NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON

PROPOSED REGULATIONS EXTENDING ADDITIONAL RELIEF FROM THE SEGREGATION RULES UNDER SECTION 382

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New York State Bar Association Tax Section

REPORT ON PROPOSED REGULATIONS EXTENDING ADDITIONAL RELIEF FROM THE SEGREGATION RULES UNDER SECTION 382

This report,[1] prepared by an *ad hoc* committee of the Tax Section of the New York State Bar Association, comments on proposed regulations under section 382[2] released by the Treasury Department and Internal Revenue Service (the "Service") on November 23, 2011 (the "Proposed Regulations").[3] The Proposed Regulations would modify the treatment under section 382 of certain "testing date" transactions involving less than 5-percent shareholders ("Small Shareholders"). If finalized in their current form, the Proposed Regulations would ease many of the substantial compliance burdens associated with the obligation of a loss corporation to monitor certain types of stock transactions that involve Small Shareholders.[4]

We commend the government for the release of the Proposed Regulations, which are consistent with many of the recommendations submitted by the Tax Section in March 2011[5] in response to the request for comments in Notice 2010-49 (the "Notice").[6] This report addresses several aspects of the Proposed Regulations, in particular the proposed rules regarding transfers of stock or other equity interests in upper-tier entities that own stock of a loss corporation, that

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1 Consisting of Lee E. Allison, Samuel J. Dimon, Lawrence M. Garrett, Stuart J. Goldring, Max A. Goodman, Vadim Mahmoudov, Andrew W. Needham, Richard M. Nugent, Jodi J. Schwartz, Karen Gilbreath Sowell, Linda Z. Swartz and Diana L. Wollman. The principal drafters of this report were Linda Z. Swartz and Richard M. Nugent. Helpful comments were received from Michael L. Schler. This report reflects solely the views of the Tax Section of the NYSBA and not those of the NYSBA Executive Committee or the House of Delegates.

2 Unless otherwise indicated, all references to "section" are to the Internal Revenue Code of 1986, as amended.

3 *See* 76 Fed. Reg. 72362 (Nov. 23, 2011) (the "Preamble").

4 A "loss corporation" includes a corporation that is entitled to use a net operating loss carryover, among other tax attributes. *See* Treas. Reg. § 1.382-2(a)(1).

5 *See* "Report on Notice 2010-49", New York State Bar Association Tax Section (Mar. 18, 2011) (the "2011 Report").

6 2010-27 I.R.B. 10 (June 11, 2010).

we believe would continue to impose substantial compliance burdens on loss corporations without furthering the basic policy objectives of the statute.

I. Background

Following an ownership change, section 382 limits the amount of a loss corporation's taxable income that may be offset each year by pre-change net operating losses ("NOLs") and certain built-in losses. To determine whether an ownership change has occurred, section 382 tracks owner shifts and equity structure shifts that affect the direct or indirect ownership of a loss corporation by 5-percent shareholders. An ownership change occurs when one or more 5-percent shareholders have increased their aggregate ownership in the loss corporation on any testing date by more than 50 percentage points during the relevant testing period.[7] A 5-percent shareholder is any person that owns, directly or indirectly, at least 5 percent of the loss corporation's stock (by value).[8]

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 from time to time (a "<u>public group</u>").[9] If an entity owns, directly or indirectly, at least 5 percent of the loss corporation's stock, the owners of such entity who are not 5-percent shareholders in their own right are treated as a separate public group of the loss corporation if they own, in the aggregate, at least five percent of the loss corporation's stock (a "<u>5-Percent Entity</u>").[10]

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[7] I.R.C. § 382(g)(1).

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

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

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

The existing regulations contain detailed segregation rules, which, if applicable, generally create a new public group that is deemed to have increased its ownership interest in the loss corporation during the relevant testing period.[11] As discussed more fully in our 2011 Report, an equity structure shift (generally an acquisitive asset reorganization or recapitalization under section 368) is the only type of transaction for which Congress mandated a special segregation rule for Small Shareholders.[12] Under the existing regulations, however, most issuances and redemptions of stock constitute segregation events as well.[13]

In the Notice, the Service outlined two possible approaches to the treatment of stock transactions involving Small Shareholders: the Ownership Tracking Approach and the Purposive Approach. The Ownership Tracking Approach, an approach already reflected in the existing regulations in many respects, tracks all readily identifiable changes in ownership involving Small Shareholders without regard to their particular circumstances.[14] By contrast, the Purposive Approach does not track all readily identifiable transactions involving Small Shareholders, primarily on the basis that Small Shareholders generally do not acquire loss

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[11] Temp. Treas. Reg. § 1.382-2T(j)(2).

[12] I.R.C. § 382(g)(4)(B)(i). Section 382(m)(4) also expressly grants the Treasury Department the authority to prescribe regulations addressing the application of the segregation rules to single corporation transactions, including a recapitalization that qualifies as a reorganization under section 368(a)(1)(E).

[13] Temp. Treas. Reg. § 1.382-2T(j)(2)(iii). The existing regulations create two limited exceptions to the segregation rules—the "small issuance" and "cash issuance" exceptions—which apply to Small Shareholders' acquisitions of loss corporation stock directly from the loss corporation. In general, a "small issuance" 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 taxable year, determined at the loss corporation's option either on a class-by-class basis or based on the value of all of the corporation's stock (other than stock described in section 1504(a)(4)). 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 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). The regulations treat each direct public group existing at the time as proportionately acquiring the issued shares. Treas. Reg. § 1.382-3(j)(5). The principles of the small issuance and cash issuance exceptions also apply to stock or other equity issuances by any 5-Percent Entity. Treas. Reg. § 1.382-3(j)(11).

[14] The existing regulations ignore transfers among Small Shareholders (i.e., "public trading") because tracking such transfers would impose undue burdens on loss corporations. *See* Temp. Treas. Reg. § 1.382-2T(e)(1)(ii).

corporation stock for the purpose of "trafficking" in NOLs.[15] In our 2011 Report, we submitted extensive comments on the Notice.

II. Proposed Regulations

The Proposed Regulations would essentially adopt the more limited Purposive Approach described in the Notice. As discussed below, the Proposed Regulations do so by expanding the current exceptions to the segregation rules to include certain secondary transfers and redemptions of loss corporation stock and certain secondary transfers and redemptions of the stock or other equity interests of 5-Percent Entities. The Proposed Regulations would apply only on a prospective basis.[16]

First, the Proposed Regulations would except from the segregation rules secondary transfers to Small Shareholders of (i) loss corporation stock by a 5-Percent Entity or an individual 5-percent shareholder and (ii) stock or other equity interests in a 5-Percent Entity by an individual 5-percent shareholder or upper-tier entity owning at least 5 percent of the loss corporation's stock (collectively, the "<u>Secondary Transfer Exception</u>").[17] The Proposed Regulations would treat each pre-existing direct public group of the loss corporation or other relevant entity as acquiring the transferred stock or other equity interests on a proportionate

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15 Notice 2010-49, 2010-27 I.R.B. at 11. The Notice requested comments on both limited and expansive versions of the Purposive Approach. Notice 2010-49, 2010-27 I.R.B. at 11-12.

16 Prop. Treas. Reg. § 1.382-3(j)(17).

17 Prop. Treas. Reg. § 1.382-3(j)(13). Under the existing regulations, the segregation rules generally apply to transfers to Small Shareholders of loss corporation stock by individual 5-percent shareholders and entities that own at least 5 percent of the loss corporation's stock, and these "principles" generally apply to a transfer of stock or other equity interests in an entity that owns directly, or an upper-tier entity that owns indirectly, at least 5 percent of the loss corporation's stock. Temp. Treas. Reg. § 1.382-2T(j)(3)(i). The Proposed Regulations would clarify that the segregation rules generally apply to such a transfer only if the transferor indirectly owns at least 5 percent of the loss corporation's stock. Prop. Treas. Reg. § 1.382-3(i)(1).

basis.[18] The Preamble explains that this exception is appropriate because secondary transfers do not provide new capital to the loss corporation and also tend to disburse the ownership of loss corporation stock, diminishing the potential for loss trafficking.[19]

Second, in the case of stock redemptions from Small Shareholders, the Proposed Regulations generally would except from the segregation rules 10 percent of the total value of the loss corporation's stock at the beginning of the taxable year or, at the loss corporation's option, 10 percent of the number of shares of the redeemed class outstanding at the beginning of the taxable year (collectively, the "Small Redemption Exception").[20] If the exception applies, the loss corporation would be treated as redeeming a proportionate share of the exempted stock from each pre-existing direct public group immediately before the redemption.[21] The Preamble explains that this exception is appropriate because redemptions actually *reduce* capital available to the loss corporation.[22]

Third, the Proposed Regulations would provide limited relief from the obligation of a loss corporation to track indirect shifts of ownership by Small Shareholders by disregarding certain transactions involving the stock or other equity interests of 5-Percent Entities, including issuances of stock or other equity interests by such entities. More specifically, the segregation

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18 Prop. Treas. Reg. § 1.382-3(j)(13).

19 Preamble, 76 Fed. Reg. 72362, 72363 (Nov. 23, 2011). Significantly, the Secondary Transfer Exception applies to secondary transfers of the equity interests of a 5-Percent Entity that are not otherwise exempt under the Upper-Tier Entity Exception (defined and discussed below). Preamble, 76 Fed. Reg. 72362, 72364 (Nov. 23, 2011).

20 Prop. Treas. Reg. § 1.382-3(j)(14). The Proposed Regulations generally would treat two or more redemptions as a single redemption if (i) the redemptions occur at approximately the same time pursuant to the same plan or arrangement, or (ii) a principal purpose of redeeming the stock in separate redemptions, rather than in a single transaction, is to minimize or avoid an owner shift. Prop. Treas. Reg. § 1.382-3(j)(14)(v).

21 Prop. Treas. Reg. § 1.382-3(j)(14)(iv)(A). A loss corporation may treat a direct public group as having been redeemed of more stock than such group's proportionate share of such stock if the loss corporation actually knows that the amount redeemed exceeds the amount so determined. Prop. Treas. Reg. § 1.382-3(j)(14)(iv)(B).

22 Preamble, 76 Fed. Reg. 72362, 72364 (Nov. 23, 2011).

rules would not apply to transactions involving 5-Percent Entities if, on the relevant testing date, (i) the applicable 5-Percent Entity owns ten percent or less (by value) of all of the loss corporation's outstanding stock (the "10-percent ownership limitation"), and (ii) the 5-Percent Entity's direct or indirect investment in the loss corporation does not exceed 25 percent of such entity's gross assets, excluding cash and cash items (the "asset threshold", and clauses (i)-(ii), collectively, the "Upper-Tier Entity Exception").[23]

The Proposed Regulations would not expand the scope of the current exceptions from the segregation rules governing issuances of stock to Small Shareholders. Instead, the Preamble requests comments as to whether further refinement of the small issuance and cash issuance exceptions might be appropriate in connection with any potential expansion of these exceptions.[24]

Finally, the Preamble observes that the significance of the treatment under the existing regulations of a group of persons who make certain coordinated acquisitions of stock as a constructive "entity" for purposes of section 382 (the "Coordinated Acquisition Rule") will increase after the Proposed Regulations become final given the additional distinctions they will draw between large and small shareholders.[25] Accordingly, the government solicits comments as to the circumstances under which final regulations should aggregate Small Shareholders into a

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23 Prop. Treas. Reg. § 1.382-3(j)(15)(i). Generally, the loss corporation could establish that an entity satisfies the 10-percent ownership limitation either through actual knowledge or, in the absence of actual knowledge to the contrary, by relying on the presumptions regarding stock ownership in Temporary Treasury Regulation section 1.382-2T(k)(1). Prop. Treas. Reg. § 1.382-3(j)(15)(iv).

24 Preamble, 76 Fed. Reg. 72362, 72364 (Nov. 23, 2011).

25 *See* Treas. Reg. § 1.382-3(a)(1).

single "entity" based on their understandings or communications with each other or third persons.[26]

III. Summary of Recommendations

The following is a summary of our principal recommendations:

- expand the Small Redemption Exception to permit the redemption of up to 25 percent of the outstanding stock as of the beginning of the taxable year such that a loss corporation would not be required to "split" its Small Shareholders into separate public groups, one of which is deemed to sell its shares back to the loss corporation;
- expand the relief afforded to loss corporations from the obligation to identity and segregate entity-level transactions with Small Shareholders who only own stock of the loss corporation by attribution by (i) increasing the 10-percent ownership limitation of the Upper-Tier Entity Exception to 30 percent; (ii) allowing a loss corporation to rely on a good faith determination as to whether such transactions qualify for relief under the Upper-Tier Entity Exception, (iii) clarifying that the Small Redemption Exception applies not only to direct redemptions of loss corporation stock, but to entity-level redemptions by a 5-Percent Entity, and (iv) treating "ordinary course" issuances and redemptions by a 5-Percent Entity as exempt "public trading" so long as the 5-Percent Entity provides primary liquidity to its owners in this manner (an "Investment Entity"), but only to the extent such owners qualify as Small Shareholders;
- clarify the application of the segregation rules reflected in Example 11 of the Proposed Regulations; and
- incorporate the Service's informal ruling approach with respect to the treatment of coordinated acquisitions of stock by Small Shareholders.[27]

IV. Analysis

The Proposed Regulations represent an important step toward reducing the substantial compliance burdens encountered by loss corporations in attempting to track transactions that do

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[26] Preamble, 76 Fed. Reg. 72362, 72365 (Nov. 23, 2011).

[27] Our 2011 Report contains a detailed explanation of our recommendations to increase the limitation under the small issuance exception from 10 percent to 25 percent and to broaden the cash issuance exception to apply to issuances in exchange for certain non-cash property. 2011 Report, at 18-19. We reaffirm these recommendations.

not reasonably implicate section 382's underlying policies. The proposed relief under the Secondary Transfer Exception subsumes many of these transactions. We also support the government's proposal to adopt the limited Purposive Approach described in the Notice, which is consistent with section 382's existing framework, and to do so by objective rules, such as the Small Redemption Exception, in lieu of alternatives that would incorporate subjective anti-abuse standards.

Notwithstanding our strong support for the overall approach of the Proposed Regulations, we recommend that final regulations incorporate the additional recommendations described above in order to more fully realize the policy objectives described in the Preamble. We explain each of our recommendations below.

A. Increase Permitted Size of Small Redemption Exception

We support the Small Redemption Exception and agree with the observation in the Preamble that the exception will allow loss corporations to plan their affairs as of the beginning of each taxable year, will obviate the need for a subjective anti-abuse rule, and will reduce the administrative burdens and section 382 impact of transactions not prone to the types of abuse that the statute is intended to prevent.[28]

In order to fully effectuate these objectives, however, we recommend that final regulations increase the percentage of stock that a loss corporation may redeem on an annual basis from 10 percent to 25 percent, which is the same threshold that we recommended for the small issuance exception in our 2011 Report. While stock issuances receive heightened scrutiny due to the accompanying infusion of capital into the loss corporation, stock redemptions actually

[28] Preamble, 76 Fed. Reg. 72362, 72364 (Nov. 23, 2011).

contract the loss corporation's capital, depleting income-producing assets, and therefore do not create loss trafficking opportunities. Accordingly, whether or not final regulations increase the small issuance exception above 10 percent, we recommend that final regulations increase the annual limitation for the Small Redemption Exception from 10 percent to 25 percent of the loss corporation's stock.

We wish to emphasize that the adoption of this recommendation would only relieve a loss corporation from the obligation to "split" its public 5-percent shareholders into separate public groups immediately before a redemption of 25 percent or less of its shares. It would *not* exempt the transaction from the statute. To the contrary, the redemption will still increase the ownership interest of any actual 5-percent shareholders of the loss corporation:

> **Example:** L, a loss corporation with 100 shares of common stock outstanding, is owned 25 percent by individual A, 35 percent by individual B, and 40 percent by Small Shareholders ("Public L"). On January 1, 2012, C acquires 35 shares of common stock from B. On July 1, 2012, L redeems 25 shares of common stock from Public L. These are the only transactions that occur during the testing period. If final regulations were to increase the 10-percent ownership limitation to 25 percent, the redemption from Public L would qualify for relief under the Small Redemption Exception. Immediately after the redemption, however, L is owned 33% by A (25/75), 47% by C (35/75) and 20% by Public L (15/75). Because the lowest percentage interest of A and C during the testing period was 25 percent and 0 percent, respectively, the redemption nevertheless causes an "ownership change" under Section 382(g).[29]

[29] (47 percent – 0 percent) + (33 percent – 25 percent) = 55 percent.

Because the redemption in this example conveyed control of the loss corporation to A and C even though it did not involve any 5-percent shareholders, the expanded relief from the segregation rules did not undermine the basic policy objectives of the statute.

In addition, some taxpayers have expressed confusion regarding one aspect of the segregation rule for redemptions under existing regulations, which is how the rule applies when the public group in question has previously increased its ownership interest in the loss corporation during the current testing period. In particular, in the case of any redemption that does not otherwise qualify for relief under the Small Redemption Exception, the resulting increase in ownership of the members of the public group who do *not* participate in the redemption should equal the difference between the percentage ownership of such members immediately after the redemption and their lowest percentage ownership during the testing period. For this purpose, the lowest percentage ownership of such members should be determined by prorating the public group's aggregate lowest percentage interest *immediately before* the redemption between the participating and non-participating members in accordance with the relative percentages of the public group that such members represent.[30]

The following example illustrates our interpretation of how the segregation rules apply under these circumstances:

> **Example:** L, a loss corporation with 100 shares of common stock outstanding, is owned 30 percent by individual A and 70 percent by Small Shareholders ("<u>Public L</u>"). On January 1, 2012, Public L acquires 15 shares of common stock from A in a transaction to which the Secondary Transfer Exception applies. On July 1, 2012, L redeems 11 shares of common stock from Public L. These are the only transactions that occur during the testing period. The

[30] Temp. Treas. Reg. § 1.382-2T(c)(1).

> Small Redemption Exception does not apply to the redemption because the 11 redeemed shares exceed the annual 10-percent limitation. L must therefore segregate Public L into 2 public groups immediately before the redemption, treating the redeemed members as part of a new public group ("Public RL") that is separate and distinct from the public group that did not participate in the redemption ("Public CL"). Public L's lowest percentage ownership in L during the testing period (70 percent) is allocated between Public CL and Public RL pro rata based on their relative ownership of L common stock immediately before the redemption (*i.e.*, 11/85 x 70% to Public RL, and 74/85 x 70% to Public CL). Public CL's percentage ownership in L is therefore deemed to increase from 60.94 percent at the beginning of the testing period to 83.14 percent (74/89) after the redemption. Accordingly, Public CL is treated as having increased its percentage ownership in L by 22.2 percent during the testing period.

To alleviate confusion, we recommend that final regulations add an example to clarify the application of the segregation rules in this context.

B. Expand Relief for Transactions Involving Equity Interests of 5-Percent Entities

As described above, section 382 generally tracks changes in beneficial ownership of a loss corporation by individuals, including individuals who invest in a loss corporation indirectly through one or more intermediate entities.[31] 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 Small Shareholders—is not likely to apply in the case of most indirect changes in ownership of a loss corporation attributable to transfers of a 5-Percent Entity's stock or other equity interests.[32] Typically, the loss corporation will have no knowledge of these transfers, which is why the existing regulations impose a duty of inquiry

[31] I.R.C. § 382(*l*)(3)(A)(ii).

[32] *See* Notice 2010-49, 2010-27 I.R.B. at 10.

upon the loss corporation.[33] In response to such inquiries, however, many 5-Percent Entities (if they respond at all) state that they are unwilling or unable under their organizational documents to disclose investor information.

We therefore believe that the Proposed Regulations would continue to subject many of these transactions to the segregation rules even though no identifiable policy abuse is present, effectively requiring loss corporations who wish to protect against an ownership change to impose artificial restrictions on capital-raising activities using worst-case assumptions.[34] Accordingly, to alleviate these often very severe burdens on loss corporations, we recommend that final regulations (i) increase the 10-percent ownership limitation in the Upper-Tier Entity Exception to 30 percent, (ii) permit a loss corporation to make a good faith determination as to whether a particular entity qualifies for the Upper-Tier Entity Exception, (iii) clarify that the Small Redemption Exception also applies to redemptions by 5-Percent Entities of their own stock or other equity interests, and (iv) treat ordinary course equity issuances and redemptions by Investment Entities as exempt "public trading." We believe that these recommendations, which are similar to our recommendations in the 2011 Report, are fully consistent with the general policy objectives of the Proposed Regulations.[35]

1. <u>Expand Upper-Tier Entity Exception and Clarify Duty of Inquiry</u>

We believe that the proposed 10-percent ownership limitation in the Upper-Tier Entity Exception is too low. Consistent with our 2011 Report (and our 1988 report on section 382), we recommend that the Upper-Tier Entity Exception exempt from the segregation rules transactions

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[33] Temp. Treas. Reg. § 1.382-2T(k)(3).

[34] Preamble, 76 Fed. Reg. 72362, 72364 (Nov. 23, 2011).

[35] *See* 2011 Report, at 19-22.

involving the equity interests of a 5-Percent Entity owning, directly or indirectly, less than 30 percent of the loss corporation's stock,[36] provided that the 5-Percent Entity also satisfies the asset threshold.[37] In our view, the remote likelihood that equity transactions among Small Shareholders one or more tiers removed from the loss corporation would reasonably implicate any loss trafficking concerns, coupled with the significant compliance hurdles imposed by the existing regulations, justifies a substantially higher ownership limitation. While the proposed 10-percent ownership limitation may reflect the belief that larger shareholders are able to obtain more information from the issuing corporation (*e.g.*, a United States shareholder that requests information regarding the Subpart F income of a controlled foreign corporation),[38] in our experience, these shareholders generally resist providing information *to* the issuing corporation regarding their *own* shareholders or equity owners.

In addition, the application of the 10-percent ownership limitation and asset threshold tests would raise practical compliance concerns. As stated above, the existing regulations generally impose a duty of inquiry upon the loss corporation to determine the direct and indirect

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[36] 2011 Report, at 21; *See* "Supplemental Report on Section 382", New York State Bar Association Tax Section, at 23 (Feb. 22, 1988).

[37] We believe that the proposed 25-percent asset threshold provides a reasonable safeguard against potentially abusive transactions and note that the Treasury Department has adopted similar standards in other contexts. *See* Treas. Reg. § 1.382-9(d)(4) (debt generally will not constitute "qualified indebtedness" for section 382(*l*)(5) purposes if, among other conditions, the debt represents more than 25 percent of the value of the creditor's gross assets on the date on which the creditor experiences an ownership change); Treas. Reg. § 1.108-2(c)(4)(ii) (requiring disclosure by a creditor that becomes related to the debtor for purposes of section 108(e)(4) if the debtor's indebtedness generally represents more than 25 percent of the value of the assets of the creditor and certain related parties). *Cf.* Treas. Reg. § 1.7704-1(h)(3) (in determining the number of partners in a partnership for purposes of the "private placement" safe harbor under Treasury Regulation section 1.7704-1(h)(1), indirect ownership only counts if "substantially all" of the value of the beneficial owner of an upper-tier flow-through entity is attributable to the flow-through entity's interest in the lower-tier partnership, and a principal purpose of the tiered arrangement is to permit the partnership to satisfy the safe harbor's 100-partner limitation).

[38] *See* I.R.C. § 951.

ownership of its stock.[39] In our experience, a loss corporation is often unable to satisfy these obligations. Specifically, many upper-tier entities, in spite of repeated inquiries from the loss corporation, simply will not (or cannot) disclose the relative ownership of their shares, either currently or during the preceding portion of the relevant testing period. We anticipate that loss corporations will experience similar compliance problems in their efforts to determine whether these entities qualify for relief under the Upper-Tier Entity Exception, in particular with respect to establishing the fair market value of the other assets of these entities. We therefore recommend that final regulations permit a loss corporation to rely on a good faith determination that it has satisfied its duty of inquiry to establish whether the Upper-Tier Entity Exception applies to a particular entity.

2. <u>Apply Small Redemption Exception to 5-Percent Entities that Do Not Qualify for Relief Under the Upper-Tier Entity Exception</u>

Under the existing regulations, both the small issuance and cash issuance exceptions to the current segregation rules apply not only to issuances of stock by the loss corporation, but to issuances of stock by upper-tier entities of the loss corporation.[40] The Proposed Regulations, however, do not by their terms extend the principles of the Small Redemption Exception to a 5-Percent Entity's redemption of its own stock or other equity interests. Because this is inconsistent with the basic framework of the existing regulations, we assume this omission was unintentional.

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[39] More specifically, a loss corporation has a duty to inquire as to the ownership of any (i) individual who has a direct 5-percent or greater interest in the loss corporation, (ii) upper-tier entity that has a 5-percent or greater interest in the next lower-tier entity, and (iii) owner that holds a 5-percent or greater interest in the loss corporation indirectly through any one upper-tier entity. Temp. Treas. Reg. § 1.382-2T(k)(3).

[40] Treas. Reg. § 1.382-3(j)(11).

As a policy matter, limiting the Small Redemption Exception to direct redemptions of stock by a loss corporation is fundamentally at odds with the basic principles of section 382, which seek to track changes in a loss corporation's beneficial ownership by individuals without regard to whether they hold their stock directly or through one or more intermediate entities. Such a limitation is also inconsistent with the stated objective of the Proposed Regulations, which is to reduce compliance burdens with respect to transactions that are unlikely to involve loss trafficking. Having determined that a loss corporation's *direct* redemptions from Small Shareholders are unlikely to facilitate loss trafficking, the Treasury Department and the Service should be even less concerned about the loss trafficking potential of redemptions to which the loss corporation is not even a party.

Extending the Small Redemption Exception to redemptions by 5-Percent Entities would also provide critical relief to loss corporations in the case of any such redemption that does not qualify for relief under the Upper-Tier Entity Exception. For example, if an equity investment in a loss corporation represents more than 25 percent of the gross assets of a 5-Percent Entity, the Upper-Tier Entity Exception would not apply to a redemption by the entity of any portion of its own stock or other equity interests, even if the entity satisfies the 10-percent ownership limitation. In such a case, *any* redemption by the entity would require the loss corporation to identity the transaction pursuant to its duty of inquiry and then segregate the Small Shareholders of the entity into separate *indirect* public groups.

To illustrate, assume that a loss corporation is a public company with a substantial market capitalization. Any shareholder of the loss corporation who owns greater than 10 percent of the stock is likely to be another entity (which may itself be public or otherwise hold substantial assets unrelated to the loss corporation). The Upper-Tier Entity Exception in this example would not apply to equity transactions involving such an entity because it does not satisfy the 10-percent ownership limitation. If the entity is a corporation, therefore, the redemption of a *single share* of stock by the entity would trigger the application of the segregation rules regardless of how small an interest in the loss corporation the share of stock represents (*e.g.*, .001 percent). Accordingly, we recommend that final regulations clarify that the Small Redemption Exception applies to any redemption of stock or other equity interests by a 5-Percent Entity that does not qualify for relief under the Upper-Tier Entity Exception to the same extent that the Small Redemption Exception would have applied to a direct redemption of stock by the loss corporation itself.

In addition, we recommend that final regulations confirm that the 10-percent limitation of the Small Redemption Exception, as applied to a redemption by a 5-Percent Entity, exempts from the segregation rules any redemption of stock of the entity that represents an indirect interest in the loss corporation of 10 percent or less, not any redemption of stock of the entity that represents 10 percent or less of the stock of the entity itself.[41] As such, a 5-Percent Entity would be permitted to redeem its own stock or other equity interests that represent an indirect stock ownership interest of the loss corporation of up to 10 percent.

To illustrate, assume that a 5-Percent Entity is a widely-held corporation that owns 20 percent of a loss corporation's stock, and that no shareholder in the 5-Percent Entity indirectly owns 5 percent or more of the loss corporation's stock. The shareholders of the 5-Percent Entity

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[41] Similarly, under current law, it is not entirely clear whether the small issuance exception permits a 5-Percent Entity to issue an amount of such entity's own equity interests that represents an indirect ownership interest in the loss corporation of up to 10 percent, or limits the 5-Percent Entity to an issuance of up to 10 percent of the entity's own equity interests. *See* Treas. Reg. § 1.382-3(j)(11). In our 2011 Report, we concluded that the former interpretation is correct and recommended that the government clarify this ambiguity. 2011 Report, at 21-22.

generally would represent a separate public group and 5-percent shareholder of the loss corporation.[42] The Small Redemption Exception in this example should allow the 5-Percent Entity to redeem up to 50 percent of its own stock, which would represent a 10 percent indirect ownership interest in the loss corporation (*i.e.*, 50 percent of 20 percent), rather than up to 10 percent of the entity's stock, which would represent only a 2 percent indirect ownership interest in the loss corporation (*i.e.*, 10 percent of 20 percent).[43] Such a rule would establish parity in the treatment of a loss corporation's direct and indirect shareholders, which is fully consistent with the principles of the statute.[44]

3. <u>Disregard Certain Issuances and Redemptions by Investment Entities</u>

Consistent with our 2011 Report, regardless of whether the Upper-Tier Entity Exception or Small Redemption Exception would otherwise apply, we recommend that final regulations treat an Investment Entity's ordinary course equity issuances and redemptions to and from equity owners who indirectly own less than 5 percent of the loss corporation's stock as exempt "public trading".[45] Because Investment Entities rarely agree to provide information regarding these transactions to their investee loss corporations, many loss corporations, despite extensive good faith efforts, simply cannot apply the existing segregation rules to issuances and redemptions by these entities. As the Preamble recognizes, this information gap frequently causes loss

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42 Temp. Treas. Reg. § 1.382-2T(g)(1)(ii).

43 This recommendation is independent of our recommendation to increase the annual percentage limitation under the Small Redemption Exception from 10 percent to 25 percent. If final regulations increase the annual limitation, the percentage of outstanding equity interests that a 5-Percent Entity could redeem in any taxable year would correspondingly increase.

44 We note that the government recognized the need for such parity in proposing that the Secondary Transaction Exception apply not only to transfers of a loss corporation's own stock, but to transfers by the owners of a 5-Percent Entity. *See* Prop. Treas. Reg. § 1.382-3(j)(13).

45 As defined above, an Investment Entity is a 5-Percent Entity that provides primary liquidity to its investors by issuing or redeeming equity interests in the ordinary course of business.

corporations to operate on the basis of worst-case assumptions in order to ensure section 382 compliance.[46] The existing regulations sensibly exempt from the segregation rules ordinary course issuances and redemptions by a regulated investment company of stock that is redeemable upon the shareholder's demand,[47] and we recommend that Investment Entities, which provide liquidity in exactly the same manner, receive the same treatment in final regulations.

C. Clarify Example 11 in Proposed Regulations

Proposed Treasury Regulation section 1.382-3(j)(16), Ex. 11 ("Example 11") provides the following example:

> L, a loss corporation, has two classes of stock outstanding, common stock and preferred stock. The preferred stock is not stock within the meaning of Treasury Regulation section 1.382-2(a)(3). A direct public group ("Public L") owns all of the L common stock. P purchased 100 percent of the L preferred stock at a time when the preferred stock represented 9 percent of the value of all of the outstanding stock of L. The common stock owned by Public L represents the remaining 91 percent of the value of L's stock. P has one class of common stock outstanding, all of which is owned by a direct public group. P redeems 30 percent of its common stock. Due to a decline in the relative value of the L common stock, the L preferred stock represents 40 percent of the value of all of the outstanding stock of L on the date of the redemption. The Upper-Tier Entity Exception does not apply to the redemption of P common stock because P owns more than 10 percent of L's outstanding stock (by value) on that date.

The import of Example 11 is unclear. More specifically, if P holds *only* preferred stock that does not constitute "stock" for section 382 purposes, P is not a shareholder of L at all. Accordingly, transfers of P equity interests (including redemptions) should have no consequence to L under section 382. Because the only apparent purpose of the example is to illustrate that fluctuations in

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46 Preamble, 76 Fed. Reg. 72362, 72364 (Nov. 23, 2011).

47 *See* Treas. Reg. § 1.382-3(k)(1).

value can disqualify a segregation transaction from relief under the Upper-Tier Entity Exception even if the fluctuation in value concerns stock that is otherwise disregarded under section 382,[48] the Treasury Department should consider modifying the example in final regulations to make P a holder of L common stock as well.[49]

D. Incorporate Service's Ruling Approach to Coordinated Acquisitions

The Preamble requests comments as to the circumstances under which a group of investors should be aggregated into a single "entity" pursuant to the Coordinated Acquisition Rule based on the investors' understandings or communications with each other or with third persons, such as the loss corporation or an underwriter.[50]

The Coordinated Acquisition Rule provides, in relevant part: "An entity includes a group of persons who have a formal or informal understanding among themselves to make a coordinated acquisition of stock. A principal element in determining if such an understanding exists is whether the investment decision of each member of a group is based upon the investment decision of one or more other members."[51] Three examples in the existing regulations illustrate the operation of the Coordinated Acquisition Rule. The examples apply the Coordinated Acquisition Rule where (i) a group of individuals, acting pursuant to a common agreement, acquired 60 percent of a loss corporation's stock (with each individual acquiring

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48 *See* Prop. Treas. Reg. § 1.382-3(j)(15)(i)(A) (applying 10-percent ownership limitation in Upper-Tier Entity Exception without regard to Treasury Regulation section 1.382-2(a)(3)).

49 We also recommend that final regulations clarify that the Upper-Tier Entity Exception takes into account all loss corporation stock (including section 1504(a)(4) stock) other than interests treated as stock under Treasury Regulation section 1.382-2T(f)(18)(iii).

50 Preamble, 76 Fed. Reg. 72362, 72365 (Nov. 23, 2011).

51 Treas. Reg. § 1.382-3(a)(1)(i). We note that the existing regulations narrowed the rule as reflected in the 1990 proposed regulations, which defined an "entity" to include a group of persons acting pursuant to a plan. *See* 55 Fed. Reg. 48639, 48641 (Nov. 21, 1990).

approximately three percent of the loss corporation's stock), and (ii) a loss corporation's management separately convinced each of 15 investors to acquire four percent of the loss corporation's stock in the market based on the understanding that the loss corporation would assemble an investor group that, in the aggregate, would acquire more than 50 percent of the loss corporation's stock.[52] By contrast, the Coordinated Acquisition Rule did not apply where 20 unrelated individuals, in the aggregate, acquired six percent of a loss corporation's stock (with no investor individually acquiring at least 5 percent of such stock) based on the advice of a common investment advisor, but where no understanding existed among the investors to purchase the stock.[53]

We recommend that final regulations provide a more detailed definition of a coordinated acquisition of stock and additional examples illustrating the scope of the rule. More specifically, we recommend that final regulations explicitly incorporate five principles into the Coordinated Acquisition Rule, all of which are consistent with private letter rulings issued by the Service.

First, we recommend that final regulations confirm that an investment advisor's right to vote and to dispose of its client's stock does not confer beneficial ownership of the stock on the investment advisor for section 382 purposes. Section 382 generally measures beneficial ownership based on economic criteria and, accordingly, treats the person who has the right to dividends and proceeds from the sale of the stock as the stock's owner (such owner, an "<u>Economic Owner</u>"). Based on this standard, an investment advisor is not the owner for section

[52] Treas. Reg. § 1.382-3(a)(ii), Exs. 1-2.

[53] Treas. Reg. § 1.382-3(a)(ii), Ex. 3.

382 purposes of client stock with respect to which the investment advisor cannot retain dividends or sale proceeds.[54]

Second, we recommend that final regulations provide that Economic Owners sharing a common investment advisor will not constitute a deemed "entity" under the Coordinated Acquisition Rule solely because the investment advisor exercises customary responsibilities relating to the loss corporation, including (i) acquiring or disposing of loss corporation stock, (ii) exercising voting rights with respect to loss corporation stock, (iii) filing a Securities and Exchange Commission Schedule 13D or Schedule 13G with respect to loss corporation stock,[55] (iv) using a common custodian to hold loss corporation stock, and (v) communicating with the loss corporation's management regarding operations, management or capital structure.[56]

Third, we recommend explicit confirmation that a loss corporation generally can determine the Coordinated Acquisition Rule's applicability based on the available Schedule 13D and 13G filings. More specifically, if an investment advisor files a Schedule 13D or 13G with respect to loss corporation stock owned by the investment advisor's clients (*i.e.*, the Economic Owners) who do not themselves file a Schedule 13D or 13G confirming the existence of a "group" within the meaning of Section 13(d)(3) of the Securities Exchange Act of 1934, the loss corporation may rely on the absence of a filing by the Economic Owners to determine that such

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54 Priv. Ltr. Rul. 2010-27-030 (Mar. 29, 2010); Priv. Ltr. Rul. 2009-02-007 (Oct. 7, 2008); Priv. Ltr. Rul. 2008-22-013 (Feb. 12, 2008).

55 For a discussion of Schedule 13D and 13G filing requirements, see Priv. Ltr. Rul. 2007-47-016 (Nov. 23, 2007).

56 Priv. Ltr. Rul. 2009-02-007 (Oct. 7, 2008); Priv. Ltr. Rul. 2007-13-015 (Dec. 20, 2006).

owners are not members of a group constituting a deemed "entity" under the Coordinated Acquisition Rule, unless the loss corporation has actual knowledge to the contrary.[57]

Fourth, we recommend that the Coordinated Acquisition Rule not apply to purchases of loss corporation stock by related private equity funds, distressed debt funds or other investment funds (collectively, "Related Funds"), unless the Related Funds acquire the loss corporation's stock for the purpose of accumulating ownership of any particular minimum percentage of the loss corporation's stock *or* for the purpose of gaining control of the loss corporation.[58] This result should obtain even where the Related Funds share a common investment manager and the same investment objectives and typically invest in the same stock and invest the same percentage of each fund's assets in such stock, absent a plan or understanding among the parties to coordinate their stock acquisitions for the above purposes.[59]

Finally, we recommend that the Coordinated Acquisition Rule not apply to private placements of stock of a loss corporation, unless, and to the extent that, the loss corporation has actual knowledge that the investors in the private placement are acquiring or holding the loss corporation stock for the purpose of changing or influencing the control of the loss corporation.[60] The Coordinated Acquisition Rule is appropriately directed at orchestrated acquisitions of loss corporation stock in the market, while the segregation rules generally police private placements and other direct stock issuances by loss corporations. Expanding the Coordinated Acquisition Rule in the private placement context, in our view, would effectively render this rule a

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[57] Priv. Ltr. Rul. 2010-27-030 (Mar. 29, 2010); Priv. Ltr. Rul. 2009-02-007 (Oct. 7, 2008); Priv. Ltr. Rul. 2008-22-013 (Feb. 12, 2008); Priv. Ltr. Rul. 2008-18-020 (Jan. 29, 2008).

[58] Priv. Ltr. Rul. 2008-18-020 (Jan. 29, 2008).

[59] Priv. Ltr. Rul. 2006-05-003 (Feb. 3, 2006).

[60] Priv. Ltr. Rul. 2010-10-009 (Dec. 4, 2009).

segregation rule by another name, creating a trap for the unwary. It would also raise complex questions relating to the tracking of dispositions of loss corporation stock by members of the constructive "entity", as well as the timing and consequences of such an entity's constructive dissolution.