

### **DEPARTMENT OF THE TREASURY**

# INTERNAL REVENUE SERVICE WASHINGTON, D.C. 20224 July 6, 2001

Number: **200140049** Release Date: 10/5/2001

TL-N-6209-00 UILC: 382.00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR: CC:LM:MCT:PHI

FROM: CC:CORP:2

SUBJECT:

TL-N-6209-00

This Chief Counsel Advice responds to your memorandum dated April 6, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND	Taxpayer	=
	Bank	=
	Р	=
	S	=
	City A	=
	Month A	=
	Month B	=
	Month C	=
	Date B	=
	Year 1	=
	Year 2	=
	Year 3	=
	Year 5	=

Year 6	=
Year 7	=
Year 8	=
Year 9	=
Year 10	=
Year 11	=
Year 12	=
\$100X	=
\$70X	=
\$35X	=
\$30X	=
\$25X	=
\$10X	=
\$5X	=
\$1X	=
<u>a</u>	=

ISSUES

Whether §§ 382(e)(2) or (I)(4) of the Internal Revenue Code of 1986 ("Code") require the value of the P loss group to be reduced for the purpose of the limitations on net operating loss carryovers, and if so, by how much?

CONCLUSION The value of the P loss group should be reduced by \$30X.

Thus, the value of the P loss group for the purposes of § 382 is \$5X.

FACTS Taxpayer is a thrift holding company whose principal subsidiary is Bank. Taxpayer is registered as a savings and loan holding company and is subject to Office of Thrift Supervision ("OTS") regulation, examination, supervision and reporting requirements. Taxpayer is required to maintain certain capital

reserves. Taxpayer itself only engages in limited business operations independent of its subsidiaries. Taxpayer's principal asset is its investment in the capital stock of Bank, and Taxpayer's ability to comply with its reserve requirement is dependent upon its ability to obtain dividends from Bank. Under applicable federal regulations, Bank may pay dividends within certain limits and only after notice to the OTS.

S, a reverse mortgage lender based in City A, was incorporated in Year 1. Reverse mortgage loans are contracts that require the lender to make monthly advances throughout the borrower's life or until the borrower relocates, prepays or the home is sold, at which time the loan becomes due and payable. Since reverse mortgages are nonrecourse obligations, the loan repayments are generally limited to the sale proceeds of the borrower's residence, and the mortgage balance consists of cash advanced, interest compounded over the life of the loan and a premium which represents a portion of the shared appreciation in the home's value, if any, or a percentage of the value of the residence.

P, a holding company, acquired all of the stock of S in Month C, Year 3. Thereafter, P and S filed consolidated federal income tax returns. Early in Year 6, P raised \$100X in an initial public offering ("IPO") of its stock.

S made loans when real estate prices were high in City A, with the expectation that real estate values would continue to rise. However, home prices in City A dropped between Years 1 and 8. In Year 8, S's reverse mortgage portfolio, which had a carrying value of approximately \$70X had to be written down to approximately \$25X. Due to operating difficulties and other factors, S ceased originating reverse mortgages in the first quarter of Year 8. However, S continued to service its outstanding mortgages. In Month A of Year 8, P announced that it planned to sell off all of its loans and liquidate itself.

In Month B of Year 8, Bank acquired over <u>a</u> percent of P's stock at a price of \$1X per share (for an aggregate purchase price of \$35X). At such time, P still retained over \$30X of the IPO proceeds in cash or cash equivalents, and S had net operating losses ("NOLs") of approximately \$25X. Shortly after the acquisition, Bank caused P to distribute its remaining \$30X of IPO proceeds to Bank. Thus, Bank's out-of-pocket cost for its P stock was \$5X. In its Year 9 and Year 10 Annual Reports, Taxpayer states that Bank utilized S's available liquidity to fund the purchase price of S's stock.<sup>1</sup> We understand that representatives for Taxpayer have said that P transferred the \$30X to Bank because Bank was in a better position to oversee the investment of the funds than P and that the funds would

<sup>&</sup>lt;sup>1</sup> The annual report refers specifically to S, but Bank actually acquired the stock of P, and the \$30X received by Bank came from P.

### TL-N-6209-00

have been made available to S had its business operations required additional capital.

On Date B, Year 9, P merged into S. S was included as a subsidiary on Taxpayer's Year 9 consolidated return. On Date B, Year 10, S was merged into Bank in a complete liquidation. S continued to service its mortgages until it merged into Bank, at which time Bank took over servicing the mortgages.

In its Year 9 Annual Report, Taxpayer predicted that by Year 11, S's pool of reverse mortgages would begin to generate a positive cash flow. In fact, S had sufficient assets to service its reverse mortgages and pay its business expenses; neither Taxpayer nor Bank contributed capital to P or S to replace any of the funds that P distributed to Bank. Taxpayer (or Bank) opened a \$10X credit facility in favor of P or S at the time of the distribution. It does not appear that P or S borrowed against this facility.

### LAW AND ANALYSIS

## Background

Section 382 of the Code limits the use of a loss corporation's net operating loss ("NOL") carryforwards if there is a substantial change in ownership of the loss corporation. This so-called "§ 382 limitation" is triggered only after an "ownership change" of the loss corporation occurs, as described in § 382(g).

If an ownership change takes place, § 382(c) provides that all NOLs are disallowed if the "new loss corporation" (i.e., the loss corporation following the ownership change) does not continue the business enterprise of the "old loss corporation" (the loss corporation prior to the ownership change) at all times during the two-year period following the date of the ownership change. Section 382(c)(1). This test is generally the same as the continuity of business enterprise rule that is generally applicable to tax-free reorganizations. See S. Rep. No. 99-313, at 234 (1986).

If there is an ownership change and the continuity of business enterprise requirement is satisfied, the taxable income of a loss corporation available for offset by pre-acquisition NOL carryforwards is limited to an annual amount equal to a prescribed rate times the fair market value of the loss corporation's stock (including any stock described in § 1504(a)(4)) immediately before the ownership change. Sections 382(a), 382(b)(1) and 382(e)(1). This limitation is increased to include the unused portion of prior years' § 382 limitations and certain built-in gains recognized by the loss corporation during the five years following the ownership change. Sections 382(b)(2) and 382(h)(1)(A)(i). Certain built-in losses recognized by the

loss corporation during that five-year period are subject to limitation in the same manner as NOLs.<sup>2</sup> Section 382(h)(1)(B) (i).

Section 382 provides rules to prevent taxpayers from circumventing the § 382 limitation. S. Rep. No. 99-313, at 233-235 (1986). Under a special rule, if a redemption *or other corporate contraction* occurs in connection with an ownership change, the value of the loss corporation's stock is determined after taking the redemption into account. (Emphasis added.) Section 382(e)(2). This rule applies whether the redemption or contraction occurs before or after the ownership change. S. Rep. No. 100-445, at 45 (1988). The rule is effective for ownership changes occurring after June 10, 1987.

Prior to the enactment of the Technical Corrections Act of 1988, § 382(e)(2) referred to "redemption" and did not include the language referring to any "other corporate contraction." In broadening the rule, Congress stated that the rule was always intended to apply to transactions that "effect similar economic results, without regard to formal differences in the structure used or the order of events." <a href="Id">Id</a>. For instance, the provision could apply to "a 'bootstrap' acquisition, in which aggregate corporate value is directly or indirectly reduced or burdened by debt to provide funds [to] the old shareholders." <a href="Id">Id</a>. Congress intended the rule to apply to cases in which "debt used to pay the [loss corporation's] shareholders remains an obligation of an acquisition corporation or an affiliate, where the acquired loss corporation is directly or indirectly the source of the funds for repayment of the obligation." (Emphasis added). <a href="Id">Id</a>.

Furthermore, § 382(I)(4) provides that if immediately after an ownership change, the new loss corporation has substantial non-business assets, the value of the old loss corporation shall be reduced. The old loss corporation is treated as having substantial nonbusiness assets if at least 1/3 of the value of the total assets of such corporation consists of nonbusiness assets. The term "nonbusiness assets" generally includes any asset held for investment, including cash and marketable stock or securities. Cash and marketable stock or securities are non-business assets, even if they are not strictly held for investment. Certain investment entities (e.g., regulated investment companies, REITs and real estate mortgage investment conduits) are exempt from this rule. Moreover, assets held as an integral part of the conduct of a trade or business (e.g., assets funding reserves of an insurance company or similar assets of a bank) would not be considered nonbusiness assets. General Explanation of the Tax Reform Act of 1986, H.R. No. 3838, 99th Cong. (1987) [hereinafter Explanation].

<sup>&</sup>lt;sup>2</sup> This memorandum does not address limitations on built-in losses.

Section 1.1502-99A(c) states that for a period ending before January 1, 1997, a consolidated group is permitted to use one of several specified methods to determine the amount of the § 382 limitation that applies to limit the use of taxable income in any post-change year ending before, on, or after January 1, 1997. The taxpayer must consistently apply the selected method. The group may use a group (or subgroup) methodology, may reasonably apply the § 382 rules on a separate entity basis, or may use a method approved by the Commissioner upon the application by the common parent.<sup>3</sup>

Section 1.1502-91A through 93A set forth the rules for determining an ownership change under § 382 for members of consolidated groups and the § 382 limitations with respect to pre-change consolidated NOLs of a loss group. These rules generally provide that an ownership change and the § 382 limitation are determined with respect to the group (or loss subgroup). Following an ownership change of a loss group (or subgroup), the amount of consolidated taxable income for any post-change year which may be offset by pre-change consolidated attributes shall not exceed the consolidated § 382 limitation (or subgroup limitation) for such year.

In the instant case, S filed a separate return until it began filing a consolidated return with P in Year 3. All of the losses S incurred prior to joining the P consolidated group are SRLYs with respect to the P consolidated group. § 1.1502-21T(c). The facts do not indicate whether or not S underwent a § 382 change of ownership at the time it was acquired by P. You have not asked us to address whether there are any limitations on S's NOLs as a result of P's acquisition of S, and that matter is not developed in this memorandum.

When S joined the P consolidated group, S and P became a loss group (the "P Group") for the purposes of § 382 with respect to losses that did not arise (and are not treated under § 1.1502-21T(c) as arising) in a SRLY. § 1.1502-91A(c). The P Group apparently underwent a § 382 ownership change in Year 6 as a result of P selling its stock in an IPO. You have not asked us to address the Year 6 § 382 ownership change, and that matter is not developed in this memorandum.

### Corporate Contraction Under § 382(e)

We agree with your determination that § 382(e) should apply to the Year 8 § 382 ownership change, in which Bank acquired over <u>a</u> percent of P's stock. Just prior to P's acquisition in Month B of Year 8, P held \$30X which had been raised in the IPO. Bank paid the P shareholders an aggregate price of \$35X for their stock

<sup>&</sup>lt;sup>3</sup> We understand that the Taxpayer used the group methodology to calculated its loss limitation.

and received a distribution of \$30X from P shortly thereafter. Taxpayer, in its Year 9 Annual Report, states that S's available liquidity was utilized to fund the purchase price of S.<sup>4</sup>

The transaction had the same economic result as if P used the \$30X to redeem an aggregate of \$30X shares of its stock from the P shareholders, and immediately thereafter, P shareholders sold over <u>a</u> percent of their remaining (aggregate) stock for \$5X to Bank. Under both scenarios: (1) the selling P shareholders would receive a total aggregate price of \$35X for their shares; (2) Bank would acquire over <u>a</u> percent of the shares of P; (3) P would distribute \$30X; and (4) Bank's out-of-pocket cost for its P shares would be \$5X. Congress intended that the redemption provisions of § 382(e) apply to transactions that "effectively accomplish similar economic results, without regard to formal differences in the structure used, or the order of events by which similar consequences are achieved." Explanation at 316.

Moreover, Congress specifically noted that a "bootstrap" acquisition, in which the aggregate value of the loss corporation is directly or indirectly reduced to provide funds to the old shareholders, is generally subject to § 382(e). Congress intended to include cases in which the "source of funds for ... the obligation [to acquire the stock of the acquired corporation] is the acquired corporation." The Taxpayer's Year 9 Annual Report states that the source of funds for the acquisition of the [P Group] came from the [P Group]. Thus, § 368(e)(2) applies to the facts of the instant case.

Berry Petroleum Co. v. Commissioner, 104 T.C. 584, 642 (1995), aff'd, 142 F.3d 442 (9<sup>th</sup> Cir. 1998) (unpublished table decision), makes it clear that a "corporate contraction" includes loans or distributions between members of an affiliated group. A transaction in which an acquiring corporation acquires a loss corporation, causes the loss corporation to pay a substantial dividend immediately after the ownership change and uses the proceeds of the distribution to pay the old shareholders of the loss corporation constitutes a corporate contraction. Id. at 642. The Berry Petroleum court concludes the transaction constitutes a corporate contraction even if the distribution is structured as a loan (that is intended to be forgiven) instead of as a formal dividend. Id. In the instant case, the Taxpayer's assertion that Taxpayer (or Bank) would have contributed part or all of the \$30X to the P Group if the P Group required such funding does not mitigate the fact that P's distribution of the \$30X to Bank caused a "corporate contraction" of the P Group. Although we benefit from hindsight, there does not appear to be any evidence that Bank intended to return the \$30X to the P Group. In any event, the distribution had

<sup>&</sup>lt;sup>4</sup> See n. 1 supra.

the effect of removing \$30X in assets from the P Group's balance sheet.<sup>5</sup> Thus, we conclude that there was a corporate contraction.

Furthermore, because the Year 9 Annual Report states that the liquidity of the P Group was used to fund the acquisition of the P Group, we conclude that the corporate contraction occurred in connection with the § 382 ownership change. Accordingly, the value of P is to be determined immediately after its contraction. The value of P for the purposes of § 382(e) is \$5X.

# Substantial Nonbusiness Assets Under § 382(I)(4)

Section 382(I)(4) reduces the § 382 limitation of a loss corporation with substantial nonbusiness assets. In order to determine whether the P Group had substantial nonbusiness assets, it must be determined whether at least one-third of the fair market value of the new P Group's assets consisted of nonbusiness assets. The carrying value of S's mortgages was reduced to approximately \$25X at some time in Year 8, but we do not know if \$25X was the value of the mortgages at the time of the § 382 ownership change. The facts do not provide a determination of the value of all of the new P Group's assets immediately following the ownership change.

The term "nonbusiness assets" includes any asset held for investment, including cash. § 382(I)(4)(c); Explanation at 319. In limited cases, cash may be held as an integral part of the conduct of a trade or business. For example, an insurance company or a bank may be required by law to hold certain cash reserves. Id. Insurance company and bank reserves are required by law. In Berry Petroleum Co. v. Commissioner, supra, the court determined that legally required cash reserves are an integral part of the banking or insurance business. Such assets are to be differentiated from assets held for future acquisitions and other business needs. The test used for § 382 is more stringent than the "reasonable needs of business" test of § 537. Id at 649-650. Section 382 allows a corporation to hold up

<sup>&</sup>lt;sup>5</sup> If P's purpose was merely to allow Bank to manage the funds, P could have put the \$30X into a bank account, retaining the \$30X on its balance sheet, and given Bank authority to manage and invest the assets in the account. Instead, the \$30X was removed from P's balance sheet and became an asset on Bank's balance sheet.

<sup>&</sup>lt;sup>6</sup> Section 382(I)(4)(B)(ii) provides an exception to the application of § 382(I)(4) for a regulated investment company to which part I of subchapter M applies, a real estate investment trust to which part II of subchapter M applies, a REMIC to which part IV of subchapter M applies or a FASIT to which part V of subchapter M applies. At the time of Bank's acquisition of the P Group, the P Group did not qualify under this exception.

to one-third of its assets as working capital before § 382(I)(4) applies. It appears that § 382(I)(4) would apply where a new loss corporation holds working capital in excess of one-third of the value of its total assets unless the cash is an "integral" part of the business or meets the "stringent" test suggested in <u>Berry Petroleum</u>. The facts do not indicate whether S was legally required to maintain cash reserves in order to engage in its reverse-mortgage business.

P raised substantial capital in the IPO in anticipation of S needing cash to make new reverse-mortgage loans. At the time of the Year 8 acquisition, P still held \$30X of the IPO funds, but S was not making new loans. S was merely servicing the loans it had made in the past. It appears that the P Group had raised more capital in the IPO than it ultimately needed to conduct its business. It is reasonable to conclude that the \$30X was a nonbusiness asset.

Taxpayer states that the P Group distributed the \$30X to Bank because Bank was in a better position to "invest" the funds than P or S. This statement lends support to treating the \$30X as an investment asset rather than as a business asset.

### CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

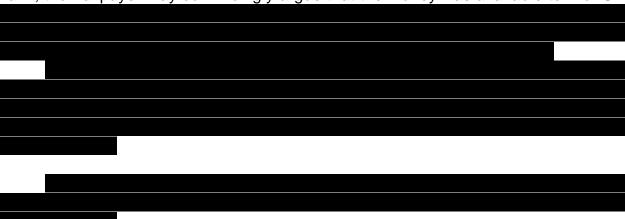
Although an argument may be advanced under § 382(I)(4) that the \$30X distributed by P to Bank is a nonbusiness asset, we presume Taxpayer will assert that the cash was an "integral" part of S's reverse mortgage business and that S would have resumed making new reverse mortgage loans had the real estate market in City A turned around. Arguably, if S resumed making loans, S would have needed the \$30X held by P. The definition of a "nonbusiness asset" is not clear. Congress provides, in the way of example, that cash is an integral part of a banking or insurance business. However, the list is not exclusive. Neither Congress nor Berry Petroleum specifically state that in order for cash to be an "integral" part of the business, the cash must be a legally mandated reserve. Rather, the Berry Petroleum court interprets the bank and the insurance company cash reserves to stand for the proposition that Congress intended a "test of need" which is more "stringent" than the "reasonable business needs" test of § 537. However, the court does not expound on the "need test," and we have no regulations that specify a standard for measuring whether the P Group's cash would satisfy this test.

The court found the facts in <u>Berry Petroleum</u> especially troubling because the new loss corporation sold business assets and received "passive assets" in their place. In the instant case, none of the P Group's business assets are sold. Rather, the old P Group and the new P Group held large amounts of cash. P raised the cash in the IPO to raise working capital because such capital was an essential element of making reverse mortgages. It is not clear that in the instant case a court

### TL-N-6209-00

would determine the \$30X was a "nonbusiness asset." It is unclear whether funds held while awaiting business conditions to improve are business assets or investment assets. If we make an argument under § 382(I)(4), we face the risk that a court will find that the \$30X held by the new P Group satisfies the "need" test.

We expect the Taxpayer to argue that at least part, if not all, of the \$30X was an "integral" part of the new P Group's business because S was required to pay out cash to the mortgagees every month. They might argue that S had to maintain a large reserve of cash to meet these obligations. Apart from the \$30X, S would be dependent on capital from the sale of properties subject to the reverse-mortgage loans. S does not generally have control over the timing of such sales. In certain circumstances the property is sold upon the death of the borrower; in other circumstances the property is volitionally sold by the borrower. Additionally, S could not be expected to accurately predict the sales price of the properties. Thus, Taxpayer may reasonably argue that although a cash reserve was not statutorily mandated, it was not only a necessary and reasonable business practice for the P Group to maintain a large cash reserve, but an integral part of the reversemortgage business. Even though the cash reserve was held and managed by Bank, the Taxpayer may convincingly argue that the money was available to P or S.



This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call (202) 622-7770 if you have any further questions.

Jasper L. Cummings, Jr.
Associate Chief Counsel (CORP)
By: Gerald B. Fleming
Senior Technician Reviewer, CC:CORP:2