

**REPORT #773**

**TAX SECTION**

**New York State Bar Association**

Valuation of a Loss Corporation

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# TAX SECTION

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October 20, 1993

Hon. Leslie B. Samuels  
Assistant Secretary (Tax Policy)  
Department of the Treasury  
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1500 Pennsylvania Avenue, N.W.  
Washington, D.C. 20220

Hon. Margaret Richardson  
Commissioner of Internal Revenue  
Internal Revenue Service  
1111 Constitution Avenue  
Room 3000  
Washington, D.C. 20224

Dear Assistant Secretary Samuels  
and Commissioner Richardson:

In February, 1991, the Treasury Department and Internal Revenue Service published Prop. Reg. §1.382-2T(f)(18)(i), which provides that in determining whether an ownership change of a loss corporation has been effected, all shares of the loss corporation having the same material terms are treated as having the same value.<sup>1</sup> In other words, in determining whether more than 50% in value of a loss corporation's stock has changed hands, features such as control premiums and blockage discounts are ignored.

<sup>1</sup> This letter was drafted by Robert A. Jacobs (co chair) and Reuven S. Avi-Yonah and Linda Z. Swartz of the Committee on Net Operating Losses. Significant contributions were made by Peter Canellos, Arthur Feder, Richard Loengard, Carolyn Lee and Michael Schler.

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On August 13, 1993, the Service issued TAM 9332004, addressing the valuation of a loss Corporation once an ownership change has been effected. TAM 9332004 holds that the section 382 limitation may reflect a control premium above the trading value of the minority stock on the New York Stock Exchange. The valuation method endorsed in the TAM to value the loss corporation differs from the one espoused in the proposed regulation to value stock to determine whether an ownership change has been effected. We agree the different purposes of the two rules justify different methods of valuing the loss corporation stock. We therefore write to express our agreement with both the proposed regulation and the TAM holding, and recommend that the proposed regulation be adopted in final form with a clarification reflecting the TAM holding.

Code §382, as modified in 1986, is an objective supplement to the subjective rule of section 269, which disallows the use of acquired tax attributes if the principal purpose of the acquisition was the evasion or avoidance of tax by using attributes the taxpayer would not otherwise enjoy. Code §382 is designed to provide a bright-line test of when the tax attributes of a loss corporation should be limited. To determine whether an ownership change has been triggered, administrative simplicity and clarity are best served by the approach adopted by the proposed regulations, i.e., all shares of the same class be treated as having the same value (the "Equal Value Rule"). Otherwise, loss corporations and IRS personnel would frequently face considerable uncertainty in determining whether an ownership change had occurred.

Assume that in an initial public offering of 50% of loss corporation L, 40% is purchased (at the public offering price) by individual A, and the remaining 10% by the L public, and that none of the new shareholders previously owned any L stock. Under Code §382(g)(1), an ownership change is triggered only if the percentage held by the new shareholders (treating the public as a single 5% shareholder under Code §382(g)(4)(A)) increases by more than 50 percentage points over the lowest percentage held by them in the preceding three years. Because in this example the percentage point increase of all new shareholders is exactly 50, no ownership change has been effected.

Under Code §382(k)(6)(C), the percentage of stock held by any person is determined by value. If the 50% of the L stock not issued in the IPO is held by ten shareholders, each of whom holds five percent of the stock, arguably the 40% purchased by A carries with it a control premium because A is the largest L

shareholder.<sup>2</sup> If the Equal Value Rule were not adopted and the TAM control premium analysis were applied in this situation, L has undergone an ownership change if the 40% stock interest acquired by A is worth more than 40% of the total stock value.

Determining control premiums, blockage discounts and the effects of operative securities law restrictions frequently would lead to unacceptable lack of certainty in determining whether an ownership change has taken place. The valuation of blocks of stock is inherently uncertain, and it would be difficult for L to determine how much the stock purchased by A is worth as compared with the other shares. Should a blockage discount be applied to A because it would be difficult for her to sell all of her 40% simultaneously, and if applied, would it offset the control premium? Moreover, it is unclear as a policy matter why a control premium should be taken into account in determining the value of shares that are publicly traded, when the purpose is to determine whether 50% of L's market capitalization had changed hands in the relevant time frame. The Equal Value Rule of the proposed regulation advances the purpose of Code §382 to provide a bright line, administrable test of when an ownership change is deemed to take place.

No such constraint is present when determining the value of a loss corporation that has undergone an ownership change. In determining the section 382(b) limitation, valuation is necessary in any event, and the value of the stock serves as a reasonable proxy for the value of the loss corporation. If 49% of the shares of a loss corporation are publicly traded and the other 51% are held by an individual, attributing the trading value to the controlling 51% would underestimate the value of the corporation, because the 49% are presumably worth less than what they would have been worth if all shares had been trading precisely because they are a minority block and the 51% carry a control premium. Thus, it is reasonable to include such factors as a control premium (and blockage discount) in the valuation. This approach, taken in the TAM, finds support in the legislative history of

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<sup>2</sup> See, e.g., Moore-McCormack Lines, Inc. v. Commissioner, 44 T.C. 745 (1965), relied upon in the TAM, in which a block representing 13% of a corporation was valued at more than 13% of the value of the corporation as determined by the public trading price of small blocks of stock.

section 382.<sup>3</sup> The authorities relied upon in the TAM relate solely to valuing the loss corporation for determining the section 382 limitation and do not apply to determining whether an ownership change has taken place.

We thus recommend the Equal Value Rule of Proposed Regulation §1-382-2T(f)(18)(i) be adopted, with a clarification that states that the Equal Value Rule does not apply in determining the value of the loss corporation for purposes of the section 382(b) limitation. We also recommend the regulation, as amended, apply to all testing dates (and not just to testing dates after January 28, 1991).

Respectfully submitted,

Peter C. Canellos

cc: Harry L. Gutman

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<sup>3</sup> See H.R. Rep. No. 841, 99th Cong., 2nd Sess., at II-187 (1986), cited in the TAM, indicating that future regulations should take into account a control premium in valuing the loss corporation stock for section 382(b) purposes. This approach to valuation is also followed by case law under section 1239(c), which generally holds that factors such as control premiums and restrictions on transferability are to be taken into account in determining whether an entity was "controlled" for purposes of section 1239. See, e.g., United States v. Parker, 376 F.2d 402 (5th Cir., 1967); Trotz v. Commissioner, 311 F.2d 927 (10th Cir. 1966); Rev. Rul. 69-339, 1969-1 C.B. 202.