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February 21, 2012

The Honorable Emily S. McMahon
Acting Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Douglas H. Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Report on Proposed Regulations under Section 382

Dear Ms. McMahon, Mr. Wilkins, and Mr. Shulman:

We write to comment on the proposed regulations under section 382 of the Internal Revenue Code that were published in the Federal Register on November 23, 2011 (the "Proposed Regulations"). The Proposed Regulations provide additional relief from the current "segregation rules" under Section 382, which apply to certain transfers of stock involving less than 5-percent shareholders of a loss corporation.

By way of background, Section 382(g)(1) generally provides that an ownership change occurs if, on any testing date, one or more "5-percent shareholders" have increased their aggregate ownership of a loss corporation by more than 50 percentage points during the preceding three years. Section 382 generally defines a 5-percent shareholder as any person who owns at least 5 percent of the stock of a loss corporation. For shareholders who own less than 5 percent of the stock, section 382 aggregates such shareholders into a separate "public group" and treats the public group as a single 5-percent shareholder. Although the statute generally ignores transfers of stock among shareholders within a public group, the current regulations provide for special segregation rules for certain types of transactions involving such

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shareholders, including issuances and redemptions of stock. When those rules apply, the loss corporation must create and track the ownership of additional public groups of less than 5-percent shareholders. The current regulations grant limited relief from these rules for certain issuances of stock.

The Proposed Regulations expand such relief to include other types of segregation transactions under the current regulations, including certain direct or indirect secondary transfers and redemptions of stock. We commend the government for releasing the Proposed Regulations, which we expect will reduce some of the compliance obstacles currently encountered by loss corporations in their efforts to identify and track transactions involving less than 5-percent shareholders. As described in our report, these obstacles are particularly acute in the case of segregation transactions that involve less than 5-percent shareholders who own stock or other equity interests of a first or higher-tier entity but do *not* own stock of the loss corporation itself.

We recommend the following additional modifications to the Proposed Regulations, which we believe will give fuller effect to the policy objectives articulated in the preamble.

First, we recommend that final regulations raise the ceiling under the small redemption exception from 10 percent to 25 percent, permitting a loss corporation to redeem up to 25 percent of its stock without requiring it to segregate its public shareholders into separate public groups. We believe a higher limitation for redemptions is appropriate for two reasons. First, unlike an issuance of stock, a redemption of stock *contracts* the amount of capital available to the loss corporation and therefore it's ability to accelerate the use of its net operating losses to shelter additional income. Second, although 25 percent is a substantially higher limitation, the small redemption exception will not otherwise exclude the redemption transaction from the normal operation of the statute. To the contrary, a small redemption will still give full effect to the resulting increase in the ownership of any actual 5-percent shareholders, in many cases triggering an ownership change.

Second, we believe the proposed relief for entity-level segregation transactions involving indirect less than 5-percent shareholders is too narrow, and will therefore not exempt many transactions that do not involve actual transfers of loss corporation stock from the segregation rules even though they implicate none of the policy concerns of the statute. This is likely to require many loss corporations who wish to avoid an ownership change to impose artificial restrictions on capital-raising activities on the basis of worst-case assumptions. As explained in our report, the basic rationale for segregation—that loss corporations have the capacity to track changes in ownership of their own stock that result from certain types of identifiable transactions with less than 5-percent shareholders—is not likely to apply to indirect transfers of this kind.

Accordingly, to alleviate these burdens, we recommend that final regulations (i) increase the upper-tier entity exception from 10 percent to 30 percent, (ii) permit a loss corporation to rely upon good faith determinations as to whether a particular entity qualifies for the upper-tier entity exception, (iii) clarify that the small redemption exception applies not only to direct redemptions of loss corporation stock, but to redemptions by first or higher-tier entities of their own stock,

and (iv) treat ordinary course issuances and redemptions by first or higher-tier entities that provide primary liquidity to their investors in this manner as exempt "public trading." We believe that each of these recommendations is consistent with the basic policy objectives of the Proposed Regulations.

Finally, the preamble to the Proposed Regulations requests comments as to the circumstances under which a group of investors should be aggregated into a single "entity" pursuant to Treasury Regulation section 1.382-3(a)(1) based on the investors' understandings or communications with each other or with third persons. As described more fully in our report, we recommend that final regulations formalize the basic principles reflected in a series of private letter rulings issued by the Internal Revenue Service on the scope of this regulation.

We appreciate your consideration of our recommendations. Please let us know if you would like to discuss these matters further or if we can assist you in any other way.

Respectfully submitted,

Andrew W. Needham
Chair

Enclosure

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