NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON NOTICE 2010-49

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Report No. 1238

New York State Bar Association Tax Section

REPORT ON NOTICE 2010-49

This report, prepared by an *ad hoc* committee of the New York State Bar Association Tax Section (the "Tax Section"),[1] responds to the Internal Revenue Service's (the "Service") request for comments in Notice 2010-49[2] (the "Notice"), which discusses potential modifications to the treatment of less than 5-percent shareholders under section 382 ("Small Shareholders").[3] We commend the government for undertaking a thorough consideration of the issues presented by the Notice. We believe that the current segregation rules cause loss corporations[4] to devote substantial time and resources tracking stock transfers involving Small Shareholders and result in ownership changes in cases where there is no identifiable abuse under section 382. Accordingly, this report discusses our recommended modifications to the segregation rules, including the current exceptions to these rules, as well as the statutory support and policy rationale for these changes. Finally, we briefly discuss potential amendments to section 382 that Congress might consider in order to focus the statute's application squarely on transactions that conflict with the statute's policies.

I. Background

In general, a corporation may carry back an NOL to each of the preceding two taxable years and carry over an NOL to each of the subsequent 20 taxable years.[5] The carryover rules permit taxpayers to average income and loss over multiple years and thus reduce distortions that would otherwise result from the annual accounting system.[6] At the same time, Congress recognized that the NOL carryover rules could lead to abusive transfers of loss corporation stock, stating that "a taxpayer could purchase the stock in a loss corporation, sell the corporation's

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[2] 2010-27 I.R.B. 10 (June 11, 2010).

[3] Unless otherwise indicated, all references to sections are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations promulgated thereunder.

[4] A "loss corporation" includes a corporation that is entitled to use a net operating loss ("NOL") carryover, a net unrealized built-in loss ("NUBIL"), a capital loss carryover, a carryover of excess foreign tax credits under section 904(c), or a carryover of general business credits or minimum tax credits under section 39 or section 53, as applicable (each, a "tax attribute"). Treas. Reg. § 1.382-2(a)(1).

[5] I.R.C. § 172(b)(1)(A). Section 172 and the accompanying Treasury regulations contain significant modifications to these general rules, which are beyond the scope of this report.

[6] S. Rep. No. 313, 99th Cong., 2d Sess., at 230 (1986), 1986-3 C.B. (vol. 3) 230; H.R. Rep. No. 426, 99th Cong., 1st Sess., at 255 (1985), 1986-3 C.B. (vol. 2) 255.

assets back to the original shareholders, and then contribute assets comprising a new business to the corporation. This series of transactions would permit the transfer of NOL carryforwards for use against another taxpayer's income."[7] Accordingly, in 1986, Congress enacted current section 382 and, as discussed below, significantly limited a corporation's utilization of its NOL carryforward following an ownership change. Congress intended that the statute would "restrict the function of carryforwards to that of an averaging device" and "reduce the number of circumstances in which NOL carryforwards can be used as a device for transferring tax benefits."[8]

Following an ownership change, section 382 limits the amount of a loss corporation's taxable income that can be offset each year by pre-change NOLs and certain built-in losses.[9] An ownership change occurs if, immediately after any owner shift[10] involving a 5-percent shareholder or an equity structure shift, one or more 5-percent shareholders have increased their aggregate ownership in the loss corporation stock[11] by more than 50 percentage points during a rolling period that is normally three years (the "testing period").[12] A 5-percent shareholder is

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7 H.R. Rep. No. 426, 99th Cong., 1st Sess., at 256 (1985), 1986-3 C.B. (vol. 2) 256.

8 *Id.* For a discussion of section 382's history, see Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations & Shareholders*, ¶ 14.42 (7th ed., 2010 Supp).

9 A discussion of other tax attribute limitation provisions, such as sections 269, 383 and 384, is beyond the scope of this report.

10 An owner shift is any change in the ownership of loss corporation stock that affects the percentage of such stock owned by a 5-percent shareholder, while an equity structure shift is one of certain specified section 368 reorganizations, as discussed below. I.R.C. § 382(g)(3); Temp. Treas. Reg. § 1.382-2T(e)(1).

11 For this purpose, "stock" generally includes both common and preferred stock other than "plain vanilla" preferred stock described in section 1504(a)(4). Treas. Reg. § 1.382-2(a)(3). In addition, section 382 provides that the Treasury Department may issue regulations treating "stock" as "not stock" and treating warrants, convertible debt interests and other similar interests as "stock". *See* Temp. Treas. Reg. § 1.382-2T(f)(18)(ii)-(iii).

12 I.R.C. § 382(g)(1), (i). The Treasury regulations determine ownership percentages based on the fair market value of the stock held by each shareholder relative to the total fair market value of the loss corporation's outstanding stock. Treas. Reg. § 1.382-2(a)(3)(i). A loss corporation must determine whether an ownership change has occurred on each testing date, *i.e.*, any date on which there is a change in ownership of loss corporation stock that affects the percentage of stock owned by a 5-percent shareholder. Treas. Reg. § 1.382-2(a)(4); Temp. Treas. Reg. 1.382-2T(e); *see* Temp. Treas. Reg. § 1.382-2T(c)(1) (applying the following "snapshot" approach to determine whether an ownership change has occurred: (i) the loss corporation must identify each 5-percent shareholder whose percentage of stock ownership in the loss corporation immediately after the close of the testing date has increased, compared to such shareholder's lowest percentage of stock ownership in such corporation at any time during the testing period, (ii) the loss corporation must compute the increase in the percentage ownership of each 5-percent shareholder separately by comparing such shareholder's percentage ownership immediately after the close of the testing date to such shareholder's lowest percentage ownership at any time during the testing period, and (iii) the loss corporation must add together all of the increases in the percentage ownership of 5-percent shareholders and disregard each 5-percent shareholder whose percentage ownership immediately after the close of the testing date has decreased or remained the same, compared to such shareholder's lowest percentage ownership interest during the testing period).

any person that owns, directly or indirectly, at least 5 percent of the loss corporation's stock (by value).[13] After an ownership change, the annual limitation on a loss corporation's NOL carryforward generally equals the product of (i) the loss corporation's equity value immediately before the ownership change (subject to certain adjustments), and (ii) the long-term tax exempt rate.[14] Section 382 increases the annual limitation for any built-in gain recognized by the loss corporation during the 5-year period after an ownership change to the extent that the loss corporation has a net unrealized built-in gain ("NUBIG") on the ownership change date.[15]

Since section 382 measures an ownership change by increases in loss corporation stock ownership among 5-percent shareholders, the 5-percent shareholder definition is critically important. Section 382 generally aggregates, and treats as a single 5-percent shareholder, all shareholders who directly own less than 5 percent of the loss corporation's stock (a "public group"),[16] while certain transactions, such as issuances of loss corporation stock, generally create additional segregated public groups.[17]

First, the aggregation rules generally apply to shareholders who each directly own less than 5 percent of a loss corporation's stock and similarly to owners of an upper tier entity[18] who each indirectly own less than 5 percent of the loss corporation's stock. The aggregation rules begin at the level of the highest tier entity that owns, directly or indirectly, at least 5 percent of the loss corporation's stock and generally apply as follows: (i) each individual who directly owns at least 5 percent of the loss corporation's stock is a 5-percent shareholder, (ii) each individual who (x) is a 5-percent owner of an upper tier entity and (y) indirectly owns at least 5 percent of the loss corporation's stock solely by reason of the stock attributed to such individual through the upper tier entity is a 5-percent shareholder of the loss corporation,[19] (iii) if the

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[13] I.R.C. § 382(k)(6)(C), (7); Temp. Treas. Reg. § 1.382-2T(g).

[14] I.R.C. § 382(e)(1). In addition, a loss corporation generally must satisfy a continuity of business enterprise test for two years after an ownership change or the annual limitation will be zero. I.R.C. § 382(c). Special rules apply after an ownership change occurring pursuant to a confirmed bankruptcy plan. *See* I.R.C. § 382(*l*)(5)-(6).

[15] I.R.C. § 382(h)(1)(A)(i), (h)(7). By contrast, built-in losses recognized by the loss corporation during the 5-year period after an ownership change are subject to the annual limitation as pre-change losses to the extent that the loss corporation has a NUBIL on the ownership change date. I.R.C. § 382(h)(1)(B)(i), (h)(7).

[16] I.R.C. § 382(g)(4)(A); Temp. Treas. Reg. § 1.382-2T(g)(1)(ii), (j)(1), (j)(2)(ii).

[17] *See* Temp. Treas. Reg. § 1.382-2T(j)(2)(iii).

[18] As used herein, an "upper tier entity" generally means a first tier entity or higher tier entity, as those terms are defined in Temporary Treasury Regulation section 1.382-2T(f).

[19] In addition, the segregation rules relating to issuances and redemptions of loss corporation stock do not apply to a regulated investment company's ("RIC") issuance or redemption in the ordinary course of business of stock that is redeemable upon the shareholder's demand. Treas. Reg. § 1.382-3(k)(1). The government explained that these exemptions were appropriate in order to relieve mutual funds of the administrative burdens created by their continuous issuance and redemption of shares. Preamble, 56 Fed. Reg. 55,858, 55,859 (Oct. 30, 1991).

owners of the highest tier entity who each indirectly own less than 5 percent of the loss corporation's stock indirectly own, in the aggregate, at least 5 percent of the loss corporation's stock, those owners constitute a separate public group and 5-percent shareholder of the loss corporation, (iv) if any separate public group in clause (iii) above indirectly owns, in the aggregate, less than 5 percent of the loss corporation's stock, such public group's stock is treated as part of the public group of the next lower tier entity, and (v) the loss corporation's public group constitutes a 5-percent shareholder of the loss corporation even if such group owns less than 5 percent of the loss corporation's stock.[20]

> **Example 1:** Small Shareholders own all of the outstanding stock of L, a loss corporation, and corporation P ("Public L" and "Public P", respectively). P purchases all of L's stock through a series of transactions on a public stock exchange. As of July 30, 2010, P acquired 51 percent of L's stock. Public P and Public L own 51 percent and 49 percent, respectively, of L's stock. Public P is treated as a 5-percent shareholder whose stock ownership in L, as of the July 30, 2010, testing date, has increased by more than 50 percentage points during the testing period. Accordingly, L experiences an ownership change on July 30, 2010.[21]

Second, the segregation rules, if applicable, create additional separate public groups and 5-percent shareholders of the loss corporation. The segregation rules include the following: (i) upon an equity structure shift to which a loss corporation is a party or any other loss corporation stock issuance covered by section 1032, the public group shareholders receiving loss corporation stock constitute a separate direct public group and separate 5-percent shareholder from the public groups that existed before the transaction,[22] (ii) if a loss corporation redeems any of its stock, each direct public group that existed before the transaction is segregated into two groups, one from which the redemption is made and the other consisting of those shareholders who did not redeem any of their stock,[23] (iii) if an entity or individual directly owning at least 5 percent of a loss corporation's stock transfers any such stock to a public group, the direct public group receiving the shares is segregated from the direct public groups that existed before the transaction and is treated as a separate 5-percent shareholder,[24] and (iv) the principles of clauses (i)-(iii) above apply to transactions involving the ownership interests of upper tier entities that own at least 5 percent of the loss corporation's stock.[25]

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20 Temp. Treas. Reg. § 1.382-2T(g)(1)-(3), (j)(1).

21 *See* Temp. Treas. Reg. § 1.382-2T(j)(1)(vi), Ex. 1.

22 Temp. Treas. Reg. § 1.382-2T(j)(2)(iii)(B).

23 Temp. Treas. Reg. § 1.382-2T(j)(2)(iii)(C).

24 Temp. Treas. Reg. § 1.382-2T(j)(3)(i).

25 Temp. Treas. Reg. § 1.382-2T(j)(3)(i), (iii). Any segregation resulting from these rules applies only in determining whether an ownership change occurs within the testing period that includes the relevant transaction. Temp. Treas. Reg. § 1.382-2T(g)(1)-(3), (j)(1). A loss corporation may elect to combine any public groups first identified in the same taxable year resulting from the application of clause (i) and the

Example 2: A direct public group owns all of the outstanding stock of L, a loss corporation ("Public L"). L completes a common stock offering that increases its outstanding stock from 100,000 shares to 300,000 shares. No person owns at least 5 percent of L's stock after the offering. Section 1032 applies to L's offering. Because of the offering, Public L is segregated from the direct public group that would otherwise exist immediately after the transaction. The 200,000 shares of L stock acquired in the offering are treated as acquired by a direct public group ("New Public L") that is separate from Public L. As a result of the offering, L has two 5-percent shareholders, Public L and New Public L, which own 33-1/3 percent and 66-2/3 percent, respectively, of L's stock. New Public L is a 5-percent shareholder that has increased its ownership interest in L by more than 50 percentage points during the testing period. Accordingly, L experiences an ownership change as a result of the offering.[26]

In addition, public shareholders that acquire loss corporation stock from the loss corporation are treated as a separate public group, subject to two limited exceptions promulgated in 1993--the "small issuance" and "cash issuance" exceptions. A "small issuance" generally is an issuance of loss corporation stock that, together with all prior issuances during the taxable year, represents not more than 10 percent of the corporation's outstanding stock as of the beginning of the year, determined either on a class-by-class basis or based on the value of all of the corporation's stock (other than section 1504(a)(4) stock), generally at the loss corporation's option.[27] If the small issuance exception does not apply to an issuance solely for cash, the cash issuance exception applies to the percentage of stock issued that equals 50 percent of the aggregate percentage of the loss corporation's stock owned by direct public groups.[28] Stock covered by either exception is treated as having been acquired proportionately by each direct public group that exists before the issuance.[29] These exceptions do not apply to an equity structure shift, except that the small issuance exception potentially applies to a recapitalization that qualifies as an "E" reorganization.[30] The principles of the small

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comparable portion of clause (iv) above if such groups separately own less than 5 percent of the loss corporation's stock. Temp. Treas. Reg. § 1.382-2T(j)(2)(iv)(A), (j)(3)(iii).

[26] *See* Temp. Treas. Reg. § 1.382-2T(j)(2)(iii)(B)(2), Ex. 3. The "cash issuance" exception discussed immediately below would modify this result. *See* Treas. Reg. § 1.382-3(j)(3).

[27] Treas. Reg. § 1.382-3(j)(2)(iii); *see* Notice 2010-50, 2010-27 I.R.B. 12 (June 11, 2010) (addressing impact of fluctuations in value among multiple classes of stock and noting that such principles are relevant in applying Treasury Regulation section 1.382-3(j)).

[28] Treas. Reg. § 1.382-3(j)(3)(i). *See also* Treas. Reg. § 1.382-3(j)(8) (integrating multiple stock issuances under certain circumstances).

[29] Treas. Reg. § 1.382-3(j)(2)-(3).

[30] Treas. Reg. § 1.382-3(j)(6).

issuance and cash issuance exceptions also apply to equity issuances by an upper tier entity that owns at least 5 percent of the loss corporation's stock.[31]

II. Notice 2010-49

In the Notice, the Service requested comments regarding potential modifications to the treatment of Small Shareholders under the Treasury regulations.[32] The Notice explained that the policy considerations underlying section 382 should determine the proper treatment of Small Shareholders and outlined two general approaches to their treatment, the Ownership Tracking Approach and the Purposive Approach.

The Ownership Tracking Approach, which the current Treasury regulations primarily reflect, seeks to ensure that section 382 applies to all abusive transactions by tracking all changes in ownership without regard to their particular circumstances. Accordingly, since it is generally not significant under the Ownership Tracking Approach whether the loss corporation shareholders who increase their ownership are Small Shareholders or 5-percent shareholders, any transaction that allows the corporation to track the increase in ownership interests held by Small Shareholders generally results in the segregation of those shareholders into a new public group.[33]

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[31] Treas. Reg. § 1.382-3(j)(11). Certain presumptions apply for purposes of the aggregation and segregation rules, including the following: (i) in applying the aggregation rules, members of a public group generally are presumed not to be members of any other public group and not to be related to any other direct or indirect shareholder, (ii) any new public group created by a segregation transaction involving an issuance of loss corporation stock or a transfer of loss corporation stock by a 5-percent shareholder generally is presumed not to include any members of a public group that existed before the transaction, and (iii) in the case of a segregation transaction involving a redemption of loss corporation stock, any new public group that owned the redeemed shares generally is presumed to own no such stock after the transaction. Temp. Treas. Reg. § 1.382-2T(j)(1)(iii), (j)(2)(iii)(B)-(D), (j)(3)(i) and (iii). *See also* Temp. Treas. Reg. § 1.382-2T(j)(2)(vi) (if multiple public groups exist because of segregation rules, an acquisition of loss corporation stock by 5-percent shareholder or the loss corporation generally is treated as made proportionately from each public group that existed before the acquisition); Temp. Treas. Reg. § 1.382-2T(k)(1)(i) (if loss corporation is subject to Regulation 13D-G promulgated pursuant to the Securities and Exchange Act of 1934, such corporation generally may rely on existence or absence of filings of Schedules 13D or 13G to identify such corporation's direct 5-percent shareholders as of any date). These presumptions, however, are subject to limitations, including: (i) a loss corporation generally must take into account actual knowledge regarding stock ownership of an individual or entity who owns, directly or indirectly, at least 5 percent of the loss corporation's stock if the loss corporation obtains such knowledge prior to filing its tax return for the taxable year in which the applicable testing date occurs, and (ii) a loss corporation may, but need not, take actual knowledge of cross ownership between members of public groups into account. Temp. Treas. Reg. § 1.382-2T(k)(2).

[32] The government also included the issues raised by the Notice on the current priority guidance plan. *See* Joint Treasury, IRS 2010-11 Priority Guidance Plan, at 4 (Dec. 7, 2010), *reprinted in* BNA Tax Mgmt. Weekly Rept. (Dec. 13, 2010).

[33] The current Treasury regulations exclude transfers between Small Shareholders given the undue burden such tracking would impose. *See* Temp. Treas. Reg. § 1.382-2T(e)(1)(ii).

By contrast, under the Purposive Approach, it would not be necessary to track all readily identifiable stock acquisitions by Small Shareholders, because Small Shareholders generally do not acquire loss corporation stock in order to traffic in NOLs, *e.g.*, by contributing income-producing assets or diverting income-producing opportunities to the loss corporation.[34] The limited and expansive versions of the Purposive Approach ("Limited Purposive Approach" and "Expansive Purposive Approach") discussed below each limit the segregation rules to those circumstances in which abusive transactions may arise.

The Notice illustrates the operation of the Ownership Tracking Approach and two versions of the Purposive Approach with two examples. In the first example, the Original Public Group owns all of the stock of X, a loss corporation. During the testing period, each of three investors acquires 10 percent of X's stock from Small Shareholders on different dates within the same testing period, and then resells the stock to Small Shareholders within a few months. Only one of the three investors holds X stock at any one time.

> Ownership Tracking Approach: A new segregated public group results each time an investor sells its X stock to Small Shareholders, and the resulting three new public groups would have a collective ownership interest and increased interest in X of 27.1 percent.[35]
>
> Limited Purposive Approach: The Original Public Group, rather than new segregated public groups, would be treated as acquiring the X stock that each investor sells to Small Shareholders. The Original Public Group would be considered to have increased its ownership interest in X only by 10 percent (90 percent to 100 percent).[36]
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> Expansive Purposive Approach: The Original Public Group would be treated as owning X's stock during the period in which the relevant investor owned the shares, thereby avoiding any owner shift.[37]

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[34] Notice 2010-49, 2010-27 I.R.B. at 11.

[35] The segregation rules require the creation of a new public group when each investor sells its X stock to Small Shareholders. Temp. Treas. Reg. § 1.382-2T(e)(1)(ii). Therefore, X has four 5-percent shareholders: Original Public Group, New Public Group 1, New Public Group 2 and New Public Group 3. The segregation rules treat each investor as acquiring its X stock proportionately from the direct public group(s) that exist immediately before the relevant acquisition. Temp. Treas. Reg. § 1.382-2T(j)(3)(i). New Public Group 1, New Public Group 2 and New Public Group 3 increased their aggregate ownership interest in X by 27.1 percent: (i) New Public Group 1 (0 percent to 8.1 percent), (ii) New Public Group 2 (0 percent to 9 percent), and (iii) New Public Group 3 (0 percent to 10 percent).

[36] The Original Public Group's ownership interest in X decreased to 90 percent each time an investor acquired a 10 percent interest in X from Small Shareholders, and increased to 100 percent upon such investor's sale of its X stock to Small Shareholders.

[37] Notice 2010-49, 2010-27 I.R.B. at 11.

In the second example, the facts are the same as above except that all of the three investors' acquisitions precede any dispositions to Small Shareholders.

> Ownership Tracking Approach: A new segregated public group results each time an investor sells its X stock to Small Shareholders, and the resulting three new public groups increase their aggregate ownership interest in X by 30 percent.[38]
>
> Limited Purposive Approach: The Original Public Group would be treated as increasing its ownership interest in X by 30 percent (70 percent to 100 percent).[39]
>
> Expansive Purposive Approach: The Original Public Group would be treated as always having owned the X stock owned by the investors for all testing dates on or after the sales to Small Shareholders, resulting in no increase in the ownership interest of any 5-percent shareholder during the testing period.[40]

The Expansive Purposive Approach could treat the Original Public Group, for testing dates on or after the Original Public Group acquires the stock from an investor, as having owned the stock during the period such stock was owned by the seller, thus eliminating any increase in X stock ownership by a 5-percent shareholder during the testing period. The Notice explains that the Expansive Purposive Approach "would be justified on the grounds that where Small Shareholders owned the shares at the beginning of the testing period and on the last testing date, no shareholder has increased its ownership interest in such a way that would allow it to engage in any abuse that § 382 was enacted to prevent."[41]

Recognizing the significant regulatory changes that the complete adoption of the Purposive Approach would require, the Notice suggests that it may be appropriate to limit the adoption of the Purposive Approach to certain transactions, and observes that stock issuances, which allow the loss corporation to receive additional income-producing capital, present concerns that neither shareholder sales nor shareholder redemptions present.[42] The Notice also explains that the government is considering more targeted changes to the segregation rules, such

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[38] Under the Ownership Tracking Approach in the first example, the aggregate owner shift was only 27.1 percent because the segregation rules (i) treat the second investor as acquiring a portion of its X stock from the new public group created by the first investor's prior sale, and (ii) treat the third investor as acquiring a portion of its X stock from the two new public groups created by the first and second investors' prior sales. Temp. Treas. Reg. § 1.382-2T(j)(2)(vi). Accordingly, the investors' purchases of X stock from the new public groups reduced the aggregate ownership interests of these public groups by 2.9 percent. This rule was inapplicable in the second example above because all of the investors' purchases of X stock occurred prior to any dispositions of X stock.

[39] The Original Public Group's ownership interest in X decreased to 70 percent due to the investors' purchases of an aggregate 30 percent interest in X stock, and increased to 100 percent upon the investors' sale of their X stock to Small Shareholders.

[40] Notice 2010-49, 2010-27 I.R.B. at 11.

[41] *Id.*

[42] *Id.*

as the possible expansion of the cash issuance exception to cover stock for debt exchanges and of the small issuance exception to exempt larger share issuances.[43]

III. Summary of Recommendations

The following is a summary of our principal recommended modifications to the segregation rules:

1. Except as provided below, the Limited Purposive Approach should apply to transactions involving a loss corporation's Small Shareholders.[44] The Limited Purposive Approach generally would treat a loss corporation's existing direct public group(s) (collectively, the "Initial Public Group") as acquiring or surrendering the relevant shares of loss corporation stock, as applicable.[45] Under the Limited Purposive Approach, on any testing date, a loss corporation would measure any increase in the Initial Public Group's ownership in comparison to the Initial Public Group's lowest ownership interest in the loss corporation during the testing period.

2. The Limited Purposive Approach should apply to a 5-percent shareholder's transfer of loss corporation stock to Small Shareholders without regard to the manner in which the transferor 5-percent shareholder acquired its loss corporation stock.

3. The Limited Purposive Approach should apply to a loss corporation's redemption of its stock from Small Shareholders (or other similar transaction), other than any such transaction that violates an applicable anti-abuse rule.

4. The Treasury Department should (i) expand the existing 10-percent limitation for the small issuance exception to 25 percent, (ii) in the case of an upper tier entity, clarify that the small issuance exception under the existing Treasury regulations allows the entity to issue an amount of shares that represents an indirect stock ownership interest in the loss corporation of up to 10 percent, and (iii) broaden the cash issuance exception to apply to stock issuances in exchange for non-cash property.

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[43] *Id.* at 11-12.

[44] For the avoidance of doubt, we are not proposing any changes to the aggregation rules in Temporary Treasury Regulation section 1.382-2T(j)(1).

[45] If the loss corporation has multiple direct public groups immediately prior to the transaction, we recommend that each such group generally be treated as participating proportionately in the transaction. *See* Temp. Treas. Reg. § 1.382-2T(j)(2)(vi) (unless loss corporation or Service establishes a different proportion, acquisition of loss corporation stock by 5-percent shareholder or loss corporation on any date on which multiple public groups exist due to the segregation rules is treated as made proportionately from each public group existing immediately before the acquisition).

5. Except as provided below, the principles of each of our recommendations should extend to stock or other equity transfers by the direct or indirect owners of upper tier entities. In the case of any redemption or similar transaction by an upper tier entity, any otherwise applicable anti-abuse rule should apply only if the loss corporation has actual knowledge of the relevant transactions and related abuse.

6. The segregation rules should not apply to transactions involving an upper tier entity that owns, directly or indirectly, less than 30 percent of the relevant loss corporation's stock.

7. Ordinary course issuances and redemptions of shares by an upper tier entity to or from owners who indirectly own less than 5 percent of the loss corporation's stock should be treated as exempt "public trading" if the upper tier entity provides primary liquidity to its owners in this manner (an "Investment Entity").

8. The potential amendments to section 382 discussed in Part IV.D below would merit consideration if Congress decides to more narrowly focus section 382 on only those transactions that conflict with the statute's policies.

IV. Analysis and Recommendations[46]

A. Statutory Authority for Segregation Rule Changes

The government has ample authority to adopt the Limited Purposive Approach in applying the segregation rules, and nothing in section 382 prohibits adoption of the approach.

First, the public group rule in section 382(g)(4)(A) treats all of a loss corporation's Small Shareholders as a single 5-percent shareholder. The Limited Purposive Approach is consistent with the public group rule insofar as this approach would treat all increases by the Initial Public Group as owner shifts and would take these owner shifts into account in determining whether the loss corporation experiences an ownership change.

Under section 382(g)(4)(B), an equity structure shift, which is any section 368 reorganization other than an "F" reorganization or a divisive "D" or "G" reorganization, is the only type of transaction for which Congress mandated a segregation rule.[47] Although the statute generally provides as a default that the segregation rules should apply in determining whether other transactions constitute owner shifts involving 5-percent shareholders and whether a loss corporation experiences an ownership change, Congress expressly granted the Treasury

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[46] The Appendix contains examples illustrating the application of the Limited Purposive Approach and the expanded small issuance exception.

[47] I.R.C. § 382(g)(4)(B)(i). The statute provides that, to the extent provided in regulations, an equity structure shift may also include "taxable reorganization-type transactions, public offerings, and similar transactions." I.R.C. § 382(g)(4)(B)(ii). This result is effectively achieved under current regulations by treating stock issuances as segregation events.

Department the authority to change this result in regulations.[48] In addition, section 382(m)(4) expressly grants the Treasury Department the authority to prescribe regulations applying section 382(g)(4) to single corporation transactions, including a recapitalization that constitutes an "E" reorganization and, thus, an equity structure shift.

Second, nothing in the legislative history or the Bluebook suggests that Congress intended to mandate the application of the segregation rules beyond multi-party section 368 reorganizations that constitute equity structure shifts under section 382(g)(3)(A). These sources do indicate Congress's intent that the Treasury Department extend the segregation rules to other transactions "in which it will be feasible to identify changes in ownership involving [Small Shareholders], because ... the changes occur as part of a single, integrated transaction ... [and] identification is reasonably feasible or a reasonable presumption can be applied. ..."[49] However, these sources are equally clear that Congress left the potential expansion of the segregation rules, and the scope of any such expansion, to the government's discretion.[50]

In addition, in connection with the earlier promulgation of the small issuance and cash issuance exceptions, the government expressly stated in the preamble to the then-proposed regulations: "The Service and the Treasury believe that it is appropriate to modify the segregation rules as applied to stock issuances that are not made in an equity structure shift."[51] The small issuance exception also applies to recapitalizations, notwithstanding that recapitalizations involving securities are also equity structure shifts if the transactions constitute

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[48] *See* I.R.C. § 382(g)(4)(C). The scope of section 382(g)(4)(C) is unclear. More specifically, based on the 1986 legislative history and the General Explanation of the Tax Reform Act of 1986 (the "Bluebook"), Congress may have intended section 382(g)(4)(C) to apply solely to transactions involving multiple entities. The Bluebook states that "Congress expected that section 382(g)(4)(C) would by its terms generally cause the segregation of the less-than-5-percent shareholders of separate entities where an entity other than a single corporation is involved in a transaction." Bluebook, at 304-05. Similarly, the legislative history and the Bluebook contain an example in which a loss corporation owned entirely by Small Shareholders issued stock to Small Shareholders in exchange for cash which tripled the issuer's value. Both sources concluded that the offering did not cause an ownership change in the absence of regulations expressly requiring this result (which were subsequently issued). *See* H.R. Rep. No. 841, 99th Cong., 2d Sess., at 178 (1986), 1986-3 C.B. (vol. 4) 178; Bluebook, at 305-06. Had Congress intended section 382(g)(4)(C) to address transactions involving a single corporation, the offering in the examples presumably would have resulted in an ownership change without the need for regulations. *Cf.* Bluebook, at 305 (loss corporation experienced an ownership change pursuant to section 382(g)(4)(C) where corporation's shareholders received 30-percent interest in combined company following a taxable merger). In any event, section 382(g)(4)(C), by its terms, allows the government to modify the segregation rules in the case of any transaction to which the provision would otherwise apply.

[49] H.R. Rep. No. 841, 99th Cong., 2d Sess., at 176 (1986), 1986-3 C.B. (vol. 4) 176; Bluebook, at 304.

[50] *See* H.R. Rep. No. 841, 99th Cong., 2d Sess., at 176-77 (1986), 1986-3 C.B. (vol. 4) 176-77; Bluebook, at 304-06.

[51] Preamble, 52 Fed. Reg. 52,738 52,739 (Nov. 5, 1992).

"E" reorganizations.[52] The Treasury Department presumably relied on the grant of regulatory authority in section 382(m)(4) in promulgating this rule.

Based on the foregoing, the adoption of our recommended modifications to the segregation rules would clearly represent a "reasonable interpretation" of section 382 that is consistent with the statute's underlying policies.[53]

B. Policy Rationale for Segregation Rule Changes

The Limited Purposive Approach is fully consistent with section 382's framework, as it would respect the Initial Public Group's status as a 5-percent shareholder and would take increases in that shareholder's ownership interest into account in determining whether a loss corporation has experienced an ownership change. In deciding how the Treasury Department should exercise its discretion to modify (and limit) the segregation rules, the fundamental policy issue is whether it is necessary to apply the segregation rules with respect to every readily identifiable transaction in order to achieve section 382's purposes. The Notice expressly recognizes that "one of the primary abuses § 382 seeks to prevent involves an acquisition of loss corporation stock followed by the contribution of income-producing assets or the diversion of income-producing opportunities to the corporation."[54] As the government previously recognized in enacting the small issuance and cash issuance exceptions, transactions involving Small Shareholders generally are less susceptible to producing results inconsistent with section 382's policies.[55]

Our recommendations are also consistent with both of the two additional policies that the Tax Section recently identified as underlying section 382: (i) tax considerations should neither incentivize nor discourage corporate acquisitions, and (ii) an administrable standard is necessary for determining section 382's application.[56] In our experience, business, investment or other economic objectives, rather than tax considerations, are usually the motivating force behind stock transactions, and, like the prior modifications to the segregation rules in the small issuance and cash issuance exceptions, our recommendations would give effect to a Small Shareholder's intent and be fully consistent with section 382's objective rules for measuring owner shifts and

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[52] Treas. Reg. § 1.382-3(j)(6).

[53] *See Mayo Foundation for Medical Education & Research v. United States*., 2011 U.S. LEXIS 609, at *24 (Jan. 11, 2001); *Chevron U. S. A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 844 (1984).

[54] Notice 2010-49, 2010-27 I.R.B. at 10. We acknowledge that the Ownership Tracking Approach reasonably effectuates this intent. However, as discussed above, Congress also granted the Treasury Department the authority to promulgate different (and less restrictive) rules for Small Shareholders.

[55] Preamble, 57 Fed. Reg. 52,738, 52,739 (Nov. 5, 1992).

[56] *See* New York State Bar Ass'n Tax Section, *Report on the Treatment of Fluctuations in Value Under Section 382(l)(3)(C)*, at 13-15 (Dec. 22, 2009).

determining whether a loss corporation experiences an ownership change, potentially employing an anti-abuse standard only in limited circumstances.[57]

We generally do not believe it is necessary to apply the segregation rules to identifiable transactions that do not reasonably implicate the abuses that section 382 intends to prevent. Moreover, adopting the Limited Purposive Approach and expansion of the small issuance and cash issuance exceptions may ameliorate the difficulties many loss corporations face in raising capital without triggering an ownership change despite the fact that no party has any intent to effect transactions inconsistent with section 382. In our view, relaxing the segregation rules would promote the worthwhile goal of allowing loss corporations more flexibility to engage in legitimate capital transactions, would likely provide greater certainty of the proper tax treatment of those transactions, and would significantly reduce the administrative burdens of loss corporations that currently devote significant time and resources analyzing owner shifts and testing for ownership changes.

In addition, our recommendations are consistent with the government's other guidance under section 382, including several notices and Treasury regulations that sensibly narrow the application of section 382. Adoption of the Limited Purposive Approach would continue the government's trend of providing thoughtful, balanced relief to taxpayers in this area.[58]

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[57] Notwithstanding section 382's objective approach, there are significant examples where the statute and Treasury regulations inquire as to a taxpayer's purpose. *See*, *e.g.*, I.R.C. § 382(*l*)(1)(A) (disregarding capital contribution received by loss corporation as part of a plan a principal purpose of which is to avoid or increase an annual limitation on corporation's NOL carryforward); Temp. Treas. Reg. § 1.382-2T(k)(4) (modifying regulation's application with respect to ownership interests structured to avoid treating a person as a 5-percent shareholder); Treas. Reg. § 1.382-4 (applying "a principal purpose test" to determine whether an option to acquire loss corporation stock is deemed exercised); Treas. Reg. § 1.382-9(d)(5)(iii) (modifying regulation's application with respect to indebtedness acquired for a principal purpose of benefitting from the loss corporation's losses).

[58] *See*, *e.g.*, Notice 2008-78, 2008-41 I.R.B. 851 (Sept. 26, 2008) (for purposes of "anti-stuffing" rule in section 382(*l*)(1), eliminating presumption that capital contribution is part of a prohibited plan solely because capital contribution occurred within two years of the ownership change, and establishing safe harbors for certain capital contributions that forthcoming Treasury regulations will except from anti-stuffing rule); Notice 2003-65, 2003-2 C.B. 747 (Sept. 12, 2003) (establishing safe harbors for application of NUBIG and NUBIL rules pending issuance of regulations; the "section 338" approach, if applicable, allows a loss corporation to take a NUBIG into account and increase its annual limitation even though the corporation does not physically dispose of, and recognize built-in gain in, the relevant assets); Treas. Reg. § 1.382-4 (generally only treats an option as exercised for section 382 purposes if, among other things, a principal purpose of the option's issuance, transfer or structuring (alone or in combination with other arrangements) is to avoid or ameliorate impact of the ownership change; by contrast, section 382(*l*)(3) and Temporary Treasury Regulation section 1.382-2T(h)(4) generally treat options to acquire loss corporation stock as exercised if such exercise would produce an ownership change); Treas. Reg. § 1.382-9(d)(3)(i) (relaxing section 382(*l*)(5)(E) by generally treating former debt holders owning less than 5 percent of the debtor's stock immediately after a bankruptcy reorganization as "qualified creditors" regardless of the actual length of time these creditors held their debt).

Finally, we considered whether the Expansive Purposive Approach, rather than the Limited Purposive Approach, would strike the best balance between appropriately limiting the reach of section 382 as Congress intended and adopting simpler, more easily administrable rules. We commend the Service for raising the Expansive Purposive Approach as the presentation of competing alternatives in the Notice assisted our analysis. Under the Expansive Purposive Approach, a loss corporation may retroactively reduce its aggregate owner shift.[59] This approach would require significant changes to section 382's current operation in which a loss corporation can only reduce its aggregate owner shift as testing date transactions "roll off" the current testing period.[60]

To illustrate, assume that Small Shareholders own all of a loss corporation's ("L") stock until X purchases 40 percent of L's stock on the market. Consider the following scenarios:

> 1. X sells its L stock to Small Shareholders during the testing period. The Expansive Purposive Approach would unwind the 40 percent owner shift.
>
> 2. X sells its L stock to Y, who later sells to Z, who later sells to Small Shareholders, in each case, during the testing period. Would the Expansive Purposive Approach apply because Small Shareholders ultimately reacquire the L stock? If so, would the analysis change if Small Shareholders only reacquire a portion of the L stock?
>
> 3. X sells 10 percent of L's stock to A, B, C and D. Would the Expansive Purposive Approach apply if any or all of the purchasers sell their L stock to Small Shareholders during the testing period?
>
> 4. X is an upper tier entity with no shareholders that are 5-percent shareholders of L. Would the Expansive Purposive Approach apply to X's liquidating distribution of the L stock to X's shareholders?

While the Expansive Purposive Approach, if adopted, logically should apply in all cases, it nonetheless would be extremely difficult to administer in the latter three scenarios above. In addition, there may be a reasonable question as to the Treasury Department's authority to adopt the Expansive Purposive Approach. More specifically, while the public group rule in section 382(g)(4)(A) generally treats Small Shareholders as a single 5-percent shareholder, the Expansive Purposive Approach would disregard certain increases in the public group's ownership during a testing period. This disregard of a public group's status as a 5-percent

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[59] *See* Notice 2010-49, 2010-27 I.R.B. at 11.

[60] We do not understand the formulation of the Expansive Purposive Approach in the Notice to permit a loss corporation to unwind a prior ownership change. *See* Notice 2010-49, 2010-27 I.R.B. at 11 ("when Original Public Group acquires shares from each investor, Original Public Group could be treated, for testing dates *on or after* such an acquisition, as having owned them during the period they were owned by the seller.") (emphasis added).

shareholder in measuring owner shifts and thus determining whether an ownership change occurs could be seen as in conflict with the statute.[61]

On balance, the Limited Purposive Approach is simpler and more administrable than the Expansive Purposive Approach and will sufficiently protect taxpayers in many cases from experiencing an ownership change as a result of non-abusive transactions. Accordingly, we recommend adoption of the Limited Purposive Approach in the case of a 5-percent shareholder's sale of loss corporation stock to Small Shareholders and a loss corporation's redemption of stock from Small Shareholders (or other similar transaction). However, given the greater potential for abuse associated with stock issuances, we believe that a more limited expansion of the small issuance and cash issuance exceptions under the existing Treasury regulations would be more appropriate than extending the Limited Purposive Approach (or the Expansive Purposive Approach) to these transactions.

We separately address in detail below our recommendations for each of these specific categories of transactions.

i. Stock Sales by 5-Percent Shareholders to Small Shareholders

Under the current segregation rules, a 5-percent shareholder's sale of loss corporation stock to Small Shareholders results in the creation of a separate direct public group and 5-percent shareholder.[62] The Limited Purposive Approach, by contrast, would treat the Initial Public Group as acquiring the relevant loss corporation shares.

In our experience, a 5-percent shareholder typically disposes of its stock to Small Shareholders to achieve the transferor's own economic objectives without regard to whether the issuer may have NOLs. A sale to Small Shareholders disperses the loss corporation's shares among multiple shareholders who generally are not in a position to contribute income-producing assets or divert income-producing opportunities to the loss corporation or otherwise profit from the corporation's NOLs. In addition, certain transactions, such as the first example in the Notice where multiple investors acquire the same loss corporation interest, artificially inflate the aggregate owner shift, which may cause (or at least increase the risk of) an ownership change under the current Treasury regulations.[63] The Limited Purposive Approach would change this

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[61] We recognize that the Expansive Purposive Approach parallels the approach of Treasury Regulation section 1.382-10(a), which addresses the treatment of a qualified trust's distribution of loss corporation shares to beneficiaries, insofar as the regulation treats a beneficiary who receives a distribution of loss corporation shares as acquiring the shares on the date, and in the manner, acquired by the trust. This regulation addresses a narrow fact pattern essentially involving indirect ownership where it is reasonable to treat the beneficiaries as the beneficial owners of the loss corporation's shares during the period that the qualified trust holds the shares. Accordingly, the facts of transactions under Treasury Regulation section 1.382-10(a) could be viewed as more sympathetic than transactions involving third parties dealing at arm's length.

[62] Temp. Treas. Reg. § 1.382-2T(j)(3)(i).

[63] Notice 2010-49, 2010-27 I.R.B. at 11.

result by treating the loss corporation's Initial Public Group as acquiring the shares that a 5-percent shareholder sells to Small Shareholders.

We believe that the Limited Purposive Approach should apply where the transferor 5-percent shareholder acquired the shares from the loss corporation itself or another 5-percent shareholder in addition to applying to sales of loss corporation shares that the transferor 5-percent shareholder initially acquired from Small Shareholders as in the Notice. In our view, a 5-percent shareholder's transfer of loss corporation shares to Small Shareholders does not enhance the utilization of the loss corporation's NOL carryforward regardless of the source from which the transferor initially acquired the shares.

Nor do we believe an anti-abuse rule is necessary with respect to sales by 5-percent shareholders to Small Shareholders. A 5-percent shareholder's sale of loss corporation stock to Small Shareholders disperses the loss corporation's ownership and should not conflict with any of section 382's policies. In addition, the Initial Public Group's purchase from a 5-percent shareholder results in an owner shift as the purchase increases the Initial Public Group's ownership interest in the loss corporation.

ii. Stock Redemptions from Small Shareholders

Under the current Treasury regulations, a redemption of loss corporation stock from Small Shareholders results in the segregation of each loss corporation direct public group into two public groups, one of which participates in the redemption and the other of which does not.[64] We generally recommend applying the Limited Purposive Approach to a loss corporation's stock redemptions from Small Shareholders (or other similar transactions) and treating the loss corporation's Initial Public Group as reducing its ownership interest in the loss corporation by virtue of the redemptions (or other similar transactions).

Redemptions from Small Shareholder rarely present significant opportunities for abuse in our experience, primarily because the cash necessary to finance the redemption will deplete the loss corporation's income-producing assets. Nevertheless, we recognize that, unlike direct trades between Small Shareholders, transfers by redemption also reduce the number of shares outstanding and, therefore, increase the relative ownership of the remaining shareholders, including the 5-percent shareholders. Moreover, the loss corporation is a party to a redemption. Accordingly, the Treasury Department may wish to consider some form of anti-abuse limitation on the application of the Limited Purposive Approach to redemptions even though such a limitation may introduce some degree of uncertainty regarding whether a particular redemption qualifies for relief from segregation.

iii. Stock Issuances to Small Shareholders

Under the current Treasury regulations, subject to the small issuance and cash issuance exceptions, Small Shareholders who acquire loss corporation stock in a section 1032 transaction

[64] Temp. Treas. Reg. § 1.382-2T(j)(2)(iii)(C)(1); *see* Temp. Treas. Reg. § 1.382-2T(j)(2)(iii)(C)(2), Ex. 1 (illustrating application of segregation rules in redemption context).

constitute a new direct public group and 5-percent shareholder separate from the direct public groups that existed before the transaction.[65] The Notice observes that stock issuances allow the loss corporation to receive additional income-producing capital and, thus, present concerns that neither shareholder sales nor shareholder redemptions present.[66] We share the government's heightened sensitivity regarding stock issuances and agree that the contribution of new capital to a loss corporation raises unique concerns.

As stated above, the Notice indicates that the government is also considering more targeted changes to the segregation rules as an alternative to the potential adoption of the Limited Purposive Approach (or the Expansive Purposive Approach).[67] Accordingly, the Tax Section considered whether adoption of the Limited Purposive Approach (or the Expansive Purposive Approach) or expansion of the existing small issuance and cash issuance exceptions would best serve the goals of (i) increasing flexibility with respect to legitimate capital raising transactions, (ii) providing greater certainty regarding the tax treatment of those transactions, and (iii) reducing related administrative burdens.

We believe that the adoption of the Limited Purposive Approach, standing alone, generally would further these goals. In addition, extending the Limited Purposive Approach to stock issuances would provide consistent rules for all testing date transactions involving Small Shareholders, including sales by 5-percent shareholders to Small Shareholders and redemptions of Small Shareholders by the loss corporation, which is generally desirable in a complicated area of the tax law.

Notwithstanding the foregoing, after extensive deliberation, we do not recommend adoption of the Limited Purposive Approach for stock issuances to Small Shareholders, principally due to the heightened potential for abuse resulting from the direct contribution of capital to the loss corporation, which may allow new shareholders to benefit from accelerated utilization of NOLs that were generated while former shareholders owned the corporation. While anti-abuse rules are useful and appropriate in many cases, we are mindful that they may raise significant administrative issues in this context. For example, the Treasury Department would need to promulgate a standard to govern the rule's application, *e.g.*, whether "a" or "the" principal purpose of an issuance is to facilitate the contribution or other acquisition of income-producing assets, or the diversion of income-producing opportunities, to a loss corporation (or an affiliate) in order to enhance the utilization of the loss corporation's (or its affiliate's) NOLs. In addition, the rule presumably would consider all facts and circumstances, and it might be appropriate to adopt safe harbors for certain types of issuances.[68] It may be difficult to craft an

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[65] Temp. Treas. Reg. § 1.382-2T(j)(2)(iii)(B).

[66] Notice 2010-49, 2010-27 I.R.B. at 11.

[67] *Id.* at 11-12.

[68] Potential safe harbors might include issuances effected to enable the loss corporation to (i) meet the basic needs of its business, *e.g.*, to fund monthly payroll or fund other operating expenses, *cf.* Treas. Reg. § 1.382-4(d)(6)(iv) (income test for determining whether an option is deemed exercised for section 382 purposes generally does not apply in such case), (ii) comply with federal or state statutes or

anti-abuse rule that would provide a loss corporation with the necessary flexibility to implement legitimate business transactions without jeopardizing the corporation's NOL carryforward, while still allowing the government to require segregation of the corporation's direct public groups in abusive cases.

For these reasons, we recommend that the government simply expand the existing small issuance and cash issuance exceptions. We believe that expanding the existing exceptions to the segregation rules would provide meaningful relief to loss corporations without the complexity and related uncertainty of an anti-abuse rule.

Accordingly, we recommend increasing the limitation under the small issuance exception from 10 percent to 25 percent, and broadening the cash issuance exception to apply to issuances in exchange for non-cash property.[69] In enacting the current small issuance and cash issuance exceptions, the government recognized, among other things, that Small Shareholders who acquire loss corporation stock in an offering are unlikely to have any more ability (or motivation) to effect transactions inconsistent with section 382 than Small Shareholders who purchase loss corporation stock from shareholders. Indeed, in promulgating the current exceptions, the Treasury Department recognized that "issuances of stock to less-than-5-percent shareholders result in a shift of ownership to persons who, because of the relative size of their ownership interest, generally have little incentive to undertake transactions to enhance the use of the loss corporation's losses."[70] In our view, this policy consideration is consistent with a higher limitation on the small issuance exception and expansion of the cash issuance exception to apply to issuances in exchange for non-cash property, such as compensatory stock issuances in exchange for services.[71] In addition, the Treasury Department's prior explanation that "considerable overlapping ownership" generally exists between a loss corporation's existing Small Shareholders and the Small Shareholders who purchase the loss corporation's stock in an

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regulatory requirements, or (iii) satisfy a bona fide compensation obligation to an employee of the loss corporation (or its affiliate).

[69] Under the current Treasury regulations, stock covered by the small issuance and cash issuance exceptions is treated as having been acquired proportionately by each direct public group that exists before the issuance. Treas. Reg. § 1.382-3(j)(2)-(3). Currently, an issuance can only qualify as a "small issuance" if the issuance, together with all prior issuances during the taxable year, generally represents not more than 10 percent of the corporation's outstanding stock as of the beginning of the year. Treas. Reg. § 1.382-3(j)(2)(iii). If the small issuance exception does not apply to an issuance solely for cash, the cash issuance exception currently applies to the percentage of stock issued that equals 50 percent of the aggregate percentage of the loss corporation's stock owned by direct public groups. Treas. Reg. § 1.382-3(j)(3)(i).

[70] Preamble, 57 Fed. Reg. 52,738, 52,739 (Nov. 5, 1992).

[71] The issuance of loss corporation stock to Small Shareholders pursuant to a stock for debt exchange raises unique, and in some cases, difficult issues. Our committee members supported various alternatives regarding the potential relaxation of the segregation rules in the case of a stock for debt exchange involving Small Shareholders, but we did not reach a consensus with respect to any alternative. Accordingly, we make no recommendation regarding the potential application of the cash issuance exception to stock for debt exchanges involving Small Shareholders.

offering similarly supports relaxing the application of the segregation rules to a loss corporation's stock issuances to Small Shareholders.[72] These changes to the small issuance and cash issuance exceptions would provide meaningful relief to loss corporations and alleviate many of the harsh results loss corporations experience under the current Treasury regulations.

iv. Transactions Involving Upper Tier Entities

As discussed below, the Tax Section makes four principal recommendations regarding the treatment of upper tier entities. First, consistent with the current exceptions to the segregation rules, the principles of our primary recommendations should apply not only to direct stock sales and redemption transactions at the loss corporation level, but to stock (or other equity) and redemption (or other similar) transactions at the upper tier entity level as well. Second, *none* of the segregation rules should apply at the upper tier entity level, unless such entity owns, directly or indirectly, a minimum percentage of the loss corporation's stock. Third, an Investment Entity's ordinary course stock issuances and redemptions should be treated in the same manner as transfers of such stock between owners of the Investment Entity (*i.e.*, as public trading).[73] Fourth, the Treasury Department should clarify an ambiguity in the current small issuance exception and clarify that an upper tier entity qualifies for the exception under existing law so long as such entity issues shares that represent an indirect stock ownership interest in the loss corporation of not more than 10 percent.

We discuss each of these recommendations below.

1. <u>General Application to Upper Tier Entities</u>.

The current Treasury regulations generally apply the principles of the existing segregation rules and their exceptions to transactions involving upper tier entities.[74] Therefore, extending the principles of our primary recommendations to indirect transfers involving upper tier entities would be consistent with the approach of the current regulations, which tracks changes in beneficial ownership by individuals whether they hold their loss corporation shares directly or through one or more intermediate entities.[75] In addition, this approach is entirely consistent with section 382's broad constructive ownership rules, which generally attribute stock owned by an entity to the beneficial owners in proportion to their ownership interests (regardless of the extent of such interests) and generally treat such stock as no longer held by the entity from which attributed.[76]

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[72] Preamble, 57 Fed. Reg. 52,738, 52,739 (Nov. 5, 1992).

[73] As defined above, an Investment Entity is an upper tier entity that provides primary liquidity to its investors by issuing or redeeming shares.

[74] Temp. Treas. Reg. § 1.382-2T(j)(3)(i), (iii).

[75] In fact, declining to extend relief to transactions involving upper tier entities would alter the impact of otherwise identical changes in beneficial ownership based upon how the Small Shareholders hold their loss corporation shares, which may even encourage loss trafficking.

[76] *See* I.R.C. § 382(*l*)(3)(A)(ii).

As discussed above, we recognize that the Treasury Department may wish to consider some form of anti-abuse limitation on the application of the Limited Purposive Approach to redemptions. In the case of redemptions (or other similar transactions) by upper tier entities, we recommend that any otherwise applicable anti-abuse rule apply only when the loss corporation has actual knowledge of the redemption (or other similar transaction). Unlike a direct redemption by the loss corporation, a redemption by an upper tier entity does not involve the loss corporation and does not reduce the number of loss corporation shares outstanding.[77] For these reasons, a loss corporation is no more likely to be aware of these transactions than it is aware of public trading in its own stock. We therefore believe that any anti-abuse rule governing redemptions (or other similar transactions) by upper tier entities should recognize these distinctions and apply different criteria from those criteria governing direct redemptions (or other similar transactions) by the loss corporation itself.

2. No Look-Through Treatment for Certain Upper Tier Entities.

As described above, Section 382 generally tracks changes in beneficial ownership of a loss corporation by individuals, whether such individuals invest directly in the loss corporation or indirectly through one or more intermediate entities. The Notice specifically requests comments regarding whether the Treasury Department should limit the obligation of a loss corporation to "look-through" upper tier entities to identify these individuals in the case of entities that hold a relatively small direct or indirect interest in the loss corporation.[78] We believe such relief is critical. As the Notice itself acknowledges, the rationale for segregation is that loss corporations have the capacity to track changes in ownership of their own stock by Small Shareholders that result from identifiable events even though loss corporations do not have the capacity to track similar changes in ownership attributable to public trading.[79] In the case of indirect changes in ownership attributable to transfers of stock or other equity interests at the level of an upper tier entity, however, this is simply not true. In the typical case, none of these transfers will be known to the loss corporation, which is reason that the current Treasury regulations impose a duty of inquiry upon the loss corporation.[80] In our experience, however, the upper tier entity is often unwilling, and in many cases not even permitted, to disclose the information.

For example, if the upper tier entity is a hedge fund, it is often simply impossible for the loss corporation to obtain the necessary information from the fund to allow the loss corporation to analyze the impact under section 382 of the multiple issuances and redemptions of equity interests at the fund level, which usually occur on a quarterly basis. In such a case, the loss corporation cannot comply with the statute. More generally, it is typically very burdensome in the best of cases, and, in our experience, impossible in the worst of cases, for loss corporations to

[77] For the same reason, these transactions also do not reduce the income-producing assets of the loss corporation.

[78] Notice 2010-49, 2010-27 I.R.B. at 12.

[79] *Id.* at 10.

[80] Temp. Treas. Reg. § 1.382-2T(k)(1)(ii), (k)(3).

obtain either current or historic ownership information regarding changes in beneficial ownership at the level of *any* upper tier entity that is not a dominant shareholder.[81]

We, therefore, recommend that the Treasury Department exempt transfers by owners of an upper tier entity from the segregation rules, unless the relevant entity owns, directly or indirectly, at least 30 percent of the loss corporation's stock.[82]

3. Investment Entities.

While the current regulations, as discussed above, generally exempt a RIC's issuance or redemption in the ordinary course of business of stock that is redeemable upon the shareholder's demand, there is no equivalent exception for Investment Entities, such as hedge funds.[83] Accordingly, we recommend that the Treasury Department extend the RIC rule to Investment Entities, and essentially treat issuances and redemptions by such entities in the ordinary course as exempt "public trading" under Temporary Treasury Regulation section 1.382-2T(e)(1)(ii). Because Investment Entities rarely provide information regarding stock issuances and redemptions to loss corporations (or other third parties), it is simply impossible for many loss corporations, despite good faith efforts, to apply the current segregation rules to these types of upper tier entities.

4. Clarify Application of Small Issuance Exception to Upper Tier Entities.

The current Treasury regulations generally provide that the "principles" of Treasury Regulation section 1.382-3(j) apply to stock issuances by an upper tier entity.[84] Under current law, it is not entirely clear whether the small issuance exception permits an upper tier entity to issue an amount of shares that represents an indirect stock ownership interest in the loss corporation of 10 percent or less, or limits the upper tier entity to an issuance of 10 percent or less of the entity's own shares. In our view, an upper tier entity qualifies for the small issuance exception under existing law so long as such entity issues shares that represent an indirect stock ownership interest in the loss corporation of not more than 10 percent. Accordingly, we recommend that the Treasury Department clarify this ambiguity.

To illustrate, assume that an upper tier entity has 100 shares outstanding, owns 20 percent of a loss corporation's stock, and no investor of the upper tier entity indirectly owns at least 5

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[81] The Tax Section has previously observed that "the segregation rules, as applied to sales of loss company stock by first-tier or higher-tier entities, impose significant record-keeping burdens on loss corporations and may influence decisions in such matters as the size of direct stock offerings by loss corporations in a manner that is arguably undesirable as a policy matter and unnecessary to prevent 'loss trafficking' of the kind that requires policing." New York State Bar Ass'n Tax Section, *Guidance on Economic Downturn Issues*, at 3 (Aug. 19, 2008).

[82] The Tax Section made this same recommendation in 1988. *See* New York State Bar Ass'n Tax Section, *Supplemental Report on Section 382*, at 23 (Feb. 22, 1988).

[83] *See* Treas. Reg. § 1.382-3(k)(1).

[84] Treas. Reg. § 1.382-3(j)(11).

percent of the loss corporation's stock. Under the aggregation rules, the upper tier entity's investors generally would represent a separate public group and 5-percent shareholder of the loss corporation.[85] We recommend that the small issuance exception apply to the upper tier entity's issuance of up to 100 shares, which would represent an indirect ownership interest in the loss corporation of 10 percent (*i.e.*, 100/200 x 20 percent), rather than only up to 10 shares, which would represent an indirect ownership interest in the loss corporation of approximately 2 percent.

C. Retroactive Application of Segregation Rule Changes

If the government accepts our recommendations, in whole or in part, we urge expeditious action to provide transitional relief to taxpayers. Many loss corporations have experienced significant increases in their aggregate owner shifts, or an outright ownership change, as a result of engaging in legitimate transactions that were subject to the segregation rules. Accordingly, we recommend that the government permit loss corporations to elect to apply our recommended modifications to the segregation rules retroactively, perhaps by issuing a notice announcing the government's intent to modify the segregation rules, including the expansion of the small issuance and cash issuance exceptions discussed above, and then promulgating regulations that permit taxpayers to apply the new rules retroactively. Temporary Treasury Regulation section 1.382-2T and, more importantly, Treasury Regulation section 1.382-3(j), which implements the small issuance and cash issuance exceptions, permitted loss corporations to apply the rules announced in those regulations retroactively. In addition, Treasury Regulation section 1.382-3(k), which modifies certain segregation rules in the case of RICs, applied retroactively.[86] We also urge the adoption of transition rules similar to those for the small issuance and cash issuance exceptions that require electing loss corporations to file amended tax returns, if necessary, for open years and to make appropriate adjustments in subsequent years to reflect any inability to file amended tax returns for closed years.[87] Presently, loss corporations potentially could amend their tax returns beginning with their 2007 taxable year, permitting qualifying loss corporations to claim relief with respect to transactions effected during the recent economic downturn.[88]

D. Potential Amendments to Section 382

The above discussion focuses on changes to the current segregation rules that we think the Treasury Department has ample authority to make under existing law. Our recommended changes, if adopted, would provide meaningful relief to loss corporations in many cases. More generally, however, the statutory language of section 382 significantly restricts the Treasury Department's ability to promulgate additional regulations that would further narrow the statute's

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[85] Temp. Treas. Reg. § 1.382-2T(g)(1)(ii).

[86] *See* Temp. Treas. Reg. § 1.382-2T(m)(4)(i); Treas. Reg. 1.382-3(j)(14)(iii); Treas. Reg. § 1.382-3(k)(2)(i).

[87] Treas. Reg. § 1.382-3(j)(14)(iii)(B).

[88] *See also* Notice 2010-50, 2010-27 I.R.B. 12 (June 11, 2010) (providing section 382 guidance regarding the effect of fluctuations in value of one class of loss corporation stock relative to another class of stock in measuring owner shifts; permitting loss corporations to change their methodology for prior years by filing amended tax returns to reflect a single methodology consistently applied).

focus to those transactions that are most likely to conflict with the statute's policies or regulations that would otherwise provide relief from the statute's often harsh effects. Accordingly, we briefly summarize below potential amendments to section 382 that Congress might consider in order to provide more expansive relief to loss corporations in addition to the regulatory changes recommended above.

In our experience, testing for ownership changes by measuring the aggregate owner shifts of all 5-percent shareholders during the testing period is overly broad. For example, Congress might consider amending the statute to limit an ownership change to (i) an acquisition of more than 50 percent of a loss corporation's shares by an individual or entity (as defined in Treasury Regulation section 1.382-3(a)(1)), (ii) a merger (or other similar transaction) in which the loss corporation's shareholders receive less than 50 percent of the combined company's ownership interests, or (iii) a transaction identified by the government as "abusive" in regulations promulgated pursuant to a broad grant of regulatory authority.[89]

This broad regulatory authority might include the authority to address questions such as whether (i) special rules are necessary for loss corporation stock issuances, (ii) it is necessary to segregate public shareholders, and (iii) special rules are necessary to address a loss corporation's ownership change pursuant to a bankruptcy reorganization or an out of court restructuring. It might be preferable, in lieu of a detailed statutory scheme, to allow the government to address most policy questions through regulations that would have the benefit of public comment and would be susceptible to subsequent modification.

Finally, in lieu of the fixed formula section 382 currently employs to calculate a loss corporation's annual limitation after an ownership change, Congress might consider providing the Treasury Department with the authority to adjust the formula. More specifically, Congress might allow the Treasury Department in appropriate cases to calculate the annual limitation as a percentage of the loss corporation's income in taxable periods after the ownership change. The relevant percentage, in turn, could reflect the ratio of the loss corporation's equity value immediately before the ownership change to such equity value immediately after the ownership change.[90]

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[89] In general, the characteristics of a loss corporation engaged in an abusive transaction may include: (i) a high ratio of NOLs to pre-transaction active business assets, (ii) a low ratio of pre-transaction active business assets to the expected amount of new capital, and (iii) a lack of meaningful business continuity following the transaction.

[90] We would be pleased to expand our discussion of these and other potential statutory amendments if the government believes that a more detailed analysis would be helpful.

Appendix

For purposes of each example below, unless otherwise indicated, assume that (i) L is a loss corporation under section 382, (ii) L has a single class of common stock outstanding that is traded on a national stock exchange, (iii) L is owned entirely by a direct public group as defined in Temporary Treasury Regulation section 1.382-2T(j)(2)(ii) ("Public L"), (iv) there have been no other owner shifts with respect to L stock during the testing period, (v) L has no actual knowledge regarding the ownership of L stock by Small Shareholders, and (vi) no ownership interest is subject to Temporary Treasury Regulation section 1.382-2T(k)(4).

Example 1: On June 1, 2011, corporation X, which is owned entirely by a direct public group ("Public X"), merges into L in a section 368(a)(1)(A) reorganization in which X shareholders receive 55 percent of L's stock. No L shareholder owns at least 5 percent of L stock immediately after the merger. The Limited Purposive Approach does not apply to the merger, which is an equity structure shift under section 382(g)(3)(A). Public X represents a separate, single 5-percent shareholder of L, and has increased its ownership interest in L by more than 50 percentage points over the lowest percentage of L stock owned by Public X during the testing period (*i.e.*, 0 percent to 55 percent). Accordingly, L experiences an ownership change as a result of the merger.

Example 2: On June 1, 2011, individual A purchases 20 percent of L's stock from Small Shareholders. On September 1, 2011, A sells all of her L stock to Small Shareholders, and no L shareholder owns at least 5 percent of L stock immediately after the sale. On November 1, 2011, B purchases 20 percent of L's stock from Small Shareholders. The Limited Purposive Approach applies to A's sale of her L stock to Small Shareholders. Accordingly, when B purchases 20 percent of L's stock, B is deemed to purchase the stock entirely from Public L, rather than, in part, from Public L and, in part, from the additional segregated public group created by A's sale of L stock on September 1, 2011. Accordingly, the total owner shift of L under section 382(g)(2) remains at 20 percent during the testing period.

Example 3: On June 1, 2011, L issues 15 percent of its stock to Small Shareholders in exchange for cash. No L shareholder owns at least 5 percent of L stock immediately after the offering. Under the small issuance exception, Public L is treated as acquiring the L shares issued in the offering, and there is no increase in Public L's ownership interest in L.

Example 4: L has 500,000 shares of common stock outstanding. On June 1, 2011, L acquires 150,000 shares of its stock for cash. No L shareholder owns at least 5 percent of L stock immediately after the redemption. The Limited Purposive Approach applies to the redemption, and L is treated as acquiring the redeemed shares from Public L. There is no change in Public L's ownership interest in L as a result of the redemption.

Example 5: Limited partnership X owns 20 percent of L's stock. No partner of X is a 5-percent owner of X as defined in Temporary Treasury Regulation section 1.382-2T(f)(10). X's partnership agreement imposes customary restrictions on the transferability of X partnership interests. As a result, X provides primary liquidity to investors by regularly issuing and redeeming partnership interests. Accordingly, these ordinary course issuances and redemptions are treated as exempt "public trading" under Temporary Treasury Regulation section 1.382-2T(e)(1)(ii).