All in the Family: NOLs and Other Family Jewels

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These days, there's a lot of talk about the artificial use of arcane tax laws that can sometimes be used to create results that Congress probably didn't intend. Indeed, the whole tax shelter debate has morphed from a technical debate about substance over form, basis, attribution and step transactions into a political debate that may even raise constitutional questions, given the raft of criminal prosecutions that now seem in the offing. My concern here is a whole lot more pedestrian and a whole lot more of interest to readers of THE M&A TAX REPORT. I'm talking about good old Code Sec. 382 and its now vaunted limitations on the use of NOLs.

Acquisition planners are always tinkering with Code Sec. 382 limits. A full-blown Code Sec. 382 study may sound a bit Dickensian, but there is no denying the fact that determining when Code Sec. 382 limits will be triggered and how they will function is key anywhere net operating losses exist. Even relatively small and unsophisticated acquisitions need to navigate this mine field. That's what makes *Garber Industries Holding Co., Inc*. 124 TC 1, Dec. 55,901 (Jan. 25, 2005). an important (and frankly scary) case. If taxpayers continue to get kicked around like they did in *Garber Industries*, it's no wonder some tax advisors tinker with attribution and other arcane rules to make them work for—rather than against—them.

Archie and Edith

I don't recall that Archie Bunker had a brother in *All in the Family*, but if he did, my *All in the Family* reference would make a bit more sense. *Garber Industries* involved two brothers and a family company. [For prior coverage of *Garber Industries*, *see* Richter, Garber Industries, M&A TAX REPORT, May 2005, at1.] Charles Garber owned 68 percent of the company, and his brother Ken owned 26 percent. The remaining six percent was held by other siblings. In a family reorganization, Charles' ownership dropped from 68 percent to 19 percent, and Ken's ownership increased from 26 percent to 65 percent.

Although this was clearly a reshuffling of ownership, there was no Code Sec. 382 ownership change, as there was no ownership shift greater than 50 percent. So far, so good. Unfortunately, less than two years after the reorganization, Ken sold his entire interest to his brother Charles. After that sale, Charles' ownership spiked from 19 percent to 84 percent. Bear in mind, of course, that just *prior* to this family reorganization, Charles owned 68 percent of the company. So, if one were to disregard the intervening family reorganization, Charles' ownership would have gone only from 68 percent to 84 percent.

On its tax return for the year of the sale by Ken to Charles, the company claimed an NOL of more than $800,000. The IRS whittled the NOL deduction to about $120,000 invoking its good old friend, Code Sec. 382.

Band of Brothers

Students of the attribution would enjoy reading through the briefs in the Tax Court and Court of Appeals. The taxpayer basically argued that siblings should be treated as family members since, after all, they are both members of a family consisting of a parent and that parent's family members. The same is true, they argued, of their relationship with their grandparents. Although the IRS might have liked the notion of an expansive reading of the attribution rules, here they argued that the family attribution rules could apply only with reference to living individuals. There was no parent or

grandparent of both Ken and Charles alive at the beginning of the three- year testing period immediately before Charles bought all of Ken's shares. Consequently, there was no individual whose family members included both of these brothers. [*See* Code Code Sec. 382(l)(3)(A)(i).]

The Tax Court didn't really like either of these arguments, although it came down much closer to the IRS's position than the taxpayer's. After a discourse through the maze of legislative history surrounding the attribution rules, the court determined that it was most likely that Congress intended the aggregation rule set forth in Code Sec. 382(l)(3)(A)(i) to apply solely from the perspective of individuals who are shareholders of the loss corporation. Since neither Ken nor Charles was a child or grandchild of an individual shareholder of their company, neither were aggregated.

Fifth Circuit

Getting the Tax Court reversed on appeal is not usually easy. Still, I was rooting for this taxpayer, particularly given what seemed the inequity of one brother transitioning from 68 percent up to 84 percent (with less than a two-year hiatus in between, where that brother's stock dropped to 19 percent). It just seemed like there ought to be a way to obviate the harsh reach of Code Sec. 382 with its Draconian limits in at least *this* case. The Fifth Circuit didn't make much of an attempt, though.

Finding that the statutory language supported the Tax Court decision that the stock owned by Ken could not be attributed to Charles (and *vice versa*), the Fifth Circuit affirmed. The Fifth Circuit stressed that this was a relatively straightforward Code provision, and that there was nothing in the statute (or the arguments advanced by *Garber Industries*) to persuade it that its simple reading of Code Sec. 382 was not correct.

Although there may have been a hint of sympathy, the Fifth Circuit opinion does note that at least one of the positions urged by the taxpayer would have yielded an overly broad approach that, if adopted, would allow almost unlimited attribution, in steps, among family members. Given all the recent furor over tax shelter transactions, which use (or misuse?) attribution, perhaps this result was inevitable.

Planning Opportunity?

For other taxpayers (not necessarily the Garbers), rigidity can have its benefits. Here, with all the stress over a living shareholder that can make the two brothers part of a family, it is worth considering making a grandparent or parent a shareholder. Perhaps even one share might save the day. The case says that this parent or grandparent needs to be living, so that suggests that tax planning in family companies (at least NOL tax planning) may be a lot easier in families with a good track record of longevity. The stock ownership has to be real, and I don't know whether it would be important to justify the parent or grandparent becoming a shareholder on some nontax basis.

Few tax advisors would want to say that a stock transfer is solely being made in order to manipulate attribution rules and prevent an ownership change under Code Sec. 382. Surely the guiding hand of a parent or grandparent would be more appropriate. But you get my point. The fact that the Tax Court and Fifth Circuit have given guidance on one hitherto unexplored avenue of attribution might (for some people anyway) be a good thing.