INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Years Involved:
Dates of Conferences:

LEGEND:

Acquiror =
Target =
Date 1 =
Date 2
Year 1 =
Year 2 =
a =
b =
c =
d =
e =
f =
g =
h =
i =
j =
k =

ISSUES:

Issue 1

When one consolidated group (the "historic Acquiror group") acquires a second consolidated group (the "historic Target group") that qualifies as a "gain corporation" for purposes of § 384 of the Internal Revenue Code of 1986, as amended (the "Code"), [1] whether one determines that there is a loss that must be allocated between the preacquisition and post-acquisition periods of the acquisition year for purposes of § 384 by calculating separately the items of income, gain, loss and deduction for each of the historic Acquiror group and the historic Target group (the "separate group approach") or by calculating such items on a combined group basis (the "combined group approach").

Issue 2

Regardless of whether the separate group approach or the combined group approach is used to determine that there is a loss that must be allocated between the preacquisition and post-acquisition periods of the year of acquisition for purposes of § 384, whether such loss may be allocated between such periods using the "closing-of-the-books" method.

Issue 3

If a loss must be allocated between the preacquisition and post-acquisition periods of the year of acquisition for purposes of § 384, whether it is necessary to determine the order of absorption of preacquisition and post-acquisition losses within the year of acquisition.

Issue 4

Whether the amount of the historic Target group's recognized built-in gain (within the meaning of § 384) ("RBIG") may be offset by some portion of the historic Target group's operating expenses for the year in which the RBIG was recognized.

CONCLUSIONS:

Issue 1

[1] All section references herein are to the Code or to the Income Tax Regulations issued thereunder, except that all references to § 301.9100 are to the Procedure and Administration Regulations.

When one consolidated group (the historic Acquiror group) acquires a second consolidated group (the historic Target group) that qualifies as a “gain corporation” for purposes of § 384, one determines that there is a loss that must be allocated between the preacquisition and post-acquisition periods of the acquisition year for purposes of § 384 by calculating items of income, gain, loss and deduction on a combined group basis, using the general rules for computing consolidated taxable income (“CTI”) except that RBIG is excluded from such computation. In Situation 1, the combined group does not have a CNOL for the year of acquisition and thus there is no loss to allocate between the preacquisition and post-acquisition periods of such year. In Situation 2, the combined group has a CNOL for the year of the acquisition that must be allocated between the preacquisition and post-acquisition periods.

Issue 2

Regardless of whether the separate group approach or the combined group approach is used to determine that there is a loss that must be allocated between the preacquisition and post-acquisition periods of the year of acquisition for purposes of § 384, such loss may not be allocated between the preacquisition and post-acquisition periods using the “closing-of-the-books” method.

Issue 3

Because whether there is a loss that must be allocated between the preacquisition and post-acquisition periods of the year of acquisition for purposes of § 384 is determined on a combined group basis, using the general rules for computing CTI, except that RBIG is excluded from such computation, it is unnecessary to determine the order in which preacquisition and post-acquisition losses are absorbed in the year of acquisition.

Issue 4

The historic Target group’s RBIG may not be offset by some amount of the historic Target group’s operating expenses for the year in which the RBIG was recognized.

FACTS:

The taxpayer (“Acquiror”) and the members of the affiliated group of which it is the common parent (the historic Acquiror group) join in the filing of a consolidated income tax return on a calendar year-end basis. On Date 1, the historic Acquiror group acquired in a taxable purchase all of the stock of Target. As a result of the acquisition, Target and the members of the affiliated group of which it was the common parent (the historic Target group) joined the historic Acquiror group on Date 2 (the "combined group").

At the time of the acquisition, the historic Target group had both capital loss carryforwards and a net unrealized built-in gain (within the meaning of § 384) in its assets. After the acquisition, the historic Target group disposed of numerous assets in taxable transactions, resulting in RBIG of approximately $f in Year 2, the year of the acquisition. These gains were included in the combined group's Year 2 tax return and were offset in the return by capital loss carryforwards of the historic Target group. Acquiror believed that the historic Target group had sufficient capital losses to offset the gain from the dispositions of the historic Target group's assets. As a result, Acquiror did not believe that § 384 was relevant to the calculation of the combined group's Year 2 taxable income. Thus, Acquiror did not think that it had a loss to allocate between the preacquisition and post-acquisition periods for purposes of § 384. Accordingly, Acquiror did not make any election, either attached to its return or otherwise, to "close its books" on the acquisition date, nor did it in fact close the books, for purposes of allocating losses between the preacquisition and post-acquisition periods.

The historic Acquiror group's Year 1 tax year and the combined group's Year 2 tax years are under examination and the current Revenue Agent Report (RAR), issued by the Internal Revenue Service (IRS), contains both agreed and unagreed adjustments. The RAR would not permit the historic Target group's capital losses to offset the historic Target group's RBIG. The historic Acquiror group had available a consolidated net operating loss ("CNOL") carrying forward from Year 1 of approximately ($a).

Acquiror, as parent of the historic Acquiror group and of the combined group, and the agent have requested technical assistance concerning the application of § 384 to the acquisition and have submitted two alternative sets of facts for consideration.

<u>Situation 1</u>

Prior to the consideration of § 384, income and loss for Year 2 for each of the historic Acquiror group and the historic Target group are as follows:

	Historic Acquiror Group Income/(Loss)	Historic Target Group Income/(Loss)	Combined Group Income/(Loss)
Separate Taxable Income/ Operating Income or (Loss)	($b)	$c	$d
Historic Acquiror Group Capital Gains	$e		$e
Historic Target Group RBIG		$f	$f

Total Year 2 CTI			$g

Situation 2

Prior to the consideration of § 384, income and loss for Year 2 for each of the historic Acquiror group and the historic Target group are as follows:

	Historic Acquiror Group Income/(Loss)	Historic Target Group Income/(Loss)	Combined Group Income/(Loss)
Separate Taxable Income Operating Income or (Loss)	($h)	$c	($i)
Historic Acquiror Group Capital Gains	$e		$e
Historic Target Group RBIG		$f	$f
Total Year 2 CTI			$j

Taxpayer's Position

Issue 1: Acquiror argues that when the historic Acquiror group acquires the historic Target group, which qualifies as a "gain corporation" for purposes of § 384, the proper method for determining whether there is a loss that must be allocated between the preacquisition and post-acquisition periods of the acquisition year for purposes of § 384 is the separate group approach, i.e., to calculate separately items of income, gain, loss and deduction for each of the historic Acquiror group and the historic Target group. Accordingly, each of the historic Acquiror group and the historic Target group must separately determine its amounts of operating income, gain, deduction, loss and RBIG. The historic Acquiror group's losses, as separately determined, are then allocated between the preacquisition and post-acquisition periods of the year of acquisition.

Issue 2: Acquiror requests permission to use the "closing of the books" method to allocate losses (whether determined on a separate group basis or a combined group basis) between the preacquisition and post-acquisition periods of the year of acquisition for purposes of § 384. Although Acquiror acknowledges that § 384(c)(3) provides for the ratable allocation of losses except as provided in regulations, and that no such regulations have been issued, Acquiror nevertheless contends that the closing of the books method should be available to it. Acquiror argues that § 384(c)(3) is self-executing in this regard. Acquiror notes that certain private letter rulings (PLRs) have permitted taxpayers to close their books for purposes of allocating losses under § 384(c)(3) and argues that such PLRs indicate that a closing of the books election is available, that relief to file a late election is thus available under § 301.9100, and that it meets the requirements for such relief.

Issue 3: Acquiror argues that if the separate group approach is used and the historic Acquiror group has a CNOL for the year of acquisition that must be allocated between the preacquisition and post-acquisition periods of such year for purposes of § 384, then the order of absorption of such losses should be that the preacquisition losses should first offset non-RBIG income (i.e., the historic Target group's ordinary income and the historic Acquiror group's capital gains), then the post-acquisition losses should be applied to the historic Target group's RBIG to the greatest extent possible before being applied to any remaining non-RBIG income. Alternatively, Acquiror contends that the preacquisition losses should first offset the non-RBIG income, then the post-acquisition losses should be applied ratably against the historic Acquiror group's capital gains, the historic Target group's ordinary income, and the historic Target group's RBIG.

Issue 4: Acquiror argues that it should be permitted to reduce the historic Target group's RBIG by a proportionate share of the historic Target group's operating expenses.

Agent's Position

Issue 1: The agent argues that when the historic Acquiror group acquires the historic Target group, which qualifies as a "gain corporation" for purposes of § 384, the proper method for determining whether there is a loss that must be allocated between the preacquisition and post-acquisition periods of the acquisition year for purposes of § 384 is the combined group approach, i.e., to calculate items of income, gain, loss and deduction for the two groups on a combined basis, using the general rules for computing CTI as set forth in the consolidated return regulations, except that RBIG is excluded from such computation in order to give effect to the prohibition in § 384 against the use of preacquisition losses to offset RBIG. If the combined group has a CNOL for the year of acquisition, that CNOL must then be allocated between the preacquisition and post-acquisition periods of such year.

Issue 2: The agent believes that Acquiror's request to use the "closing of the books" method to allocate its losses between the preacquisition and post-acquisition periods of the year of acquisition for purposes of § 384 should be denied.
The agent argues that § 384 provides for the ratable allocation of losses except as provided in regulations and that no such regulations have been issued. Further, the IRS has not issued a revenue ruling, revenue procedure, notice, or announcement providing for a closing of the books election under § 384. Accordingly, the Agent concludes that no such election is available and, accordingly, that relief to make a late

election is not available under § 301.9100. The agent further argues that even if principles similar to those contained in § 301.9100 are applied, the taxpayer cannot satisfy such standards.

Issue 3: The agent argues that if the combined group approach is used and the combined group has a CNOL for the year of acquisition that must be allocated between the preacquisition and post-acquisition periods of such year for purposes of § 384, then an ordering rule for the absorption of preacquisition and post-acquisition losses within the year of acquisition is unnecessary. Under this approach, if the combined group has CTI for the year of acquisition, then there is no loss to allocate. If, on the other hand, the combined group has a CNOL for the year of acquisition that must be allocated between the preacquisition and post-acquisition periods, the portion of the CNOL allocated to the preacquisition period cannot be used against RBIG and, since no other income remains, that limited loss must be carried forward. The portion of the loss allocated to the post-acquisition period can be used to offset RBIG to the fullest extent possible.

Issue 4: The agent argues that no basis exists for reducing the Target group's RBIG by a proportionate share of the Target group's operating expenses.

APPLICABLE LAW:

Section 384 provides that, where one corporation acquires control of a second corporation (or acquires the assets of a second corporation in a reorganization described in § 368(a)(1)(A), (C), or (D)) and either corporation is a gain corporation, "income for any recognition period taxable year (to the extent attributable to recognized built-in gains) shall not be offset by any preacquisition loss (other than a preacquisition loss of the gain corporation)."

Section 384(c)(3) defines the term "preacquisition loss" to mean

> (i) any net operating loss carryforward to the taxable year in which the acquisition date occurs, and
> (ii) any net operating loss for the taxable year in which the acquisition date occurs to the extent such loss is attributable to the period in such year on or before the acquisition date.

In the case of a corporation with a net unrealized built-in loss, the term "preacquisition loss" includes any recognized built-in loss.

Section 384(c)(3)(A) states that "[e]xcept as provided in regulations, the net operating loss shall, for purposes of clause (ii), be allocated ratably to each day in the year." The Treasury Department and the IRS have not issued regulations under § 384.[2]

Section 384(c)(4) provides that the term "gain corporation" means any corporation with a net unrealized built-in gain.

Section 384(c)(1) generally defines "RBIG" as any gain recognized during the recognition period on the disposition of any asset except to the extent the gain corporation (or, in any case described in subsection (a)(1)(B), the acquiring corporation) establishes that (i) such asset was not held by the gain corporation on the acquisition date, or (ii) such gain exceeds the excess (if any) of (A) the fair market value of such asset on the acquisition date over (B) the adjusted basis of such asset on such date.

Section 384(c)(8) provides that, except as provided in regulations, 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 respective meanings as when used in § 382(h), except that the acquisition date is taken into account in lieu of the change date.

Section 382(h), as modified by § 384(c)(8), provides that "net unrealized built-in gain" and "net unrealized built-in loss" mean the amount by which (i) the fair market value of the assets of the corporation immediately before the acquisition date is more or less, respectively, than (ii) the aggregate adjusted basis of such assets at such time.

Section 382(h), as modified by § 384(c)(8), generally provides that "recognized built-in loss" means any loss recognized during the recognition period on the disposition of any asset except to the extent the corporation establishes that (i) such asset was not held by the corporation immediately before the acquisition date or (ii) such loss exceeds the excess of (A) the adjusted basis of such asset on the acquisition date, over (B) the fair market value of such asset on such date.

Section 382(h), as modified by § 384(c)(8), provides that "recognition period" means the five-year period beginning on the acquisition date and "recognition period taxable year" means any taxable year any portion of which is in the recognition period.

Section 384(c)(6) provides that, except as provided in regulations and except for purposes of subsection (b), which provides for an exception for corporations under common control, all corporations which are members of the same affiliated group immediately before the acquisition date are treated as one corporation.

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[2] The IRS opened a regulations project under § 384 in 1989, see Department of the Treasury Semiannual Agenda, 54 FR 17052 (April 24, 1989), and discontinued the project effective June 30, 1992, see Notice 92-12, 1992-16 I.R.B. 35.

Section 384(e)(2) provides an ordering rule for losses carried from the same taxable year. Under this rule, in any case where a preacquisition loss for a taxable year is limited under subsection (a) and a net operating loss ("NOL") from such year is not subject to such limitation, taxable income is treated as first being offset by the limited loss.

Section 1501 provides that an affiliated group of corporations shall have the privilege of filing a consolidated return with respect to imposition of income tax in lieu of filing separate returns. This privilege is subject to the provisions of the chapter including the regulations prescribed under § 1502.

Section 1.1502-2 provides that the tax liability of a group for a consolidated return year is determined by adding together the tax imposed on the CTI for such year as determined under § 1.1502-11 and certain other taxes imposed under other Code sections.

Section 1.1502-11 provides that CTI for a consolidated return year is determined generally by calculating and adding the separate taxable income for each member of the group, as determined under § 1.1502-12, and requiring that amount to be adjusted for certain items of the group, including the consolidated net operating loss ("CNOL") deduction for the year and any consolidated capital gain net income.

Section 1.1502-12 provides that "separate taxable income" is computed in accordance with the provisions of the Code relating to taxable income of separate corporations, except that, among other things, no NOL deduction shall be taken into account.

Section 1.1502-21(e) provides that any excess of deductions over gross income, as determined under § 1.1502-11(a), without regard to any CNOL deduction, is referred to as the CNOL.

Section 1.1502-76(b)(1)(i) provides that a consolidated return must include the common parent's items of income, gain, deduction, loss, and credit for the entire consolidated return year and each subsidiary's items for the portion of the year for which it was a member. If a consolidated return includes items of a corporation for only a portion of its tax year, items for the portion of the year not included in the consolidated return must be included in a separate return (including the consolidated return of another group).

Section 1.1502-76(b)(1)(ii)(A)(*1*) provides that if a corporation becomes or ceases to be a member during a consolidated return year, it becomes or ceases to be a member at the end of the day on which its status as a member changes, and its tax year ends for all Federal income tax purposes at the end of that day.

Section 1.1502-76(b)(2)(ii)(A) provides that although the periods ending and beginning with a member's change in status are different tax years, items (other than extraordinary items) may be ratably allocated between the periods if (1) the member with a change in status is not required to change its annual accounting period or its method of accounting as a result of its change in status and (2) an irrevocable ratable allocation election is made under paragraph (b)(2)(ii)(D) of this section.

Section 1.1502-76(b)(2)(ii)(B) provides that under a ratable allocation election, paragraph (b)(2) of this section applies by allocating to each day of the original year of the member with the change in status an equal portion of that member's items taken into account in the original year, except that extraordinary items must be allocated to the day they are taken into account.

Section 1.1502-80(a) provides that the Code generally is applicable to the consolidated group to the extent the consolidated return regulations do not exclude its application.

Sections 301.9100-1 through -3 provide the standards the IRS uses to determine whether to grant an extension of time to make a regulatory election. Section 301.9100-1(b) provides that for this purpose, a "regulatory election" is an election whose due date is prescribed by a regulation published in the Federal Register, or a revenue ruling, revenue procedure, notice, or announcement published in the Internal Revenue Bulletin.

Section 301.9100-3 provides that a request for relief to make a late election will be granted when the taxpayer provides evidence to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith, and that the grant of relief will not prejudice the interests of the Government.

Section 301.9100-3(b)(1) provides that, except as provided in paragraphs (b)(3)(i) through (iii), a taxpayer is deemed to have acted reasonably and in good faith if the taxpayer (1) requests relief under this section before the failure to make the regulatory election is discovered by the IRS, (2) failed to make the election because of intervening events beyond the taxpayer's control, (3) failed to make the election because, after exercising reasonable diligence, the taxpayer was unaware of the necessity for the election, (4) reasonably relied on the written advice of the IRS, or (5) reasonably relied on a qualified tax professional and the tax professional failed to make, or advise the taxpayer to make, the election.

Section 301.9100-3(b)(3)(i) through (iii) provides that a taxpayer is deemed not to have acted reasonably and in good faith if it (1) seeks to alter a return position for which an accuracy-related penalty has been or could be imposed under § 6662 at the time the taxpayer requests relief and the new position requires or permits a regulatory election for which relief is requested, (2) was informed in all material respects of the required election and related tax consequences, but chose not to make the election, or

(3) uses hindsight in requesting relief. With respect to hindsight, § 301.9100-3(b)(iii) provides that if specific facts have changed since the due date for making the election that make the election advantageous to a taxpayer, the IRS will not ordinarily grant relief. In such a case, the IRS will grant relief only when the taxpayer provides strong proof that the taxpayer's decision to seek relief did not involve hindsight.

ANALYSIS:

Issue 1

Acquiror and the agent have asked us whether, when one consolidated group (in this case, the historic Acquiror group) acquires a second consolidated group (in this case, the historic Target group) that qualifies as a "gain corporation" for purposes of § 384, one determines that there is a loss that must be allocated between the preacquisition and post-acquisition periods of the acquisition year for purposes of § 384 under the separate group approach, i.e., by calculating separately items of income, gain, loss and deduction for each of the historic Acquiror group and the historic Target group, or under the combined group approach, i.e., by calculating items of income, gain, loss and deduction on a combined group basis, using the general rules for computing CTI as set forth in the consolidated return regulations, except that RBIG is excluded from such computation.

We start with the premise that, in deciding to file a consolidated return in lieu of separate returns, a taxpayer voluntarily subjects itself to the rules for computing CTI as set forth in the consolidated return regulations. Section 1501 states that an affiliated group of corporations shall have the privilege of filing a consolidated return with respect to imposition of income tax in lieu of filing separate returns and that this privilege is subject to the provisions of the chapter including the regulations prescribed by § 1502. See, e.g., Garvey, Inc. v. United States, 1 Cl. Ct. 108, 116 (1983) (noting that the election to file a consolidated return inherently carries with it both advantages and disadvantages and that "the affiliated group that voluntarily elects to file a consolidated return 'must now take the bitter with the sweet.'") We also note that the primary purpose of the consolidated return system is to minimize the effect that the separate existence of affiliated corporations has on the aggregate tax liability of the consolidated group. See, e.g., United Dominion Industries, Inc. v. United States, 532 U.S. 822, 840 (2001) (Stevens, J., dissenting) ("[I]t is generally accepted that the rationale behind the consolidated return regulations is to allow affiliated corporations that are run as a single entity to elect to be treated as a single entity."); Handy & Harman v. Burnet, 284 U.S. 136 (1936) (noting that the purpose of the consolidated return provisions is to allow business that are run as a single entity to elect to be treated for tax purposes as a single entity even though the business is conducted by means of more than one corporation.). Further, a fundamental cornerstone of the consolidated return regulations is that losses of the group are applied against income of the group. See 1 Andrew J. Dubroff, et al, Federal Income Taxation of Corporations Filing Consolidated Returns

§ 1.01 ("The ability to offset one member's losses against another member's income may be the single most important feature of filing on a consolidated basis.").

Specifically, § 1.1502-2 provides that the tax liability of a consolidated group is determined by adding together the tax imposed on the CTI for such year as determined under § 1.1502-11 and certain other taxes imposed under other Code sections. Section 1.1502-11 provides that CTI for a consolidated return year is determined generally by calculating and adding the separate taxable income for each member of the group, as determined under § 1.1502-12, and requiring that amount to be adjusted for certain items of the group which are determined on a consolidated basis, including the CNOL deduction for the year and any consolidated capital gain net income. Applying these rules to the case at hand, and before considering the CNOL deduction or the effect of § 384, the combined group's CTI in Situation 1 is $g (the sum of $d, $e, and $f) and the combined group's CTI in Situation 2 is $j (the sum of ($i), $e, and $f). But for the application of § 384, Acquiror's CNOL carryforward of ($a) from Year 1 would be available to offset $g or $j, as the case may be. The question is the extent, if any, that § 384 alters these results.

Section 384 was enacted by the Revenue Act of 1987 specifically to address gaps in the 1986 version of section 382 and was substantially modified by the Technical and Miscellaneous Revenue Act of 1988. The legislative history of § 384 indicates that in enacting this provision Congress was concerned that other specific limitations on tax attributes, namely § 382, which had been revised in 1986 in order to prevent loss-trafficking, and § 269, did not apply to a situation where a loss corporation acquired a built-in gain corporation and used its preacquisition losses to offset the acquired corporation's RBIG. <u>See</u>, <u>e.g.</u>, H.R. Rep. No. 100-391, at 1092 (1987). Congress was concerned that "in some instances, loss corporations may effectively be paid to 'launder' built-in gains or to take over 'burnt-out' tax shelter or similar property." <u>Id</u>. Congress wanted to write a bright-line rule that did not rely on a "principal purpose" test. Accordingly, the legislative history states that § 384 "provides that loss corporations will be precluded from using their losses to shelter built-in gains of an acquired company recognized within 5 years of the acquisition." <u>Id</u>.

In arguing their respective positions on the proper interpretation of § 384, both the agent and the taxpayer rely on the statutory language and the amendments thereto, and the legislative history. As originally enacted, § 384(a)(1) provided that if

> (A) a corporation (hereinafter in this section referred to as a "gain corporation") becomes a member of an affiliated group, and
> (B) such corporation has a net unrealized built-in gain, the taxable income of such corporation for any recognition period taxable year (to the extent attributable to recognized built-in gains) shall not

> be offset by any preacquisition loss of any other member of such group.

A similar rule applied to asset acquisitions.

The original version of § 384 included the same definition of "gain corporation" as does current § 384 – a corporation with a net unrealized built-gain. Similarly, old § 384 provided essentially the same definition of "preacquisition loss" – any NOL carryforward to the taxable year in which the acquisition occurs and any NOL for the taxable year in which the acquisition date occurs to the extent such loss is allocable to the period in such year on or before the acquisition. The original version § 384 also looked to § 382(h) for definitions of several terms.

After its enactment, old § 384 received a fair amount of criticism. First, § 384(a)(1) was criticized because it was unclear whether § 384 applied only where a loss corporation acquired a gain corporation or whether it also applied where a gain corporation acquired a loss corporation. See, e.g., Peter A. Glicklich, Section 384: Less Left for Loss Corporations,16 J. Corp. Tax'n 23, 33 (1989). In addition, old § 384 did not include a specific rule on the treatment of the members of the same affiliated group and thus the treatment of affiliated groups was uncertain. Specifically, it was unclear if the threshold requirement for net unrealized built-in gain found in § 382(h)(3) and made applicable by § 384(b)(4) of old § 384 applied on a separate or consolidated basis. See, e.g., Glicklich, supra, at 36-40. Similarly, it was unclear if the determination of whether a corporation was a "gain corporation" was made on a separate or consolidated basis. Id. at 33. Finally, it was unclear how the application of § 384 was affected by subsequent intra-group transactions. Id. at 34.

In 1988, Congress substantially amended § 384. As amended, § 384(a) provides that, where one corporation acquires a second corporation (or acquires the assets of a second corporation in a reorganization described in § 368(a)(1)(A), (C), or (D)) and either corporation is a "gain corporation," "income for any recognition period taxable year (to the extent attributable to recognized built-in gains) shall not be offset by any preacquisition loss (other than a preacquisition loss of the gain corporation)." Thus, this change makes it clear that § 384 applies where a gain corporation acquires a loss corporation and vice versa. In addition, amended § 384(a) clearly states that built-in gains may be offset by preacquisition losses of the gain corporation. The term "preacquisition loss" was changed slightly to add that in the case of a corporation with a net unrealized built-in loss, the term "preacquisition loss" includes any recognized built-in loss.

With respect to affiliated groups, § 384(c)(6) was added to provide that

> [e]xcept as provided in regulations and except for purposes of subsection (b) [relating to an exception for corporations under common control], all

> corporations which are members of the same affiliated group immediately before the acquisition shall be treated as one corporation. To the extent provided in regulations, Section 1504 shall be applied without regard to subsection (b) thereof [relating to nonincludible corporations] for purposes of the preceding sentence.

Section 384(c)(7) was added to provide that any reference to a corporation includes a reference to any predecessor or successor thereof.

With respect to the treatment of affiliated corporations, the legislative history describes the general rule of § 384(c)(6) and then gives three examples of the operation of such rule. First, the legislative history states that the determination of whether the de minimis threshold for built-in gain or loss is satisfied is made on an affiliated group basis, unless regulations provide otherwise. Second, the legislative history addresses the effects of intra-group transactions by stating that if a corporation becomes a member of an affiliated group and subsequently merges with another member, although gains or losses which were limited under § 384 as a result of the stock acquisition rule when the corporation became a member of the group will continue to be limited, gains or losses accruing after the date of affiliation and before the merger will not be preacquisition losses with respect to the merger. Third, the legislative history includes the following example which makes clear that the losses of the gain corporation can offset RBIG and that the determination of whether a corporation is a gain corporation is done on an affiliated basis:

> [A]ssume that one corporation has appreciated assets and another has net operating loss carryforwards; and the two file a consolidated return. In addition, assume that neither corporation acquired the other in a transaction subject to the limitations of section 384, and that the use of the losses of the one against gain from the appreciated assets of the other is not otherwise limited by any provision of the Code or regulations. If this group acquires a loss corporation, in determining the application of section 384, the group is treated as one corporation to determine whether it is a gain corporation. Furthermore, if it is a gain corporation, so that the losses of the newly acquired loss corporation may not be used to offset the old group's gains, the prior losses and gains of the old group can still offset one another, since the losses of that group are not preacquisition losses of the gain corporation under section 384(a).

H.R. Rep. No. 100-795, at 412-13 (1988).

In Acquiror's view, the foregoing statutory and legislative history support its claim that in order to effectuate § 384, the historic Acquiror group and the historic Target group must be treated as separate entities. Acquiror argues that by amending § 384(a) to state specifically that RBIG can be offset by preacquisition losses of the gain corporation, Congress was expressing a preference for treating each group as a separate entity and that this preference was also expressed by the addition of § 384(c)(6) stating that all members of an affiliated group immediately before the acquisition are treated as one corporation. In Acquiror's view, by making a distinction in the statute and the legislative history between preacquisition losses of the gain corporation and preacquisition losses of the loss corporation, and providing that RBIG may be offset by the former but not the latter, Congress was essentially directing that all items of gain, income, loss and deduction be computed on a separate basis.

Acquiror further argues that because § 384 only expressly proscribes the use of certain preacquisition losses (i.e. those of the loss corporation) to offset RBIG, Congress in effect expressed the view that all post-acquisition losses should be freely useable against RBIG. Acquiror argues that, by applying the general rules for computing CTI, except that RBIG is excluded, the agent not only limits the extent to which the historic Acquiror group's preacquisition losses can be used to offset RBIG, as contemplated by § 384, but also limits the extent to which the historic Acquiror group's post-acquisition losses can offset RBIG, which is not contemplated by the statute.

Finally, Acquiror argues that in analogous situations involving limitations on favorable tax attributes, the calculation of the limitation is done on a separate basis, i.e., by reference to the acquired entity or acquired group of entities and not to a combination of acquiring and acquired entities. In particular, Acquiror argues that the § 384 limitation on the use of losses to offset RBIG is much like the limitation in § 1.1502-21(c) on NOL carryovers and carrybacks from a separate return limitation year ("SRLY") and the SRLY limitation in § 1.1502-15 on built-in losses.

Accordingly, Acquiror proposes that each of the historic Acquiror group and the historic Target group must separately determine their amounts of operating income, gain, deduction, loss and RBIG. The historic Acquiror group's losses, as separately determined, would then be allocated between the preacquisition and post-acquisition periods of the year of acquisition. The taxpayer would not combine the historic Acquiror group's losses with the historic Acquiror group's capital gain, nor would it combine these losses with the historic Target group's operating income or RBIG.

The agent views the statutory and legislative history of § 384 differently. In the agent's view, the legislative history makes clear that Congress had three goals in enacting § 384(c)(6). First, Congress intended that whether the de minimis threshold for net unrealized built-in gain or loss is met should be determined by treating all members of an affiliated group as one corporation. The agent notes that in so doing, Congress stopped affiliated groups from moving gain or loss among group members in an attempt to circumvent § 384. Second, Congress also wanted the determination of whether a corporation was a gain corporation to be done on an affiliated basis. Third, Congress wanted to make clear that if one corporation becomes a member of an affiliated group and § 384 applies to limit losses and that corporation subsequently merges with another member of the group, any losses limited under § 384 as a result of the initial acquisition whereby the corporation joined the group will continue to be limited; however, gains or losses accruing after the date of affiliation and before the merger will not be preacquisition losses with respect to the merger. The agent argues that if Congress had additionally intended to alter the basic framework for computing CTI, it would have said so explicitly.

In the agent's view, § 384 prohibits the use of certain losses to offset RBIG but does not does not otherwise override, supercede or invalidate any of the consolidated return regulations. Section 1.1502-80(a) provides that the Code generally is applicable to the consolidated group to the extent the consolidated return regulations do not exclude its application. The agent argues that, in order to apply § 384 in the consolidated return context, the definition of "preacquisition loss" in § 384(c)(3) must be read as referring to the CNOL. The agent notes that in United Dominion, supra, the Supreme Court considered the fundamental nature of a group's CNOL. In that case, the Court considered the extent to which single entity treatment applied in computing product liability losses in the consolidated group context. In the absence of regulatory guidance, the Court concluded that, although individual members of the group contribute to a consolidated loss, there is no concept of members having their own, separate NOL. In fact, the Court concluded that the concept of separate loss "simply does not exist." Id. at 830. Instead, the members contribute to the consolidated loss and the consolidated loss is exclusively an attribute of the group as a whole, at the consolidated level.

The agent argues that in addition to defining "preacquisition loss" as referring to the CNOL, all that is necessary to effectuate § 384 is to exclude RBIG from the computation of CTI because, for § 384 purposes, it is the only item that cannot be offset freely. Under the agent's combined group approach, it must first be determined that the combined group has a CNOL for the year of acquisition using the general rules for computing CTI except that RBIG is excluded, and only when such a CNOL exists is it necessary to allocate the CNOL between the preacquisition and post-acquisition periods. Under this view, in order to apply § 384, it simply is not necessary to calculate separately all items of income, gain, loss, and deduction. To perform such separate calculations would impermissibly treat the historic Acquiror group and the historic Target group as separate and distinct corporations for purposes of computing CTI, thus contradicting the most fundamental principles of the taxation of consolidated groups.

We agree with the agent. Section 384 proscribes the use of preacquisition losses (other than those of the gain corporation) to offset RBIG. In our view, the fact that Congress amended § 384 to state specifically that preacquisition losses of the gain corporation are not limited is best read as a belated recognition that the definition of "gain corporation" as "any corporation with a net unrealized built-in gain" means that a corporation can be a gain corporation and yet still possess loss carryovers. Absent the amendment, such carryovers would constitute preacquisition losses and would be limited. It is not necessary to read into this change an intention by Congress to alter the general rules for computing CTI.

Further, in our view the fact that § 384 specifically proscribes the use of preacquisition losses (other than those of the gain corporation) to offset RBIG should not be read to state also that post-acquisition losses can freely offset RBIG on a dollar for dollar basis, as opposed to offsetting non-RBIG income. Further, nothing in the statute or legislative history specifically states that items of income, gain, loss and deduction attributable to the gain corporation, other than RBIG, must be separately tracked or identified in the post-acquisition period. Although it is true that, in this case, because the historic Acquiror group acquired control of the historic Target group by a stock purchase, it is fairly easy for the parties to identify items of income, gain, loss and deduction on a separate group basis, the mere fact that certain information can be readily obtained does not mean that such information must be used when it ordinarily would not be relevant to parties when computing CTI.

With respect to § 384(c)(6), we agree with the agent that the legislative history indicates that Congress had three goals in enacting that provision – to ensure that the de minimis threshold was determined on an affiliated basis, to ensure that whether a corporation was a gain corporation was determined on an affiliated basis, and to address the effect of intra-group transactions on the § 384 limitation. We also agree with the agent that if Congress intended to permit corporations to determine separately all items of income, gain, loss and deduction and then to apply a portion of one member's loss against capital gains of another member, rather than first combining the income and losses of the group, and thus intended to depart radically from the general rules for computing CTI, it would have said so explicitly.

In addition, we note that the agent's combined group approach, which uses the general rules for computing CTI except that RBIG is excluded from such computation, is consistent with a similar calculation under § 382. Section 382 provides for a limitation on NOL carryforwards and certain built-in losses following an ownership change. As noted above, § 384 was enacted to close perceived gaps in the limitation provided by § 382, and § 384 borrows heavily from § 382(h) for terminology and definitions. Thus, there is a close relationship between the two provisions. The agent's approach for determining whether the taxpayer has a CNOL that must be allocated between the preacquisition and post-acquisition periods corresponds to the calculation made under §§ 382(b)(3) and 382(h).

Specifically, § 382(a) sets forth the general rule that the amount of the taxable income of any new loss corporation for any post-change year which may be offset by pre-change losses shall not exceed the § 382 limitation for such year. Section 382(b)(3) provides a special rule for a post-change year which includes the change date. That rule states that in the case of any post-change year which includes the change date,

> (A) Subsection (a) shall not apply to the portion of the taxable income for such year which is allocable to the period in such year on or before the change date. Except as provided in subsection (h)(5) and in regulations, taxable income shall be allocated ratably to each day in the year.
>
> (B) For purposes of applying the limitation of subsection (a) to the remainder of the taxable income for such year, the section 382 limitation shall be an amount which bears the same ratio to such limitation (determined without regard to this paragraph) as –
>
> (i) the number of days in such year after the change date, bears to
> (ii) the total number of days in such year.

Section 382(h)(5) provides that, for purposes of subsection (b)(3),

> (A) in applying subparagraph (A) thereof, taxable income shall be computed without regard to recognized built-in gains to the extent such gains increased the section 382 limitation for the year (or recognized built-in losses to the extent such losses are treated as pre-change losses), and gain described in paragraph (1)(C), for the year, and
>
> (B) in applying subparagraph (B) thereof, the section 382 limitation shall be computed without regard to recognized built-in gains, and gain described in paragraph (1)(C), for the year.

<u>See</u> <u>also</u> Treas. Reg. § 1.382-6 (RBIG and recognized built-in loss are not taken into account in determining the loss corporation's allocable net income or loss, and net capital gain or loss from the change year).[3]

[3] We note that, as discussed below with respect to Issue 2, § 1.382-6 allows taxpayers to elect to allocate losses between the preacquisition and post-acquisition periods using the "closing of the books" method. Section 1.382-6 also has a "ceiling rule" which requires that in no event can the amount of income or loss allocated to either the pre-change date period or the post-change date period exceed the corporation's

We note that, as discussed in more detail below with respect to Issue 3, under the agent's combined group approach, it is not necessary to formulate an ordering rule for the absorption of preacquisition and post-acquisition losses within the year of acquisition. Where both a limited preacquisition loss and an unlimited post-acquisition loss are carried from the same year, Congress provided an ordering rule in § 384(e)(2), which states that the limited loss is used first. Congress obviously was concerned with providing ordering rules when necessary. If Congress had intended for the separate group approach to be used to determine if a loss must be allocated for purposes of § 384, its failure to include an ordering rule for the year of acquisition was a glaring omission. In our view, when faced with two competing interpretations of the statute, one of which requires us to create additional rules for even the most common situations to which the statute applies, and one of which renders the creation of such rules unnecessary, the latter interpretation is more reasonable. That is, Congress' failure to provide an ordering rule for the year of acquisition suggests that Congress thought such a rule was unnecessary. Thus, the combined group approach, under which such a rule is unnecessary, is appropriate.

We also note that the agent's combined group approach ensures that consistent results would be obtained regardless of whether the historic Acquiror group obtained control of the historic Target group through a stock acquisition or through an asset acquisition, i.e., if Target had merged into Acquiror. "The ability of members to share their respective items leads to the consolidated return regulations often being characterized as achieving a practical merger, but the analogy is far from complete." 2 Dubroff, supra at § 42.02[2]. Where possible, the tax consequences of a sale of stock and a sale of assets should be the same. See generally David F. Abbott, A Matter of Equity and Convenience – The Nature of the Consolidated Return as Reflected in Recent Developments, 67 Taxes 1072, 1079 (1989) (discussing the legislative history of the Revenue Act of 1987, which added § 1503(e), and noting that Congress thought the consequences of a stock disposition and asset disposition should be the same).

Finally, although it is true that § 384 bears some similarity to the SRLY limitation, it is also true that similarities exist to some extent among all of the loss limitations provisions – § 269, § 382, § 384, and the SRLY rules – in terms of underlying purpose, as well as, to some degree, the specific operation of the rules. For example, as discussed above, § 384 was enacted to fill gaps in § 382 and borrows heavily from § 382 for its terminology. Nonetheless, the various limitations are not identical and each limitation applies independently with little or no coordination among them, except for the § 382/SRLY overlap rules, which generally provide that if there is an overlap between the application of the SRLY and § 382 limitations with respect to an NOL, the

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income or loss for the entire year (determined without regard to the closing of the books). The same issue thus exists under § 1.382-6 – on what basis does one determine the amount of loss for the year that must be allocated between the preacquisition and post-acquisition periods. We think this issue would be answered the same way in the context of § 1.382-6 and that the combined group approach would be used.

application of the SRLY limitation is eliminated. See § 1.1502-15(g), § 1.1502-21(g), and § 1.1502-22(g). Although there is some overlap between the SRLY limitation and the § 384 limitation, the scope of the two rules only overlaps in certain situations.

In sum, we conclude when one consolidated group (the historic Acquiror group) acquires a second consolidated group (the historic Target group) that qualifies as a "gain corporation" for purposes of § 384, one determines that there is a loss that must be allocated between the preacquisition and post-acquisition periods of the acquisition year for purposes of § 384 under the combined group approach, i.e., by calculating items of income, gain, loss and deduction on a combined group basis, using the general rules for computing CTI, except that RBIG is excluded from such computation.

This interpretation is the most consistent with the statutory language, and corresponds with a similar calculation under §§ 382(b)(3) and (h)(5). Further, this interpretation effectuates § 384 with minimal disruption to the general rules for the taxation of consolidated groups. Section 384 generally limits taxpayers' abilities to use certain preacquisition losses, and § 384(c)(3) enables taxpayers to identify those limited losses. It is necessary only to segregate RBIG in making this calculation, because for § 384 purposes, it is the only item that cannot be offset freely. It is not necessary to separately calculate other items of income, gain, loss, and deduction to apply § 384.

Under this approach, if the taxpayer has consolidated taxable income for the year of acquisition, then there is no loss to allocate. If, on the other hand, the taxpayer has a CNOL for the year of acquisition that must be allocated between the preacquisition and post-acquisition periods, the portion allocated to the preacquisition period cannot be used against RBIG and, since no other income remains, that loss must be carried forward. The portion of the loss allocated to the post-acquisition period can be used to offset RBIG to the fullest extent possible and any remaining amount of post-acquisition loss can be carried forward.

Accordingly, we believe that, in Situation 1, the combined group has no CNOL in Year 2, and thus, there is nothing to allocate between the preacquisition and post-acquisition periods. Acquiror cannot use any of the historic Acquiror group's CNOL carryforward of ($a) from Year 1 to offset the historic Target group's RBIG; however, it can use its CNOL carryforward to offset its $d of operating income and $e of capital gain. In Situation 2, we believe that the combined group does have a CNOL of ($j) for Year 2 (the sum of ($i) and $e), which must be allocated ratably between the preacquisition and post-acquisition periods of Year 2. (See the discussion under Issue 2 with respect to the method of allocation.) The portion of the CNOL allocated to the pre-acquisition period cannot be used to offset RBIG and, since there is no other type of income or gain remaining, the preacquisition loss must be carried forward. The portion of the CNOL allocated to the post-acquisition period can be used to offset RBIG.

Issue 2

Section 384(c)(3) states that "[e]xcept as provided in regulations, the net operating loss shall . . . be allocated ratably to each day of the year". The IRS and Treasury Department have not issued regulations concerning § 384(c)(3). The IRS opened a regulations project under § 384 beginning in 1989, see Department of the Treasury Semiannual Agenda, 54 FR 17052 (April 24, 1989), and discontinued the project effective June 30, 1992, see Notice 92-12, 1992-16 I.R.B. 35.

Notwithstanding the absence of regulations, the IRS has issued PLRs in which it permitted taxpayers to use the "closing of the books" method for purposes of allocating losses under § 384.[4] These PLRs have allowed taxpayers to elect to close their books on the acquisition date, thereby bifurcating the taxable year into two distinct periods, a preacquisition period and a post-acquisition period. The taxpayer must then determine the amount of its preacquisition loss for the taxable year that includes the acquisition by allocating items of income, gain, loss, and deduction to the actual period in which they occurred. However, the PLRs also provided that the closing of the books shall not result in an amount of NOL or net capital loss apportioned to the period after the acquisition that is greater than the net operation or net capital loss for the entire year in which the acquisition date occurs. The closing of the books method is somewhat less administrable than the ratable allocation method, but closing of the books offers a more accurate determination of the amount of loss that arises in the preacquisition period.

The IRS has issued PLRs permitting the closing of the books method for purposes of § 384 in the absence of regulations because of the increased accuracy of such method and because of the close relationship between § 384 and § 382, which provides for a limitation on NOL carryforwards and certain built-in losses following an ownership change. Section 382(b)(3), which provides a special rule for determining the § 382 limitation for a post-change year that includes the change date, and § 382(d)(1), which defines the term "pre-change loss," both require ratable allocations of taxable income and NOL, except as provided in regulations. After the amendment of § 382 by the Tax Reform Act of 1986, the Treasury and the IRS issued Notice 87-79, 1987-2 C.B. 387, which required that a taxpayer use the ratable method of allocation over the entire taxable year unless the taxpayer obtained a PLR from the IRS allowing a closing of the books method.[5] Subsequently, the Treasury and the IRS issued § 1.382-6 which provides operating rules for allocating income and loss to the pre-change and post-change periods of the taxable year in which a § 382 change date occurs. Section 1.382-6 specifically provides for a closing of the books election. Section 1.382-6 also contains a "ceiling rule" which requires that in no event can the amount of income or loss allocated to either the pre-change date period or the post-change date period

[4] PLR 200238017 (June 11, 2002), PLR 9734028 (May 22, 1997), PLR 9734029 (May 22, 1997), PLR 9734030 (May 22, 1997), PLR 9644004 (Aug. 6, 1996), PLR 9306013 (Nov. 13, 1992), and PLR 9027008 (March 30, 1990).

[5] We note that most of the PLRs issued by the IRS approving the closing of the books method for purposes of § 384 also involved a request for permission to use the closing of the books method for purposes of § 382 pursuant to Notice 87-79.

exceed the corporation's income or loss for the entire year (determined without regard to the closing of the books).

The IRS's reliance on § 382 seems reasonable in light of the legislative history of §§ 382 and 384. Both § 382 and § 384 contain similar "pro-rata" language for purposes of determining taxable income or loss allocable to the period before the acquisition. While the legislative history of § 384 does not discuss regulations to be issued under § 384(c)(3), § 382(d)(1)(B) contains nearly identical language to § 384(c)(3), and the legislative history of the 1986 amendments to § 382 contemplates offering a closing of the books method. Specifically, the House-Senate Conference Committee Report states:

> The [section 382] regulations may provide that income realized before the change date from discrete sales of assets would be excluded from the ratable allocation and could be offset without limit by pre-change losses. Moreover, these [section 382] regulations may provide a loss corporation with an option to determine the taxable income allocable to the period before the change by closing its books on the change date and thus forgoing the ratable allocation.

H.R. Conf. Rep. No. 99-841, at p. 186 (1986).

Because the statutory language in § 384 duplicates the language in § 382, one might infer that Congress contemplated that regulations issued under § 384 could permit a closing of the books method. Acquiror goes further and suggests that the statute is self-executing, because it is reasonably clear what Congress intended the regulations to provide. We do not believe this statute is self-executing.

It is the position of the IRS that a statute is not self-executing with respect to a reference to regulations unless the statute itself or the legislative history gives some specific guidance as to what the content of the regulations should be. Where such guidance is missing, the statute is not self-executing. Similarly, in a case such as the one at hand, where the statute not only specifically prescribes a method of allocation but also states that regulations can provide for a different method, but where neither the statute nor the legislative history provide any guidance as to what that other method might be, the statute is not self-executing with respect to regulations concerning such other method. In this case, § 384 statute provides for ratable allocation, except as provided in regulations, and is silent as to what the regulations might provide. The legislative history for § 384 is silent on this issue.

Because the statute is not self-executing, and because the IRS has not issued regulations, a revenue ruling, a revenue procedure, a notice, or an announcement providing for an election under § 384 and establishing due date for such an election, we conclude that no such regulatory election exists. Further, because no regulatory election exists, relief to make a late election cannot be granted under § 301.9100.

Thus, we are confronted with a situation in which no election for closing of the books method exists and yet such method has been made available to taxpayers via the PLR process. Because Acquiror is currently under audit, it can no longer seek to obtain a PLR on this issue. Rev. Proc. 2004-1, I.R.B. 2004-1, at § 6.01. Although a PLR issued to another taxpayer is binding on the IRS only with respect to that taxpayer and is not otherwise binding precedent, this ruling practice does suggest that it is reasonable for the taxpayer to believe that the closing of the books method is sometimes available to taxpayers for purposes of applying § 384, at least where taxpayers timely seek such a PLR. Thus, Acquiror has properly raised the issue during the process for obtaining technical advice.

We are aware of no authority establishing principles and standards for determining when relief can be sought for a particular treatment, such as the closing of the books method, made available to taxpayers only via PLR.[6] The most obvious analogy is to § 301.9100. Thus, while relief technically is not available under § 301.9100, we believe that similar principles and standards should be applied in this context.

As set forth above, § 301.9100-3(a) provides that a request for relief to make a late regulatory election will be granted when the taxpayer provides evidence to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith, and that the grant of relief will not prejudice the interest of the Government. Section 301.9100-3(b)(1) provides lists a variety of circumstances in which a taxpayer is deemed to have acted reasonably and in good faith. Conversely, § 301.9100-3(b)(3)(iii) lists a variety of circumstances in which a taxpayer is deemed not to have acted reasonably and in good faith, including situations in which the taxpayer uses hindsight in requesting relief. With respect to hindsight, the regulations state that relief ordinarily will not be granted if a change in facts since the due date for making the election makes the election seem advantageous.

Acquiror believes it can establish, based upon the foregoing standards, that it should be considered to have acted reasonably and in good faith. Acquiror has represented that, had Acquiror been aware that § 384 was relevant to the calculation of

[6] Acquiror refers us to PLR 9043024 (July 27, 1990) as an example of the IRS granting § 301.9100 relief to file a late election in the absence of regulations providing for such election. As discussed above, a PLR is not binding on the IRS except with respect to the taxpayer to whom the PLR was issued. We note, however, that the election at issue in PLR 9043024 had been announced in, and the due date of the election prescribed by, Notice 88-67. Although PLR 9043024 predates the revision of the § 301.9100 regulations that expanded the definition of "regulatory election" to encompass elections whose due date was prescribed by a revenue ruling, revenue procedure, notice, or announcement published in the Internal Revenue Bulletin, in addition to regulations published in the Federal Register, we note that, under the current § 301.9100 regulations, the election at issue in the PLR would constitute a "regulatory election."

its taxable income, it would have sought to close its books upon the acquisition of the historic Target group for purposes of applying § 384. The combined group's original Year 2 return is silent as to the group's § 384 allocation method because, at the time the Year 2 return was prepared, § 384 was not implicated. After the subsequent audit adjustment disallowed the historic Target group's capital loss carryforward, the historic Target group did not have sufficient preacquisition losses to offset its Year 2 RBIG. Accordingly, at that time, Acquiror communicated its desire to use the closing of the books method. Acquiror has declared that it could have complied with the requirements for requesting a PLR permitting the closing of the books method, if it had been aware of the need for such permission. In the PLRs in which the IRS allowed taxpayers to use the closing of the books method, the IRS requested several representations, all of which Acquiror states it could have and would have made if it had known that § 384 was relevant.

The agent has suggested that even if we would have permitted Acquiror to elect the closing of the books method in a PLR, had Acquiror requested one, it is too late now to provide relief because Acquiror did not timely seek to obtain approval to use such method. Moreover, the agent suggests that under the principles § 301.9100, Acquiror should not be deemed to be acting reasonably and in good faith because its decision to seek permission to use the closing of the books method is based on hindsight. We agree. Acquiror thought that the historic Target group had sufficient losses to offset its Year 2 RBIG and thus chose, based on the facts available to it at that time, not to seek a PLR permitting the closing of the books method. Upon audit, Acquiror has discovered that the facts are different and that the historic Target group does not have sufficient losses to offset its RBIG. Due to this change in facts, the closing of the books method now seems advantageous. To permit Acquiror at this late date to use the closing of the books method would reward hindsight. Taxpayers should not be able to "wait and see" what happens on audit or otherwise.

Because (i) the closing of the books method is currently available only by obtaining a PLR permitting such method, (ii) Acquiror failed to request such a PLR, (iii) relief under § 301.9100-3 technically is unavailable to Acquiror because no regulatory election exists, and (iv) under principles similar to those contained in § 301.9100-3, we conclude that Acquiror has not acted reasonably and in good faith because it is using hindsight, we conclude that Acquiror may not use a closing of the books method to allocate the combined group's CNOL, if any, for Year 2.

Issue 3

Acquiror argues that if the separate group approach is used and the historic Acquiror group has a CNOL for the year of acquisition that must be allocated between the preacquisition and post-acquisition periods of such year for purposes of § 384, then the order of absorption of such losses should be that the preacquisition losses should first offset non-RBIG income (i.e., the historic Target group's ordinary income and the historic Acquiror group's capital gains), then the post-acquisition losses should be applied to the historic Target group's RBIG to the greatest extent possible before being applied to any remaining non-RBIG income. Alternatively, Acquiror contends that the preacquisition losses should first offset the non-RBIG income, then the post-acquisition losses should be applied ratably against the historic Acquiror group's capital gains, the historic Target group's ordinary income, and the historic Target group's RBIG. Acquiror prefers to use post-acquisition losses to reduce RBIG as much as possible because the historic Acquiror group has a CNOL carryforward from Year 1 of approximately $a. This CNOL carryforward clearly constitutes a preacquisition loss under § 384(c)(3) and thus cannot be used to offset RBIG although it can be used to offset non-RBIG income.

Acquiror bases its argument for a taxpayer favorable ordering rule for the absorption of preacquisition and post-acquisition losses within the year of the acquisition on § 384(e)(2). That provision provides a rule for losses carried from the same year and states that

> In any case in which
> (A) a preacquisition loss is subject to limitation under [section 384(a)], and
> (B) a net operating loss from such taxable year is not subject to such limitation, taxable income shall be treated as having been offset 1st by the loss subject to such limitation.[7]

Acquiror argues that § 384(e)(2) supports its contention that, after preacquisition losses have been applied to non-RBIG income, post-acquisition losses should offset RBIG to the fullest extent possible. Acquiror contends that the ordering rule set forth in § 384(e)(2) is taxpayer favorable and thus expresses Congressional intent to maximize taxpayers' ability to use losses. Thus, Acquiror contends that its proposed taxpayer favorable stacking rule allowing post-acquisition losses to be used against RBIG first is a reasonable extension of § 384(e)(2).

The agent argues that if the combined group approach is used and, using the general rules for computing CTI as set forth in the consolidated return regulations except that RBIG is excluded from such computation, the combined group has a CNOL for the year of acquisition that must be allocated between the preacquisition and post-acquisition periods of such year for purposes of § 384, then an ordering rule for the absorption of preacquisition and post-acquisition losses within the year of acquisition is unnecessary.[8] We agree. Under this approach, if the combined group has CTI for the year of acquisition, then there is no loss to allocate. If, on the other hand, the combined

[7] This ordering rule for the absorption of losses is similar to a rule provided in section 382(l)(2)(B). Section 382(l)(2)(B) permits section 382 limited NOLs to be absorbed before NOLs that are not limited by section 382.

[8] As discussed above, the fact that the combined group approach renders unnecessary the creation of an ordering rule for the absorption of preacquisition and post-acquisition losses in the year of acquisition, supports the appropriateness of the combined group approach.

group has a CNOL for the year of acquisition that must be allocated between the preacquisition and post-acquisition periods for purposes of § 384, the portion of the CNOL allocated to the preacquisition period cannot be used against RBIG and, since no other income remains, that limited loss must be carried forward. The portion of the loss allocated to the post-acquisition period can be used to offset RBIG to the fullest extent possible. Any remaining post-acquisition loss can be carried forward.

Issue 4

Acquiror argues that the amount of the historic Target group's RBIG that is subject to a § 384 limitation should be determined net of an appropriate portion of the historic Target group's expenses. Acquiror provides no authority for its position on this issue, and appears to rely solely on a letter from a commentator urging Treasury to promulgate regulations addressing open issues under § 384.

The agent notes that § 384(c)(1) defines RBIG to mean any gain recognized during the recognition period on the disposition of any asset. To determine the amount of gain one looks to § 1001, which provides that "the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in § 1011 for determining gain . . . ". Section 1011 refers to § 1012, which states that the basis of property generally is its cost. Section 1016 enumerates adjustments to basis, which include only those expenditures, receipts, losses or other items properly chargeable to the capital account. This list of adjustments does not include current year's operating expenses.

The agent argues that no basis exists for an adjustment to RBIG based on a proportionate amount of the current year's operating expenses. We agree.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.