Loss-Selling in Alaska

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Table of Contents

1. Summary
2. Basic Loss-Selling Example
3. Overview
4. NOLs and Alaska Native Corporations
5. Debate over NOLs-selling

Summary

“Loss selling,” more formally known as Net Operating Loss selling (NOLs selling), was a business practice allowed previous to 1984 by which businesses could sell other businesses their financial losses (http://www.investopedia.com/terms/n/netoperatingloss.asp#axzz1odg4aOOT) for tax purposes. It is a rubric term that encompasses a range of tax-sheltering practices which were based on the transfer of NOLs and profits among otherwise unaffiliated companies.

In essence, the buying firm used the “purchased losses” to offset profits. This reduced its income tax burden. Congress disallowed loss selling in 1984, but an exemption was granted for Alaska Native Corporations (ANCs). The IRS pushed back against continuing of NOLs sales for ANCs, and it was necessary for Congress to pass additional legislation in 1986 to allow unencumbered NOLs selling by ANCs. 1986 to 1988 was the “NOLs boom” for ANCs. ANCs monopolized NOLs selling in the US, and sold roughly $1.5 billion in NOLs, for over $400

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million in revenues. Large NOLs sales were completed with high-profile corporations like Ford, Quaker Oats, Pillsbury (https://docs.google.com/a/uw.edu/viewer?a=v&q=cache:fdpqyzrNqzUJ:caselaw.findlaw.com/data2/californiastatecases/A105155.DOC+&hl=en&gl=us&pid=bl&srcid=ADGEESg76sejpd14slc00ZKl Walgreens, and Hilton Hotels (http://community.seattletimes.nwsource.com/archive/?date=19900401&slug=1064185). ANCs generated most of the losses by selling natural resources at below their appraised or claimed asset value. NOLs selling was fully disallowed by Congress in 1988.

Basic Loss-Selling Example

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Ace Forestry owns a forest appraised at a value of $100/acre, but knows it can only get $20/acre for the logs. It knows that logging the land would cost $20/acre, meaning it would break even.

However, Ace is in the NOLs selling business. It wants to deplete its assets, to sell the loss.

Ace cuts the trees and sells the logs, at a “wash”: $20 revenues - $20 expenses = $0 net income.

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Ace then marks the value of those forests down from $100 (the appraised value) to $20 (the sale value) on its accounting books. The result is an $80/acre net operating loss.

Pilgrim Cereal Corporation, a distant company, is highly profitable. They pay an 11% tax on their profits. Ace sells Pilgrim its $80/acre NOLs at a rate of 10%… meaning, $8 for each $80 loss. That's a fraction of the actual value lost. To Pilgrim, the loss is only "worth" the amount of taxes it can negate. Ace, on the other hand, values $8 in cash more than its standing timber.

Pilgrim puts Ace's NOLs on its accounting books, offsetting its profits. Since Pilgrim paid 10% for the losses to offset its profits, instead of 11% in taxes, it has saved 1%.

Ace has now made $8/acre to log its land. It has converted a large non-liquid asset (timber) into a small liquid asset (cash). Pilgrim has increased its profits by 1%. The other 10% of its profits, which would also have gone to taxes, were instead been paid to Ace.

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Overview

Net Operating Loss selling (NOLs-selling) is the practice of transferring losses from the accounting books of one business to another. An otherwise profitable corporation purchases NOLs from an unprofitable corporation. It uses them to offset its profits, and thus paying lower taxes.

NOLs-selling was a tax shelter (http://en.wikipedia.org/wiki/Tax_shelter) device legal for US corporations previous to 1984. Congress ended NOLs-selling with the 1984 Deficit Reduction Act, but provided a special exemption for Alaska Native Corporations (ANCs). To overcome IRS objections, further legislation in the 1986 Tax Reform Act was required before ANCs could resume NOLs sales. This opened the way for a brief NOLs selling boom (http://caselaw.lp.findlaw.com/scripts/getcase.pl?navby=search&case=/data2/circs/9th/9535857.html), from 1986 to 1988. NOLs selling was disallowed for ANCs in the Technical and Miscellaneous Revenue Act of 1988. NOLs selling is not to be confused with “tax-loss selling” (http://financial-dictionary.thefreedictionary.com/Tax-Loss+Selling) or “wash selling” (http://financial-dictionary.thefreedictionary.com/Wash+Selling), which both involve the sale of stock.

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NOLs and Alaska Native Corporations

When Congress prohibited NOL-selling in 1986, former U.S. Senator Ted Stevens (AK) inserted a special exception into the tax reform bill that kept NOLs-selling legal for Alaska Native Corporations (ANCs) (http://en.wikipedia.org/wiki/Alaska_Native_Regional_Corporations). Previously, NOLs selling was legal for all US corporations, and ANCs had only minor involvement in the NOLs market. The exception gave ANCs a monopoly on NOLs selling. From 1986 to 1988, NOLs selling was an important and lucrative business for ANCs. During these years they conducted 95% of their total lifetime NOLs sales (http://www.iser.uaa.alaska.edu/Publications/corpfinance.pdf) (7.7 MB). Because the ANCs held a monopoly on a scarce financial product (sellable NOLs), this product immediately commanded a much higher price. NOLs sales were quickly restructured so that much of the tax-savings of the purchasing corporation flowed back to the ANCs.

Many of the recently-formed ANCs were in financial difficulties and had suffered extensive losses throughout their short history. By turning their early business failures into a lucrative product, loss-selling revitalized many ANCs. The large cash infusions saved them from bankruptcy. Between 1986 and 1988, ANCs sold an estimated $1.5 billion in losses, for $426 million in revenues. Today many ANCs are profitable and diversified corporations. The tradeoff for the Federal Government was a reduction in taxes paid by the companies on the other end of the deals.

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Most losses sold were not the losses that ANCs had incurred by spending more cash than they took in on direct operations. ANCs deliberately generated NOLs by selling natural resources, such as logging and mining rights, at less than the originally assessed value. The sales resulted in losses of asset value (http://en.wikipedia.org/wiki/Asset), equal to the differences between the book value of the assets and the sale prices. NOLs-selling activity was also unevenly distributed among ANCs: CIRI (http://www.ciri.com/), Sealaska (http://www.sealaska.com/page/home), and Doyon (http://www.doyon.com/) corporations accounted for 60% of total NOLs sales.

Debate over NOLs-selling

Critics such as Joe Mehrkens, a forest economist, assert (http://www.adn.com/article/20110526/sealaska-land-bill-just-more-same) that loss selling encouraged business practices that were specifically designed to reap cash profits while incurring large "book losses," often to the detriment of sustainability.

As expressed in a 1988 document by Monica E Thomas (http://www.alaskool.org/projects/ancsa/ARTICLES/mthomas/ANCSA_Update.htm), at the University of Alaska:

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> “A technical amendment in the 1986 Tax Reform Act (US Public Law 99-514 1986) permits Alaska Native corporations to sell net operating losses to profitable corporations which use the losses to reduce their taxes through write-offs. Up to 80% of the tax savings are then funneled back to the Native corporations. This provision was created to aid financially ailing Native corporations, but critics argue that accounting manipulation has created huge paper losses never anticipated by the writers of the legislation.”

Logging practices designed to create asset losses exemplify critics’ concerns about bookkeeping manipulations and poor stewardship. Many ANCs sold the logging rights on their forests at prices below their assessed values, creating both cash revenues and major asset losses.

Another example is the Bering River Coal Field (/Issues/AlaskaCoal/BeringCoalDeposit.html), where coal mining rights were sold at a loss. The Bering River Coal remains in the ground today, almost two decades after the end of NOLs selling. Selling the asset was sufficient to generate NOLs. Provided the rights to extract a resource were sold, actual resource extraction was not strictly necessary, but was often conducted to generate more revenues. Large-scale clear-cutting of ANC forests in many cases depleted both long-term asset value and the ecological base of local subsistence practices.

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Proponents argued that there were long delays in delivery to Native Corporations of lands promised in the Alaska Native Claims Settlement Act (ANCSA) (http://en.wikipedia.org/wiki/Alaska_Native_Claims_Settlement_Act). During that time, Alaskan timber prices plummeted. From this perspective, ANCs suffered major asset losses as a result of delays in land delivery, since they could have sold their timberland at higher prices if it had been delivered to them immediately:

As stated in a Doyon Native Corporation tax-related appeal (http://law.justia.com/cases/federal/appellate-courts/F3/214/1309/533497/):

> “By the mid-1980s, due in large measure to delay caused by Congressional inaction in providing title to the land that had been selected by the Native Corporations, many of the Native Corporations were in severe financial difficulties. The various Native Corporations incurred substantial operating losses during this period, bringing some to the verge of bankruptcy. In an attempt to alleviate some of these fiscal problems, Congress enacted § 60(b)(5) of the Deficit Reduction Act of 1984 (”DEFRA 1984”), which afforded special tax treatment for the Native Corporations.

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Further Reading

> A 1997 lawsuit brought by Native Village Corporations against Native Regional Corporations over loss-selling (http://caselaw.lp.findlaw.com/scripts/getcase.pl?navby=search&case=/data2/circs/9th/9535857.html)

> "Financial Performance of Native Regional Corporations" (1991) prepared by University of Alaska, Anchorage (http://www.iser.uaa.alaska.edu/Publications/corpfinance.pdf)

> "Another Environmental Crisis Confronts Prince William Sound" (1990) article by the Seattle Times (http://community.seattletimes.nwsource.com/archive/?date=19900401&slug=1064185)

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