House Report at 47. However, the legislative history also indicates that an opposite result may be reached for section 384 purposes. See House Report at 414.

(5) According to section 384(c)(1)(B), accrued income items recognized within the recognition period are to be taken into account in determining the corporation's net unrealized built-in gain.

i. This language implies that accrued items not recognized within the recognition period are ignored in calculating net unrealized built-in gain.

ii. Thus, in computing the threshold for net unrealized built-in gains, it is unclear whether the gain corporation must assume that accrued income items will be recognized within five years, or whether the opposite assumption may be made.

iii. If the threshold is exceeded only by assuming that accrued items will be recognized within five years, amended returns may be necessary if recognition of such items is delayed beyond the close of the recognition period.

iv. Similarly, it is unclear how accrued deductions are to be treated.

e. Problems in aggregating corporations

Since section 384(c)(6) treats members of an affiliated group as a single corporation, it is unclear how a corporation's net unrealized built-in gain/loss is to be computed.

(1) The General Explanation states that the determination of whether the *de minimis* threshold for net unrealized built-in gain or loss is satisfied is to be made on an aggregate basis. *See* Gen. Expl. at 422.

(2) However, it is unclear whether stock investments in other members must be ignored in computing net unrealized built-in gain or losses. *See* LTR 8849061. If so, will a subsequent sale of such stock be exempt from section 384, or will it be treated as a sale of the underlying asset?

2. Recognition Period Taxable Year and Recognition Period

The term "recognition period taxable year" means any taxable year any portion of which is in the recognition period. Section 382(h)(7)(B). For section 384 purposes, the "recognition period" is the five-year period beginning on the acquisition date. Section 382(h)(7)(A), as modified by section 384(c)(8).

a. Under old section 384, the recognition period for a particular target could be extended (apparently unintentionally) beyond the five-year recognition period in certain situations.

(1) To illustrate, loss corporation (L) acquired all of the stock of gain corporation (G) on 1/1/88. On 1/1/92, L liquidated G in a section 332 liquidation.

(2) Normally, the five-year recognition period would close on 12/31/93.

(3) However, because the liquidation was also a transaction described in old section 384(a)(2), a new five-year recognition period would begin on 1/1/92.

(4) In effect, under old section 384, the recognition period for G would extend nine years -- 1/1/88-12/31/96.

(5) The successor rule of revised section 384(c)(7) apparently eliminates this problem.

b. Query whether losses and gains recognized within a recognition period taxable year but beyond the close of the recognition period will be prorated to the portion of the year within the recognition period.

3. Recognized Built-In Losses

For section 384 purposes, the term "recognized built-in loss" means any loss recognized during the recognition period on the disposition of any asset, except to the extent that the corporation establishes that: (1) the disposed asset was not held by the corporation immediately before the acquisition date, or (2) the recognized loss exceeds the excess of the adjusted basis of the asset on the acquisition date over its value as of such date. See section 382(h)(3)(B) (as modified by section 384(c)(8)).

a. Section 382(h)(3)(B) presumes that all losses recognized in the recognition period are "recognized built-in losses." This presumption in effect is carried over to section 384 under section 384(c)(8).

b. As with recognized built-in gains, losses must be recognized during the recognition period (not during a recognition period taxable year) to constitute "recognized built-in losses."

c. OBRA amended section 382(h)(2)(B) to treat depreciation deductions as built-in losses, except to the extent that the new loss corporation establishes that such deductions are not attributable to excess basis as of the change date. Congress had previously commissioned a Treasury study on this matter

as part of TRA 86. <u>See</u> P.L. 99-514, § 621(d)(1).

d. As indicated above, under section 382(h)(6)(B) accrued deductions may be treated as recognized built-in losses. Presumably, similar treatment will apply for section 384 purposes.

IV. <u>COMMON CONTROL EXCEPTION</u>

A. <u>The Revised Statute</u>

1. Revised section 384(b)(1) provides that section 384 will not apply to the preacquisition loss of any corporation if such corporation and the gain corporation were members of the same "controlled group" at all times during the five-year period ending on the acquisition date. For this purpose, the section 1563(a) controlled group definition applies except that:

-- "50 percent" applies instead of "80 percent";

-- 50 percent vote <u>and</u> value will be required; and

-- section 1563(a)(4) does not apply. Section 384(b)(2).

2. Under revised section 384(b)(3), the common control period would be shortened if either the gain corporation or the loss corporation was not in existence for the full five-year pre-acquisition date period. <u>See</u> H.R. Rep. No. 1104, 100th Cong., 2d. Sess. 16 (1988).

3. It is unclear how section 384(c)(6) interacts with the common control exception. For example, assume that loss corporation (L) acquires gain corporation (G) and that control of G itself is acquired by P corporation within the subsequent five-year period.

a. It would seem that G's gains and L's losses should continue to be subject to section 384 to the same extent as before P's

acquisition. That is, G and L would not be treated as one corporation with respect to each other.

b. However, in determining if P's gains, if any, are limited, it would seem that G and L should be treated as one corporation (*i.e.*, as to P only).

c. This interpretation unfortunately is not entirely clear from the statute, but it seems to be consistent with the legislative intent. *See* House Report at 412.

B. The Old Statute

1. Under section 384(b), an exception was provided whereby section 384 would not apply if more than 50 percent of the stock (by vote and value) of the gain corporation was held throughout the five-year period ending on the acquisition:

-- in the case of a stock acquisition, by members of the acquiring affiliated group, or

-- in the case of an asset acquisition, by the acquiring corporation or members of such acquiring corporation's affiliated group.

2. Where the gain corporation had not been in existence for the full five-year period, the common control exception apparently did not apply. No exception was provided where the loss corporation was not in existence for the full five-year period.

V. MISCELLANEOUS

A. Coordination with Section 172

Section 384(e) was added by TAMRA to coordinate section 384 with section 172.

1. Under section 384(e)(1), if any preacquisition loss cannot offset a recognized built-in gain by reason of section 384, then such gain will not be

taken into account in determining the amount of preacquisition losses which may be carried forward to other years under section 172(b)(2).

a. This provision merely appears to clarify that such preacquisition losses will <u>not</u> be reduced as if they had offset such gain.

b. Thus, for example, if loss corporation (L) has a $200 preacquisition loss and gain corporation (G) recognizes $50 of gain that is subject to section 384, L's preacquisition loss is not reduced to $150 as if it had offset such gain.

2. Although such clarification is welcome, provisions similar to section 382(l)(2) are needed for section 384 purposes.

a. For example, assume that loss corporation (L) has an NOL carryover from 1987 of $200. In 1988, L has no income and acquires all of the stock of gain corporation (G). For 1989, L has losses of $200. In 1990, G sells assets and recognizes built-in gain.

b. To what extent may L use post-acquisition losses (1989) to offset the $50 of section 384 gain? <u>Compare</u> section 382(l)(2)(A).

(1) If L's losses from 1987 are limited, the better view would be to treat L's carryover from 1987 as being zero, so that section 172(b) would not act to bar usage of the 1989 losses.

(2) If earlier losses must be used first before later losses can be utilized, in effect the later losses would be subject to section 384, which they are not.

c. Suppose G also has a NOL carryover from 1987 of $200. Which of the loss carryovers from 1987 must first be applied to non-section 384 gain? <u>See</u> section 384(e)(2). <u>Compare</u> section 382(l)(2)(B) (where losses subject to section 382 and losses not subject to

section 382 are carried forward from the same year, limited losses are used first)

B. Coordination with Taxable Income

Section 384(a) provides that preacquisition losses may not offset income of the corporation for any recognition period taxable year to the extent attributable to recognized built-in gains. It is unclear precisely how this phrase should be applied.

1. For example, assume the following situations:

	A	B
Operating Income	$100	$100
Recognized Built-in Gain	40	40
Recognized Built-in Loss	0	(40)
	0	
Taxable Income	$140	$100

2. In situation A, income attributable to recognized built-in gains is clearly $40.

3. In situation B, it is unclear whether income attributable to recognized built-in gains is $40 or $0.

   a. One can argue that $40 is appropriate because taxable income was increased to this extent by the recognized built-in gain.

   b. However, one can also argue that recognized built-in loss should first offset recognized built-in gain.

      (1) Net unrealized built-in gain -- the total amount subject to section 384 -- is computed by netting gains and losses.

      (2) Therefore, the amount actually subject to section 384 -- recognized built-in gain -- should also be netted. *Cf.* sections 1374(a) and (d)(2) as amended by TAMRA (recognized built-in gains are subject to section 1374 tax only if in excess of recognized built-in losses)

C. Scope of Section 384

Rules similar to section 384 are to apply in the case of excess credits (as defined in section 383(a)(2)) or net capital losses. Section 384(d).

D. Regulatory Authority

1. Under section 384(f), Treasury has authority to prescribe regulations "as may be necessary to carry out the purposes of this section," including regulations to ensure that section 384 is not circumvented through:

    -- the use of any provision of law or regulations (including subchapter K), or

    -- contributions of property to the gain corporation.

2. The legislative history indicates that Congress fears that built-in gain allowable to one partner can be shifted to a loss corporation through the use of the "ceiling rule" under Treas. Reg. § 1.704-3(b)(1).[1] See Conf. Report at 973. Importantly, regulations are to apply prospectively from the date of Treasury notice as to how the rule will be implemented and its scope. Id. at 974.

3. With respect to contributions of property, rules similar to section 382(l)(1) may apply for section 384 purposes. See Conf. Report at 97.

E. Effective Dates

1. Section 384 applies in cases where the acquisition date is after December 15, 1987,

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[1] In 1993 and 1994, Treasury issued regulations allowing a partnership to make "curative" or "remedial" allocations in order to correct the distortions created by the ceiling rule. See Treas. Reg. §§ 1.704-3(c) and (d). However, built-in gains can still be shifted if the partnership chooses not to make such allocations (i.e., if the partnership uses the "traditional method" of Treas. Reg. § 1.704-3(b)).

subject to a binding contract/letter of intent exception. See P.L. 100-203, ll § 10226(c).

a. The TAMRA revisions generally are retroactive to December 15, 1987.

b. However, a corporation can elect to have old section 384 apply where the acquisition date is prior to March 31, 1988.

(1) This election must be made in the manner prescribed by Treasury and must be made before the due date of the return for the period which includes the acquisition date or the close of 120-day period after enactment of TAMRA, whichever is later. See TAMRA, § 2004(5).

(2) For specific procedures on making this election, see Announcement 89-40, 1989-12 I.R.B. 95.

(3) This election should be considered where a gain corporation acquires a loss corporation prior to March 31, 1988. Such an acquisition clearly is covered by section 384, but may not be covered by old section 384.

2. Under the old statute, even though a target stock acquisition was completed before the section 384 effective date, if the acquiring corporation liquidated the target after December 15, 1987, or otherwise transferred its assets in a tax free reorganization, section 384 could apply.

a. This could occur because under old section 384(a)(2), the asset acquisition would be treated as an acquisition subject to section 384, notwithstanding the earlier stock acquisition.

b. The common control exception, as originally drafted, would provide relief only if the stock acquisition occurred more than 5 years ago, or if the liquidated subsidiary was

owned by a member of the gain corporation's affiliated group for at least five years.

c. Under revised section 384, the problem apparently would be corrected through the successor rule of section 384(c)(7).

VI. ILLUSTRATIONS

A. Stock Acquisitions

1. Example One

a. Loss corporation (L) is owned entirely by individual A. Gain corporation (G) is owned entirely by individual B. Both L and G are calendar-year taxpayers. At the close of business on 6/30/88, L buys all of the stock of G from B. L and G then file consolidated returns. On 1/1/93, G sells assets and realizes a gain of $200, $50 of which is treated as a recognized built-in gain.

b. Section 384 (both old and revised versions) applies, and L may not offset the $50 gain with any of its preacquisition losses. The remaining $150 of gain is not subject to section 384.

c. If G had sold the asset on 1/1/94, section 384 would not apply to any of the gain realized since the disposition of the asset occurred after the close of the recognition period (7/1/88-6/30/93).

d. If G sold the asset on 9/1/93 (i.e., after the close of the recognition period but within a recognition period taxable year), query whether the related gain would be prorated to the portion of the year within the recognition period.

e. The acquisition date would be 6/30/88 -- the date L acquired control. Thus, technically an asset sale by G on 6/30/88 would be subject to section 384, but any related gain could not be offset by L's losses.

f. Note that under the old statute, the acquisition date is the date G becomes a member of the L group. Under the consolidated return regulations, this date apparently is 7/1/88, not 6/30/88. Thus, an asset sale by G on 6/30/88 would not be subject to section 384. This is not objectionable because the related gain could not be offset by L's losses.

2. Example Two

a. Same facts as example 1 above, except that G acquires all of the stock of L from A.

b. Revised section 384(a) applies where either corporation is a gain corporation. Thus, in the example, revised section 384 would apply as a result of the acquisition.

c. The old version of section 384 appears to apply even though G acquired the stock of L. See old section 384(a)(1) (gain corporation "becomes a member of an affiliated group").

(1) Since old section 384 appeared applicable only where a loss corporation acquired a gain corporation, and not vice versa, this seemed to be an unintended result.

(2) Under the old statute, this problem would not arise if G were already a member of another affiliated group.

(3) In such a case, G would not become a member of an affiliated group as a result of its acquisition of L. G would already be a member of an affiliated group, and the language of old section 384(a)(1) would not seem applicable.

3. Example Three

a. Same facts as example 1, except that G owns all of the stock of GL-1, a loss corporation.

b. Under section 384(c)(6), G and GL-1 apparently would be treated as one corporation. Assuming G and GL-1 are treated in the aggregate as a gain corporation, GL-1's preacquisition losses could be used to offset G's recognized built-in gains (but not L's preacquisition losses).

c. Under old section 384, the $50 of section 384 gain from the 1/1/93 asset sale could not be offset by preacquisition losses of either L or GL-1.

(1) The language of old section 384(a)(1) was broad enough to encompass preacquisition losses of corporations that were members of the gain corporation's affiliated group prior to the acquisition of the gain corporation (GL-1).

(2) In this case, old section 384 achieved results similar to the existing SRLY rules.

(3) However, if G liquidated GL-1 <u>after</u> G was acquired by L, the existing SRLY rules would not prevent GL-1's losses from being offset by G's built-in gains, but old section 384 apparently would.

4. <u>Example Four</u>

a. Same facts as example 3, except that G liquidates GL-1 <u>prior</u> to the acquisition by L.

b. Under old section 384, the $50 of recognized built-in gain from the 1/1/93 asset sale apparently could be offset by G's losses (those inherited from GL-1 under section 381) but not L's preacquisition losses.

c. Under revised section 384, the liquidation is not necessary due to section 384(c)(6).

5. Example Five

   a. Assume that loss corporation (L) acquires all of the stock of gain corporation (G) in a B reorganization. Three years later, L sells all of its G stock for cash and recognizes a significant gain.

   b. The gain on the stock sale technically is not subject to section 384, since the stock of G was not held by G itself on the acquisition date (or any other date). See section 384(c)(1).

      (1) Thus, gain with respect to the stock is not recognized built-in gain.

      (2) As a policy matter, the stock sale gain should be subject to section 384 -- but only to the extent of G's net unrealized built-in gain that has not been previously recognized in the recognition period.

   c. Similar concerns arise where L acquires G's assets in a triangular merger under section 368(a)(2)(D) and L's stock in its subsidiary reflects the bases of G's assets.

   d. A related problem is faced under section 382 where built-in gain with respect to a subsidiary member of a consolidated group is determined with reference to the subsidiary's assets (rather than its stock), and the parent subsequently sells the subsidiary's stock.

B. Asset Acquisitions

1. Example One

   Loss corporation (L) is entirely owned by individual A. Gain corporation (G) is owned entirely by individual B.

   a. If G merges into L, section 384 (both old and new versions) would apply. G's recognized built-in gains may only offset

G's losses and L's post-acquisition losses. Section 382 may apply to L, depending on the percentage of L stock received by B.

b. If L merges into G, old section 384 apparently would not apply, but revised section 384 would. Section 382 may apply to L's losses, depending on the percentage of G stock received by A.

c. Assume that L merges into G, and A receives 51 percent of the G stock (i.e., a reverse acquisition). Section 382 does not apply.

(1) Old section 384 would not apply, unless rules similar to the reverse acquisition rules were to apply to treat the transaction as if G merged into L.

(2) However, revised section 384 would apply where either corporation is a gain corporation. Thus, in the instant case, revised section 384 would apply to G regardless of the percentage of stock received by A.

2. Example Two

a. Loss corporation (L) acquires all of the stock of gain corporation (G) as of the close of business on 6/30/88 in exchange solely for cash. G has a net unrealized built-in gain of $200, and no loss carryovers. Both L and G are calendar-year taxpayers. On 12/31/88, L liquidates G. On 1/1/93, L sells assets formerly owned by G, and recognizes a gain of $200 -- $50 of which had accrued as of 7/1/88; $100 of which accrued as of 12/31/88.

b. Until G was liquidated, old section 384(a)(1) applied. The acquisition date for old section 384(a)(1) purposes is assumed to be 7/1/88.

c. Once G was liquidated, old section 384(a)(2) applied. The acquisition date for section

384(a)(2) purposes is 12/31/88. Apparently, this later acquisition date began a new recognition period.

d. Old section 384(c)(2) did not specify which acquisition date controlled for purposes of determining the recognition period where both section 384(a)(1) and (a)(2) apply.

   (1) The determination of which acquisition date controlled determined how much gain on the 1/1/93 asset sale was subject to section 384 -- the gain accrued as of the first acquisition date (7/1/88) or the second acquisition date (12/31/88).

   (2) Similarly, this same determination fixed the date to determine L's preacquisition losses. If the earlier date controlled, only $50 would be subject to section 384.

e. Assuming the first acquisition date controlled, under old section 384(a)(2), L could not offset the $50 recognized built-in gain with any preacquisition losses of L. The remaining gain of $150 would not be subject to section 384, and could be offset by L's preacquisition losses. Thus, in this context, old section 384 was stricter than the existing SRLY rules.

f. This immediate problem disappears under revised section 384 since section 332 liquidations no longer trigger section 384. In any event, according to the TCA 88 General Explanation, this problem would be corrected as a result of the successor rule contained in section 384(c)(7). <u>See</u> Gen. Expl. at 421.

   (1) In the instant case, the examples in the General Explanation indicate that section 384 will apply to the same extent after the liquidation of G as before.

(2) Thus, although not stated, G's net unrealized built-in gain and L's preacquisition losses would not be recomputed as of the liquidation.

(3) Also, the examples indicate that a new recognition period will not begin as of the liquidation.

g. Although these are the correct results, it is difficult to see how they are achieved under the statutory language alone.

(1) The language of section 384(c)(7) appears to add nothing of content. That is, it does not eliminate the overlap of section 384(a)(1)(A) and (B).

(2) For example, assume that loss corporation (L) buys the stock of gain corporation (G) and subsequently <u>merges</u> G into another subsidiary of L (L-1).

i. The merger of G into L-1 may be viewed as an acquisition of assets under revised section 384(a)(1)(B).

ii. Section 384(c)(7) does not appear to alter this result, nor does it provide that section 384(a)(1)(A) is to remain controlling.

(3) Section 384(c)(7) should be revised to provide that section 384(a)(1)(A) will take precedence over section 384(a)(1)(B) or more simply, that an earlier acquisition date with respect to the same entity or its assets will control.

h. Apparently, the only way to reach the intended results under the revised statute is to ignore the merger and treat L-1 and G as the same entity under revised section 384(c)(6). However, it is unclear whether section 384(c)(6) is rendered inapplicable

if section 384(b) is not satisfied. _See_ section 384(c)(6).

3. _Example Three_

   a. Loss corporation (L) acquires all of the stock of corporation (G) on 1/1/89. At the time of the acquisition, G's built-in gain was _de minimis_, so that G technically was not a gain corporation. Three years later, on 1/1/92, L merges into G in a tax-free merger. At the time of the merger, G's assets have appreciated to the point that G is a gain corporation. On 1/1/93, G sells its historic assets and recognizes gain.

   b. Although L acquired control of G on 1/1/89, section 384 did not apply because G was not a gain corporation. However, the subsequent merger is described in section 384(a)(1)(B) and section 384 now applies because G is a gain corporation. The common control exception cannot be used since G and L have not been members of the group for five years. _See_ section 384(b).

   c. Since neither L nor G were subject to section 384 before the merger, section 384(c)(7) should protect G after the merger, assuming the statutory language hurdles can be overcome (_see_ example 2, above).

      (1) In addition, the legislative history indicates that post-affiliation gain is not subject to section 384. _See_ Gen. Expl. at 412.

      (2) Thus, if G had zero built-in gain at the time of affiliation (a result that follows from the _de minimis_ test), then all of G's built-in gain must be treated as post-affiliation gain which is not subject to section 384.

   d. Also, one can argue that since section 384 did not apply to the initial stock acquisition, L and G should be treated as one corporation under section 384(c)(6).

However, the cross reference in section 384(c)(6) to section 384(b) may mean that section 384(c)(6) is unavailable where section 384(b) has not been satisfied (although this is far from clear).

e. If neither section 384(b) or (c)(7) protects G from section 384 (an unlikely result), a related issue arises: whether G's built-in gain includes only the incremental increase that arose after L and G became affiliated, the gain built-in as of the stock acquisition, or all of the built-in gain as of the merger.

4. Example Four

a. Assume the same facts as in Example 2, except that L owns all of the stock of LG-1, a gain corporation, and G owns all of the stock of GL-1, a loss corporation.

b. Under the old statute, the $50 recognized built-in gain realized by L on 1/1/93, attributable to assets formerly held by G could not be offset by L or LG-1's preacquisition losses. In addition, under the old statute, the 1/1/93 gain also could not be offset by GL-1's preacquisition losses.

(1) However, under the old statute such gain apparently could be offset by post-acquisition losses of any of such corporations.

(2) Under old section 384, if G liquidated GL-1 before 7/1/88 and L thereafter liquidated G on 12/31/88, the $50 of recognized built-in gain apparently could be offset by the preacquisition losses of GL-1 which G inherited.

i. Under section 381, such losses are losses of G. Under section 384, such losses are also preacquisition losses of the gain corporation.

ii. Under the old statute, if G liquidated GL-1 on or after 7/1/88, GL-1's losses apparently would not be treated as GL's preacquisition losses.

(3) Under revised section 384(c)(6), the liquidation of GL-1 is unnecessary.

c. Assume that LG-1 sells an asset and recognizes a gain of $100. Such gain would not be limited by old section 384 (since LG-1 did not become a member of a group). Such gain could be offset by L's losses, but the existing SRLY limitations would prevent such gain from being offset by GL-1's preacquisition SRLY losses.

(1) Under revised section 384(c)(6), G and GL-1 would be tested for gain corporation status in the aggregate, as would L and LG-1. Assuming that G and GL-1 in the aggregate are a gain corporation and L and LG-1 are not, the gain recognized by LG-1 would not be subject to revised section 384.

(2) This is because LG-1's gain is not recognized built-in gain. See section 384(c)(1)(C) (net unrealized built-in gain limitation).

(3) Although not entirely clear from the language in section 384(a), if L and LG-1 were treated as a gain corporation in the aggregate, LG-1's gain could not be offset by G or GL-1's preacquisition losses (only L or LG-1's preacquisition losses).

5. Example Five

a. Loss corporation (L) is entirely owned by individual A. Gain corporation (G) is entirely owned by individual B. On 6/30/88, G is merged into L, and B receives 60% of the L stock. L has a net unrealized built-in gain of $0.

b. Section 382 applies to L's losses accrued as of 6/30/88. Section 384 applies to G's gains accrued as of 6/30/88.

c. The section 382 change date and the section 384 acquisition date are the same date -- 6/30/88.

d. On 1/1/93, L disposes of an asset formerly held by G. The recognized built-in gain derived therefrom can be offset by G's preacquisition losses (if any) -- without section 382 limitation. Such gain cannot be offset by L's preacquisition losses (which are also pre-change losses) not even to the extent of L's section 382 limitation. Such gain can be offset by L's <u>post</u>-acquisition losses without limitation under section 384 or section 382.

e. On 1/1/93, L disposes of one of its historic assets and recognizes a gain.

   (1) Such gain can be offset by L's <u>post</u>-change losses and G's losses (if any) without limitation under section 382. Such gain may be offset by L's <u>pre</u>-change losses to the extent of L's section 382 limitation.

   (2) If L's net unrealized built-in gain exceeded the *de minimis* threshold, L would be a gain corporation under section 384. In such a case, recognized built-in gains of L apparently could not be offset by G's preacquisition losses, but they would increase L's section 382 limitation.

C. <u>Common Control</u>

1. <u>Example One</u>

Individual A owns all of the stock of L corporation and G corporation. A has held such stock since both corporations were formed 20 years ago.

a. If G is merged into L on 12/31/88, the common control exception as originally drafted, would not apply.

(1) L would be subject to old section 384, since the stock of G was not held by the acquiring corporation (L) or members of such corporation's affiliated group.

(2) The same result apparently would obtain if A sold all of the G stock to L.

b. Under revised section 384(b), the common control exception applies to corporations that were members of the same controlled group for the 5 year period ending on the acquisition date. Thus, the transaction would not be subject to revised section 384.

2. Example Two

Individual A owns all of the L corporation stock. On 12/31/88, L forms LG-1 and contributes gain assets to LG-1. Three years later, on 12/31/91, L liquidates LG-1.

a. Under the old statute, the recognized built-in gains of LG-1 were subject to section 384. The old section 384 common control exception apparently did not apply.

b. Under the revised statute, section 384 would not apply because the 5 year period would be shortened to encompass only the period in which LG-1 was in existence. *See* section 384(b)(3).

3. Example Three

Individual A formed three corporations -- L, L-1 and G -- several years ago. G formed G-1, and G-1 formed G-2. L and L-1 are loss corporations. G, G-1 and G-2 currently are gain corporations.

a. Suppose A sells the stock of L, L-1 and G to individual B. B causes L and L-1 to merge

into G-1. Does section 384 apply, and if so to what extent?

b. Suppose the merger of L and L-1 takes place prior to the sale of G stock to B. Does section 384 apply, and if so to what extent?

D. Ceiling Rule Illustration

1. Fact Pattern

a. Assume that a loss corporation (L) has substantial loss carryovers that are about to expire. L forms a partnership with P. L contributes $200 in cash and P contributes $200 worth of depreciable property (with a basis of zero). The property has a remaining life of five years (with no salvage value) and will earn $40 per year. The partnership plans to invest the $200 received from L in portfolio securities which will earn a 10 percent return over the subsequent five-year period. The partnership adopts the traditional method of making section 704(c) allocations.

2. Capital Account Analysis

a. P's "book" capital account reflects the fair market value of the contributed property. For purposes of computing depreciation for "book" (or economic) purposes, and thus changes in "book" capital accounts, the property will be depreciated using its fair market value. For book purposes, income and depreciation will be shared equally.

b. For tax purposes, depreciation can be claimed only with respect to the partnership's tax basis. See Treas. Reg. § 1.704-3(b)(1). Since, on these facts, the basis is zero, no depreciation will be allowed for tax purposes.

c. As of the close of the five-year period, the events described above would be reflected in the partners' capital accounts as follows:

	P		L	
	Book	Tax	Book	Tax
Beginning Capital Account	$200	-0-	$200	$200
Gross Income:				
Investments ($20 x 5 = $100)	50	50	50	50
Operating ($40 x 5 = $200)	100	100	100	100
Depreciation	(100)	-0-	(100)	-0-
Ending Capital Account	$250	$150	$250	$350

d. The book capital accounts reflect the fact that, economically, the partnership earned only $100 during the five-year period (i.e., the return on its portfolio securities), which was shared equally by P and L.

(1) The depreciable property did not generate any income from an economic standpoint (since the $200 generated was offset by the $200 of economic or book depreciation).

(2) However, for tax purposes, the partnership earned $300 ($200 from the depreciable property and $100 from the securities), which was shared equally by P and C.

(3) The difference between the partners' book and tax capital accounts reflects the fact that taxable income was higher than book since the property could not be depreciated for tax purposes, although it was for book purposes.

3. Partnership Liquidation

At the end of this five-year period, the partnership would hold $300 in cash and $200 worth of securities (assuming no change in value). If the partnership were to liquidate,

the cash and property would be distributed in accordance with book capital accounts.

a. Assuming the partners decide that P will receive the securities, P would receive $50 in cash and $200 in securities. L would receive $250 in cash.

b. Under section 731, P would recognize no gain and would take a basis under section 732 in the securities of $100 ($150 tax basis - $50 cash received = $100 basis assigned to the securities). Under section 731, L would recognize a loss of $100 ($350 tax basis - $250 cash received).

4. Comparison

a. If P had simply retained the depreciable property, he would have reported $200 of income during the period. By using the partnership, P shifted $100 of taxable income to L as a result of the ceiling rule. Moreover, P will not pick up this income until the securities are sold, in which case the $100 of ordinary income will be converted into long-term capital gain (assuming the securities are capital assets and that they are sold for at least $200).

b. If L had invested its $200 directly, it would have had only $100 in income. However, L sheltered its increased income with its loss carryovers. L, in effect, converted its loss carryovers into a fresh capital loss (via the partnership liquidation) which could be used to offset any capital gains.

(1) If L has no capital gains, the partnership could have purchased section 1231 property with the $250 and distributed that property to L.

(2) If this latter technique overcomes the step transaction hurdle, L would not recognize a loss until the property was sold ($250 assumed sales price - $350

basis under section 732). The loss likely would be an ordinary loss under section 1231.

(3) In addition, in exchange for the "rental" of their losses, L can demand an increased return on its partnership investment.

c. Similar benefits can be obtained if income is shifted to other low-bracket type taxpayers, such as those in an AMT position. Also, the ceiling rule may shift additional passive income to limited partners with excess passive losses.

5. Modes of Attack

It remains to be seen how the section 704(c) regulations will deal with this problem. In the meantime, this planning device should not be subject to attack under the substantiality regulations since those regulations defer to the section 704(c) rules. See Treas. Reg. § 1.704-1(b)(1)(vi).

a. Where a loss corporation is the cash contributing partner, section 382 should not apply either, since no ownership change occurs in the formation of a partnership. In addition, regulatory authority under section 382(m)(3) should not apply if the allocations of all partnership items are consistent with the partners' interest in the partnership (with the specific exclusion for section 704(c) allocations). See Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 327 (1987) (excepting qualified partnership allocations under section 168(j)(9)(B), now section 168(h)(6)(B)).

b. However, Treasury has authority to attack these cases under section 384(f)(1) (although it is difficult to see: (1) how section 384(a) is triggered by the formation of a partnership, and (2) how the ceiling rule causes built-in gain to be recognized).

In any event, regulations under section 384(f)(1) will be prospective only. H.R. Rep. No. 495, 100th Cong., 1st Sess. 974 (1987).

c. In addition, the potential to use partnerships to avoid the corporate level tax on future income derived from property contributed by a corporation to a partnership may be restricted by regulations promulgated under section 337(d). The legislative history indicates that section 337(d) will be used to prevent partners from using the ceiling rule to defer the recognition of built-in gain to a corporate partner. H.R. Rep. No. 795, 100th Cong., 2d Sess. 65 (1988).