NEW YORK STATE BAR ASSOCIATION
TAX SECTION

REPORT ON THE TREATMENT OF CAPITAL CONTRIBUTIONS UNDER CODE SECTION 382(l)(1)

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This report is in response to Notice 2008-78[1] (the "Notice"), in which Treasury and the Internal Revenue Service (collectively, the "Service") set forth interim guidance under Section 382(l)(1) (the so-called "anti-stuffing" rule) on which taxpayers may rely pending the issuance of further guidance, and requested comments with respect to the appropriate scope and application of Section 382(l)(1) and a variety of particular approaches or issues.[2] As discussed below, we support the general approach taken in the Notice, which addresses certain aspects of Section 382(l)(1), and we believe that is important that regulations also address the other aspects of such provision.[3]

I. Background

A. Section 382 Limitations

Section 382(l)(1) was enacted in 1986, as part of the enactment of present day Section 382.[4] Section 382 generally imposes an annual limitation on the amount of a loss corporation's taxable income that may be offset by pre-change losses following an ownership change of the loss corporation.[5] In general, the annual limitation is equal to the product of (i) the "value of the old loss corporation" times (ii) the long-term tax exempt rate.[6] In addition, the annual limitation is increased for any built-in gains

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[1] 2008-41 I.R.B. 851.

[2] Unless otherwise indicated, all references to "Section" or "§" are to the Internal Revenue Code of 1986, as amended (the "Code"), and all references to "Treas. Reg." or "regulations" are to the regulations promulgated thereunder.

[3] This report was prepared by the Committee on Bankruptcy and Losses of the New York State Bar Association Tax Section, and was principally drafted by Stuart J. Goldring and Max A. Goodman, with substantial contributions from Russell Kestenbaum, Lee Zimet and Drew Batkin. Helpful comments were received from Peter Blessing, Andrew Braiterman, Vadim Mahmoudov, David Miller, Erika Nijenhuis, Michael Schler, David Sicular and Willard Taylor.

[4] P.L. 99-514, § 621(a).

[5] § 382(a).

[6] § 382(b)(1).

recognized during the 5-year period following the ownership change if and to the extent that the loss corporation has a "net unrealized built-in gain" at the time of the ownership change.[7] Conversely, any built-in losses recognized during the 5-year period following the ownership change are subject to the annual limitation as pre-change losses if and to the extent that the loss corporation has a "net unrealized built-in loss" at the time of the ownership change.[8]

The "value of the loss corporation" is generally the value of the stock of the loss corporation immediately before the ownership change, subject to certain adjustments.[9] These adjustments include: (i) certain capital contributions, as provided by Section 382(l)(1), which is the subject of this report, (ii) subsequent redemptions or corporate contractions in connection with the ownership change, (iii) substantial nonbusiness assets, and (iv) the fair market value of the stock of any non-consolidated, controlled subsidiaries of the loss corporation.[10]

In general, whether a loss corporation has a "net unrealized built-in gain" or a "net unrealized built-in loss" at the time of an ownership change is determined by taking the aggregate value of the loss corporation's assets over the aggregate tax basis of its assets, subject to adjustment for built-in income and deduction items.[11] In this regard, pending the issuance of applicable regulations, Notice 2003-65[12] provides, in respect of certain permitted safe harbors, that a loss corporation's net unrealized built-in gain or loss is equal to (i) the amount realized if, immediately before the ownership change, the loss corporation had sold all of its assets at fair market value to a third party that assumed all

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[7] § 382(h)(1)(A)(i), (h)(7).

[8] § 382(h)(1)(B)(i), (h)(7). If a loss corporation has a net unrealized built-in loss for Section 382 purposes, Section 56(g)(4)(G) and the regulations thereunder require that, for purposes of the "adjusted current earnings" adjustment to the alternative minimum tax, the loss corporation must adjust the tax basis of its assets to reflect their fair market value measured immediately before the ownership change. Treas. Reg. § 1.56(g)-1(k)(1).

[9] § 382(e)(1). Where the ownership change occurs pursuant to a bankruptcy court order or confirmed bankruptcy plan, Section 382(l)(6) as implemented by Treas. Reg. § 1.382-9(j) generally utilizes the value of the loss corporation immediately after the ownership change, but not in excess of the pre-change gross asset value of the loss corporation's assets. Given this focus, the regulations provide that the provisions of Section 382(l)(1) do not apply in determining the post-change value, but do apply in a modified form in determining the loss corporation's pre-change gross asset value. *See* Treas. Reg. § 1.382-9(j), (k)(4), (l)(4).

[10] *See* § 382(e)(2), (l)(1) and (l)(4); Treas. Reg. § 1.382-8.

[11] § 382(h)(3)(A)(i), (6)(C).

[12] 2003-2 C.B. 747.

of its liabilities, minus (ii) the loss corporation's aggregate adjusted tax basis in its assets and any deductible liabilities of the loss corporation that would be included in the amount realized on the hypothetical sale (with certain additional potential adjustments for the impact of a prior Section 382, 383 or 384 limitation or continuing Section 481 adjustment). As an administrative threshold, if the amount of the net unrealized built-in gain or loss would not exceed the lesser of $10 million or 15% of the fair market value of the loss corporation's assets immediately before the ownership change (excluding cash items and certain marketable securities), the amount of the net unrealized built-in gain or loss is deemed to be zero.[13]

B. *Purpose and Application of Section 382(l)(1)*

Section 382(l)(1) provides:

(1) Certain capital contributions not taken into account.

(A) In general. Any capital contribution received by an old loss corporation as part of a plan a principal purpose of which is to avoid or increase any limitation under this section shall not be taken into account for purposes of this section.

(B) Certain contributions treated as part of plan. For purposes of subparagraph (A), any capital contribution made during the 2-year period ending on the change date shall, except as provided in regulations, be treated as part of a plan described in subparagraph (A) [herein referred to as the "two-year rule"].

Section 382(l)(1) is often referred to as the "anti-stuffing" rule, reflective of its self-declared purpose, to prevent taxpayers from manipulating any Section 382 limitation by means of a capital contribution.

The Conference Report to the Tax Reform Act of 1986 is relatively brief in its explanation of this provision. As to the meaning of "capital contribution," it parenthetically provides without further explanation that such term includes a Section 351 transfer.[14] The Joint Committee on Taxation explanation then adds that "[t]he term 'capital contribution' is to be interpreted broadly to encompass any direct or indirect infusion of capital into a loss corporation (*e.g.,* the merger of one corporation into a

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[13] § 382(h)(3).

[14] Conference Report to the Tax Reform Act of 1986, H.R. Conf. Rep. No. 99-841, at II-189 (1986) (hereafter cited as "Conference Report").

commonly owned loss corporation)."[15] This same direction appeared in the earlier House Report to the Tax Reform Act of 1985, absent the parenthetical,[16] but it is interesting to note that the proposed statutory provision at that time expressly provided that "[e]xcept as provided in this subparagraph, the term 'capital contribution' means any amount received by the corporation – (I) for stock in the corporation, or (II) as a contribution to capital."[17] In contrast, neither the Senate Report to the Tax Reform Act of 1986 nor the Senate version of the proposed statutory provision contained any statement regarding the meaning of the term "capital contribution."[18]

As to the application of the two-year rule, the Conference Report provides that:

> The conferees intend that the regulations will generally except (i) capital contributions received on the formation of a loss corporation (not accompanied by the incorporation of assets with a net unrealized built-in loss) where an ownership change occurs within two years of incorporation, (ii) capital contributions received before the first year from which there is an NOL or excess credit carryforward (or in which a net unrealized built-in loss arose), and (iii) capital contributions made to continue basic operations of the corporation's business (*e.g.,* to meet the monthly payroll or fund other operating expenses of the loss corporation).

The Conference Report further states that "[t]he regulations also may take into account, under appropriate circumstances, the existence of substantial nonbusiness assets on the change date [for which a specific statutory adjustment is provided] and distributions made to shareholders subsequent to capital contributions, as offsets to such contributions."[19]

To date, no regulations have been issued under Section 382(l)(1), and the only regulatory exception to the two-year rule is that found in Treas. Reg. § 1.382-9(k)(4), which exempts capital contributions occurring prior to an earlier ownership change to

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[15] Staff Joint Committee on Taxation, "General Explanation of the Tax Reform Act of 1986," at 318 (May 4, 1987) (hereafter cited as "Blue Book").

[16] House Committee on Ways and Means Report to the Tax Reform Act of 1985, H.R. Rep. No. 99-426, at 269 (1985) (hereafter cited as "House Report").

[17] H.R. 3838, 99th Cong., 1st Sess. § 321(a) (December 7, 1985) (proposed section 382(n)(1)(B)(i)).

[18] *See* Senate Committee on Finance Report on the Tax Reform Act of 1986, S. Rep. No. 99-313, at 244 (1986) (hereafter cited as "Senate Report"); H.R. 3838, 99th Cong., 2nd Sess. § 621(a) (May 29, 1986) (proposed section 382(k)(1)).

[19] Conference Report at II-189.

which Section 382(l)(6) applies. The Notice is the first broad-based action by Treasury to implement Congress' intentions and consider the appropriate scope of Section 382(l)(1). Nevertheless, over the last 20 years, the Service has issued a number of private letter rulings and other statements interpreting the provisions of Section 382(l)(1) and administratively exempting certain contributions from the two-year rule.

Many of these private letter rulings concluded without discussion (other than a citation to the House Report) that the proceeds of stock issuances constitute capital contributions for purposes of Section 382(l)(1).[20] Other rulings concluded without discussion that the scope of "capital contribution" for purposes of this provision includes the proceeds of the exercise of warrants, options and/or stock rights.[21] Significantly, as relates to the two-year rule, the Service, in Technical Advice Memorandum 9332004,[22] stated that the absence of regulations does not preclude it from applying an exception to the two-year rule "if it is appropriate to do so." In that ruling, the Service applied the exception to the two-year rule for "capital contributions made to continue basic operations of the corporation's business" found in the legislative history (the "basic operations exception") by tracing the use of the proceeds of the capital contribution in question to operational expenses that arose proximate in time to the contribution. Since then, the Service has issued a handful of private letter rulings applying the basic operations exception in a similar manner.[23] Most recently, Letter Ruling 200814004[24] administratively exempted from the two-year rule a prior capital restructuring involving both debt forgiveness and debt-for-stock exchanges within the context of a confirmed bankruptcy plan, even though no ownership change had occurred as a result of such prior restructuring, thereby rendering Treas. Reg. § 1.382-9(k)(4) inapplicable.

In addition to the Notice, the Service recently issued Notice 2008-100,[25] which provides guidance regarding the application of Section 382 to loss corporations whose

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[20] *See, e.g.,* Ltr. Rul. 9508035 (Nov. 30, 1994); Ltr. Rul. 9541019 (July 10, 1995); Ltr. Rul. 9630038 (May 1, 1996). *See also* Ltr. Rul. 8927079 (April 14, 1989) (applying provision to stock issuance without discussion or citation).

[21] *See* T.A.M. 9332004 (Apr. 30, 1993); Ltr. Rul. 9706014 (Nov. 13, 1996). *See also* Ltr. Rul. 8927079 (April 14, 1989) (applied provision to the exercise of warrants and stock rights without discussion or citation).

[22] Apr. 30, 1993.

[23] *See* Ltr. Rul. 9508035 (Nov. 30, 1994); Ltr. Rul. 9541019 (July 10, 1995); Ltr. Rul. 9630038 (May 1, 1996); Ltr. Rul. 9706014 (Nov. 13, 1996); Ltr. Rul. 9835027 (May 29, 1998); Ltr. Rul. 200730003 (Apr. 27, 2007).

[24] Jan. 2, 2008.

[25] 2008-44 I.R.B. 1081.

instruments are acquired by Treasury under the Capital Purchase Program ("CPP") pursuant to the Emergency Economic Stabilization Act of 2008 (P.L. 110-343). Notice 2008-100 provides, among other things, that "any capital contribution made by Treasury to a loss corporation pursuant to the CPP shall not be considered to have been made as part of a plan a principal purpose of which was to avoid or increase any section 382 limitation."

II. Notice 2008-78

The Notice provides rules for determining whether a capital contribution is part of a plan within the meaning of Section 382(l)(1), and seeks comments as to the content of future regulations under Section 382(l)(1). Taxpayers may rely on the rules set forth in the Notice with respect to ownership changes occurring in any taxable year ending on or after September 26, 2008, unless and until additional guidance is issued.

The Notice provides that a capital contribution shall not be presumed to be part of a plan a principal purpose of which is to avoid or increase a section 382 limitation solely as a result of having been made during the two-year period ending on the change date, effectively turning off the two-year rule. Rather, whether a capital contribution is part of a plan is determined based on all the facts and circumstances.

Despite this general facts and circumstances test, the Notice sets forth four safe harbors for capital contributions to be excepted from the operation of Section 382(l)(1).[26] The Notice is clear that the failure of a contribution to fall within a safe harbor does not constitute evidence that it is part of a plan. The first two safe harbors use terms taken from Treas. Reg. § 1.355-7 – the regulation that is principally concerned with determining the existence of a plan for purposes of Section 355(e)[27] – and the Notice provides for the importation of those defined terms with appropriate substitutions.

The first safe harbor applies to a contribution by a person who is neither a "controlling shareholder" (determined immediately before the contribution) nor a related party (within the meaning of Section 267(b) and determined immediately after the contribution) where 20% or less by value of the corporation's stock is issued, there is no "agreement, understanding, arrangement, or substantial negotiations" regarding a transaction that would result in an ownership change, and the ownership change occurs more than six months after the contribution.

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[26] The Notice also provides an exception from Section 382(l)(1) for contributions captured by Treas. Reg. § 1.382-9(k).

[27] Section 355(e) effectively turns off the nonrecognition rules of Sections 355(c) and 361(c) for any distribution "which is part of a plan (or series of related transactions) pursuant to which 1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation."

The second safe harbor covers a contribution by a related party (determined immediately after the contribution) where 10% or less by value of the corporation's stock is issued, or by an unrelated party, in each case where there is no "agreement, understanding, arrangement, or substantial negotiations" regarding a transaction that would result in an ownership change and the ownership change occurs more than one year after the contribution.

The third safe harbor exempts contributions in exchange for stock issued in connection with the performance of services, or stock acquired by a retirement plan, under the terms and conditions of the safe harbors found in Treas. Reg. § 1.355-7(d)(8) or (9), respectively.

The final safe harbor of the Notice implements, in part, the legislative history of Section 382(l)(1), by exempting contributions received on the formation of a corporation (not accompanied by the incorporation of assets with a net unrealized built-in loss) or received before the first year from which there is a carryforward of a net operating loss, net capital loss, excess credit or excess foreign taxes (or in which a net unrealized built-in loss arose).

The Notice also provides, in accord with the legislative history, that appropriate adjustments must be made to ensure that a reduction in value due to a capital contribution does not result in a duplicate reduction under the substantial nonbusiness asset rule in Section 382(l)(4).

III. Summary of Recommendations

The following is a summary of our principal recommendations relating to future regulations to be issued under Section 382(l)(1):

1. As a general matter, we support the approach adopted by the Service in the Notice, including the elimination of the two-year rule, the employment of a general facts and circumstances approach in determining whether a capital contribution is part of a prohibited plan, the use of safe harbors for particular circumstances, and the importation of the plan concepts and safe harbors from Treas. Reg. § 1.355-7.

2. Regulations should clarify the meaning of the term "capital contribution" for Section 382(l)(1) purposes. Specifically, the regulations should adopt a broad interpretation of capital contribution that encompasses all direct or indirect infusions of capital for equity securities of a loss corporation, regardless of the contributor's intent or prior shareholder status.

3. Regulations should confirm that a prohibited plan under Section 382(l)(1) includes a plan to avoid or increase *any* limitation, including the provisions of Section 382(h) applicable to net unrealized built-in gains and losses.

4. In adjusting for a "bad" capital contribution, regulations should adjust only for the value of the capital contribution at the time of the contribution, and not the impact of the capital contribution (*e.g.*, appreciation, depreciation and interim earnings) as of immediately before the ownership change.

5. Regulations should eliminate the risk of a double reduction under Section 382(l)(4) where the loss corporation has substantial nonbusiness assets and a "bad" capital contribution by reducing the amount of the adjustment under Section 382(l)(4) by the capital contribution. Similarly, where Section 382(l)(1) applies to a capital contribution and Section 382(e)(2) applies to a redemption or other corporate contraction, regulations should eliminate the risk of a double reduction by reducing the amount that is the subject of the redemption or corporate contraction adjustment by the capital contribution (even if the capital contribution also reduces the amount of the nonbusiness asset adjustment).

6. With respect to the Notice's first and second safe harbors, regulations should clarify, among other things, that the 20% and 10% stock issuance limitations apply to all related contributions of which the contribution being tested is a part, and that a sole shareholder can satisfy the 10% stock issuance limitation where no stock is actually issued on the basis of the amount of stock that would economically have been issuable in respect of the capital contribution.

7. Regulations should consider expanding the Notice's fourth safe harbor to except capital contributions preceding the existence of a material amount (rather than *any* amount) of tax attributes subject to Section 382, based on an objective criteria.

8. Regulations should create additional safe harbors for (i) capital contributions the proceeds of which are traceable to funding basic operating expenses of the corporation's business that occur proximate in time to (*e.g.*, within six months of) the contribution, as long as the corporation has a bona fide need for outside funding of such operating expenses at the time of the contribution; (ii) in general, capital contributions that occur more than two years prior to an ownership change; and (iii) capital contributions that occur before a prior ownership change.

9. Regulations should include the following plan factors for use in a facts and circumstances determination:

- the existence of substantial nonbusiness assets on the change date;
- the failure to use or deploy contributed assets in the business;
- the proximity in time between a capital contribution and an ownership change;
- the contributor is an existing shareholder (but the weight of the factor should depend on the relative size of the shareholdings, so that relatively little weight would be given for a contribution by a small shareholder); and
- certain additional plan factors based on the regulations under Section 355.

10. Regulations should include the following non-plan factors for use in a facts and circumstances determination:

- a bona fide business need for a capital contribution (with increasing weight based on the proximity in time between the contribution and the development of the business need);
- the use of the proceeds for basic operations;
- the absence of significant tax attributes at the time of the capital contribution;
- where a capital contribution occurs pursuant to a debt restructuring, the financial distress of the loss corporation;
- a capital contribution by reason of the exercise of a stock option or the conversion of convertible debt that was not issued as part of a prohibited plan, or was outstanding for more than two years;
- a creditor-required capital contribution (with decreasing weight if the creditor is, or is likely to become, a shareholder);
- the capital contribution is made in connection with a distribution by the loss corporation;
- the contribution was motivated by a legitimate non-Section 382 tax purpose but only if the expected non-Section 382 tax benefit is materially greater than any expected Section 382 tax benefit;
- circumstances substantially similar to a safe harbor; and
- certain additional non-plan factors based on the regulations under Section 355.

IV. Analysis and Recommendations

As discussed herein, future regulations should address the broader scope and application of Section 382(l)(1), as well as the two-year rule. For clarity and certainty in application, and in furtherance of the intended purpose of Section 382(l)(1), it is important to address certain core aspects of Section 382(l)(1), including what constitutes a "capital contribution" for this purpose and what adjustments are required to implement the statutory directive that the capital contribution "shall not be taken into account."

A. *Core Aspects of Section 382(l)(1)*

1. What Constitutes a "Capital Contribution"

Central to the application of Section 382(l)(1) is the definition of "capital contribution." This term is not defined in the Code, nor is it expressly defined in the Notice. However, the term "capital contribution" has a well-accepted meaning under general tax principles. Such term generally includes any transfer of property or other consideration by a *shareholder* to a corporation (whether or not pro rata) *intended* to protect or increase the value of its investment in the corporation, regardless of whether

additional shares of stock are issued.[28] Thus, both the status and intent of the contributor are essential elements of the general tax definition of a capital contribution.[29]

Nevertheless, the legislative history of Section 382(l)(1) indicates the term "capital contribution" was intended to have a broader meaning than under general tax principles. For example, the Conference Report, in describing the operation of Section 382(l)(1), states that any capital contribution "(including a section 351 transfer)" made as part of a prohibited plan is not taken into account.[30] One can easily debate the intended scope of this parenthetical. Somewhat more directly, the Joint Committee on Taxation explanation states that the term capital contribution "is to be interpreted broadly to encompass any direct or indirect infusion of capital into a loss corporation (*e.g.*, the merger of one corporation into a commonly owned loss corporation)."[31] Thus, the Joint Committee on Taxation explanation can be read as saying that any infusion of capital into the loss corporation would be considered a capital contribution, whether or not the "contributor" was a prior stockholder and regardless of the contributor's particular intent. As observed above, the House Report had contained the same directive (other than the parenthetical), but at the same time the House version of Section 382(l)(1) had expressly provided that "[e]xcept as provided in this subparagraph, the term 'capital contribution' means any amount received by the corporation – (I) for stock in the corporation, or (II) as a contribution to capital,"[32] which currently Section 382(l)(1) does not. In view of such omission, it may be questioned whether the Joint Committee on Taxation interpretation was overly broad.[33] Moreover, it is our understanding that some practitioners have

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[28] *See Commissioner v. Fink*, 483 U.S. 89, 97 (1987). *See also Lidgerwood Mfg. Co. v. Commissioner*, 229 F.2d 241 (2d Cir. 1956) (parent corporation's cancellation of debt of two wholly-owned subsidiaries in exchange for their stock was a capital contribution because purpose was "to improve the latter's financial position so that [they] may continue in business"); Treas. Reg. § 1.61-12(a) ("In general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt.").

[29] We recognize that the general tax definition of capital contribution can include a contribution by a non-shareholder. *See, e.g.*, Treas. Reg. § 1.118-1. However, such a capital contribution presumably would be motivated by other purposes besides Section 382 avoidance, and, thus, is not further discussed in this report.

[30] Conference Report at II-189.

[31] Blue Book at 318.

[32] H.R. 3838, 99th Cong., 1st Sess. § 321(a) (December 7, 1985) (proposed section 382(n)(1)(B)(i)). In contrast, the Senate version of the Tax Reform Act of 1986 did not contain this provision, and the Senate Report did not comment on the meaning of the term "capital contribution."

narrowly construed Section 382(l)(1) as only applying to capital contributions within their traditional meaning.

In accord with the Joint Committee on Taxation explanation, the Service in private rulings has included within the scope of Section 382(l)(1) any amounts received in respect of a stock issuance, regardless of (i) whether such issuance was part of a Section 351 transaction or (ii) the particular intent of the contributor (in contrast to the capital raising purpose of the company).[34] This has included amounts received upon exercise of warrants, options and/or stock rights.[35] Moreover, the safe harbors proposed by the Service in the Notice implicitly incorporate the concept that any amounts received for stock are properly considered a capital contribution for Section 382(l)(1) purposes.

In view of the foregoing, we believe that it is important that future regulations clarify the meaning of the term "capital contribution" for Section 382(l)(1) purposes. Moreover, recognizing the anti-abuse purpose of Section 382(l)(1) and consistent with Treasury's regulatory authority under Section 382, we believe that such regulations should adopt a broad interpretation of capital contribution in accord with that employed by the Service to date. Accordingly, the term should include all direct or indirect infusions of capital for equity securities of a loss corporation, including those pursuant to a merger of the loss corporation or for the issuance or exercise of stock options[36] –

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[33] *See* Martin D. Ginsburg & Jack S. Levin, Mergers, Acquisitions, and Buyouts ¶ 1210.2.1.4 (2008) ("In the absence of regulations, it is unclear whether P's purchase of [preferred stock in a non-Section 351 exchange] was a "capital contribution" and hence disregarded in computing T's Code § 382 limitation.").

[34] *See, e.g.*, Ltr. Rul. 8927079 (Apr. 14, 1989) (loss corporation issued convertible preferred stock to an investor); Ltr. Rul. 9508035 (Nov. 30, 1994) (loss corporation issued stock in four related offerings); Ltr. Rul. 9541019 (July 10, 1995) (loss corporation issued stock in two public offerings); Ltr. Rul. 9630038 (May 1, 1996) (loss corporation issued stock in a public offering). The nature of a public offering, in particular, makes it almost impossible to determine the intent or prior shareholder status of the contributor. *See also* Field Service Advisory 199910009 (Dec. 2, 1998), concluding that, had modified debt constituted "stock" for federal income tax purposes, the exchange of "old" debt for such stock would have been a capital contribution.

[35] Ltr. Rul. 8927079 (Apr. 14, 1989); T.A.M. 9332004 (Apr. 30, 1993); Ltr. Rul. 9706014 (Nov. 13, 1996).

[36] In this regard, we recognize that that the Service has informally ruled that the value of stock options should be taken into account in determining the value of the loss corporation for purposes of determining the Section 382 annual limitation, despite Section 382(k)(6)(B) requiring regulations, and assume that the Service will continue to maintain that position. *See, e.g.*, T.A.M. 9332004 (Apr. 30, 1993). We also encourage Treasury to issue regulations so providing. We do not propose nor suggest that the amount received with respect to an imbedded stock "option" within the broader meaning of an option for Section 382 purposes, such as in the case of convertible debt, be treated as a capital contribution.

regardless of the contributor's intent or prior shareholder status and regardless of whether the exchange qualifies under Section 351.

2. "Any Limitation" Under Section 382

By its terms, Section 382(l)(1) applies if a capital contribution is part of a plan a principal purpose of which is to avoid or increase "any limitation" under Section 382. Although commonly expressed simply in terms of the annual limitation of Section 382(b), a plain reading of the statutory language together with the legislative history to Section 382(l)(1) convince us that a prohibited plan includes a plan to manipulate or avoid the provisions of Section 382(h) applicable to net unrealized built-in gains and losses.[37]

In this regard, we observe that the House version of Section 382(l)(1) expressly applied with respect to the Section 382 annual limitation and the net unrealized built-in gain and loss rule (including the threshold requirement).[38] Although this explicit language is not found in the subsequent bills, the Senate Report, the Conference Report and the Joint Committee on Taxation explanation all state that Section 382(l)(1) is intended to apply to any capital contribution that is part of a plan to avoid "any of the special limitations under section 382."[39] We find no reason for any other interpretation of this language, and suggest that future regulations confirm this application.

Within the context of the consolidated return regulations governing the application of Section 382, the Service has already expressly provided that "[a] member of a consolidated group (or loss subgroup) may not, in determining its separately computed net unrealized built-in gain or loss, include any gain or loss with respect to assets acquired with a principal purpose to affect the amount of its net unrealized built-in gain or loss."[40]

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[37] This does not necessarily encompass an independent purpose to avoid the provisions of Section 56(g)(4)(G), applicable to ownership changes of a loss corporation which has a net unrealized built-in loss. Such provision is not technically a limitation under Section 382.

[38] H.R. 3838, 99th Cong., 1st Sess., § 321(a) (December 7, 1985) (proposed section 382(n)(1)(A)). Curiously, the House Report only refers to the annual Section 382 limitation. House Report at 269.

[39] Senate Report at 244; Conference Report at II-189; Blue Book at 318.

[40] Treas. Reg. § 1.1502-91(g)(4).

3. "Shall Not Be Taken Into Account"

Section 382(l)(1)(A) provides that a capital contribution received by a loss corporation as part of a plan a principal purpose of which is to avoid or increase any limitation under Section 382 "shall not be taken into account" for purposes of Section 382.[41] However, none of the Code section, its legislative history or published guidance indicate the proper method for disregarding the value of a particular capital contribution.

Specifically, it is unclear whether the amount of the capital contribution to be deducted from the corporation's equity value in applying Section 382 is (1) the amount of cash or value of property contributed, measured as of the date of the contribution, or (2) an adjusted value of the contribution that measures the contribution's actual or estimated effect on the loss corporation's value during the period from the date of the contribution through immediately prior to the ownership change.

The first approach is easiest to implement as it requires solely a valuation of specific assets on a date certain, and if stock was issued in connection with the contribution this may constitute evidence of the value of the contributed property. Furthermore, a literal reading of Section 382(l)(1) suggests that just the value of the property contributed measured on the day the property is contributed should be excluded from value in computing a Section 382 limitation, because the provision only references the capital contribution and not amounts derived or lost with respect thereto. It is our understanding that most tax practitioners currently take into account only the capital contribution itself, and not any earnings derived therefrom nor any change in value (upwards or downwards) in the property contributed, when applying Section 382(l)(1).

However, the policy behind the anti-stuffing rule of preventing inflation of any Section 382 limitation by injecting capital into a loss company prior to an ownership change[42] could suggest that further increases in the equity value of a loss corporation derived from cash or property contributed as a part of a plan with a principal purpose of avoiding or increasing such limitation also should not be taken into account in determining the limitation amount because the accretion in value from the property (whether by way of earnings or appreciation thereon) will correspondingly increase the value of the loss corporation.

Certain other anti-stuffing provisions in the Treasury Regulations take into account the post-contribution impact of a "bad" contribution. For instance, Treas. Reg. §

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[41] We note that, although capital contributions received as part of a prohibited plan that are accompanied by the issuance or surrender of stock may reduce limitations imposed under Section 382, they are still taken into account in determining whether a loss corporation initially has undergone an ownership change under Section 382.

[42] *See* Blue Book at 296-97.

1.1502-20(e)(2) prior to removal by T.D. 9424 (September 17, 2008) provided an anti-stuffing rule to prevent intra-consolidated group asset transfers designed to avoid the recognition of gain or impact of the loss disallowance rule upon the disposition or deconsolidation of a corporation. The rule applied if an intra-group asset transfer occurred within two years of a direct or indirect disposition or deconsolidation of subsidiary stock. The rule required reduction of the basis of the subsidiary's stock to the extent necessary to cause recognition of the amount of gain that would have been recognized if the stuffing transaction had not occurred.[43]

Similarly, Treas. Reg. § 1.338-4(h)(7) provides that if a built-in loss asset is contributed to an affiliate in a transferred basis transaction in advance of a stock sale for which a Section 338 election will be made and the purpose of the transfer is to reduce gain (or increase loss) recognized on the deemed sale of such affiliate's stock, "the gain or loss recognized by target on the deemed sale of stock of the target affiliate is determined *as if such asset had not been contributed or transferred*" (emphasis added). It is not clear, though, that the phrase "shall not be taken into account" used in Section 382(l)(1) is intended to have as broad an application as these other anti-stuffing provisions.

Additionally, if the earnings or appreciation attributable to a capital contribution are taken into account for purposes of Section 382(l)(1), then fairness dictates that losses and depreciation in value attributable to capital contributions must be taken into account as well. This principle was employed in Treas. Reg. § 1.1502-20(e)(2) prior to removal by T.D. 9424 (September 17, 2008),[44] and would appropriately be applied under Section 382(l)(1) if the second approach were adopted.

Both the first approach and the second approach would favor some taxpayers and harm others. A taxpayer that has suffered losses with respect to a capital contribution subject to Section 382(l)(1) would prefer the second approach, while a taxpayer that has enjoyed earnings or appreciation from such a capital contribution would prefer the first approach. Although policy considerations standing alone might favor the second approach, we believe, on balance, that the administrative costs and uncertainty of the second approach are not justified.

The primary concern with measuring the impact that a capital contribution has on the value of the loss corporation's equity by reference to the value of such asset on the ownership change date and any income or loss generated by the asset from the contribution date is that it infuses a potentially inordinate amount of complexity and uncertainty into measuring the amount taken into account. The calculation may be

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[43] *See* Notice of Proposed Rulemaking, Fed. Reg. Vol. 55, No. 227, p.49075, 49081 (Sept. 26, 1990). *See, e.g.*, Treas. Reg. § 1.1502-20(e)(3), Ex. 3, prior to revocation.

[44] *See, e.g.*, Treas. Reg. § 1.1502-20(e)(3), Ex. 3, prior to removal.

simple enough if the contribution is cash invested in an interest-bearing account or publicly-traded securities. However, cash is fungible, and thus even determining the particular use of a cash contribution may not be simple. Moreover, tracing and valuation complexities rapidly increase where businesses or business assets are contributed or acquired for the cash contribution.

We therefore recommend that the forthcoming regulations adopt the first approach and only take into account the value of the capital contribution on the contribution date for purposes of applying Section 382(l)(1). Recognizing that a contribution date approach does present some potential for manipulation, we also suggest the inclusion of an anti-abuse rule.

Aside from the measurement of the capital contribution, there is also some uncertainty as to what the phrase "shall not be taken into account for purposes of this section" means. For example, assume that a built-in loss asset is contributed to the loss corporation for the purpose of increasing the stock value for Section 382 purposes. It is clear that the value of the contributed asset must be backed out of the stock value in computing the Section 382 annual limitation, but is the built-in loss asset also excluded from the determination of the loss corporation's net unrealized built-in gain or loss? This exclusion would reduce the loss corporation's net unrealized built-in loss or increase (or create) a net unrealized built-in gain. Undoubtedly, this is not the result that Congress would have wanted. Yet, in the absence of regulations, it is at least one fair reading of the statute, since the directive seems to state without exception that the capital contribution will not be taken into account for any purpose of Section 382 (and not only to the extent that the loss corporation would be benefited). Accordingly, regulations should clarify that the proper result in this instance is that the built-in loss asset continues to be taken into account in the determination of net unrealized built-in gain or loss.

4. Eliminating Duplication Between Overlapping Provisions

Section 382(l)(4) provides that the value of a loss corporation may be reduced for purposes of computing the annual Section 382 limitation when the loss corporation has substantial nonbusiness assets immediately after an ownership change. The Notice rightly provides that, if the value of a loss corporation is subject to reduction under both Sections 382(l)(1) and 382(l)(4), appropriate adjustments must be made to ensure that a reduction in value is not duplicated. This is consistent with the legislative history of Section 382(l)(1),[45] and should be included in future regulations.

We recognize that such an anti-duplication rule could give rise to difficult issues with respect to tracing the use of the proceeds of a capital contribution. For example, due to the fungibility of cash, it could be quite hard to determine whether and how much contributed cash (or the proceeds realized upon the disposition of other contributed

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[45] *See* Conference Report at II-189.

assets) was used by a loss corporation to acquire nonbusiness assets. Moreover, because cash is generally fungible, a tracing approach generally serves as a trap for the unwary. Accordingly, from both a policy and administrability perspective, we believe that the regulations should forego tracing and, instead, the amount of "bad" capital contributions subject to Section 382(l)(1) should be netted against the reduction in the value of a loss corporation that would otherwise be required under Section 382(l)(4).

Similarly, Section 382(e)(2) provides that the value of a loss corporation is reduced for purposes of computing the annual Section 382 limitation when a redemption or other corporate contraction occurs in connection with an ownership change. We likewise believe that a reduction in value should not be duplicated by subtracting out the value of a capital contribution under Section 382(l)(1) and then further reducing the value of a loss corporation by a redemption or other corporation contraction. Accordingly, as in the case of the reduction for nonbusiness assets, we recommend that the amount of "bad" capital contributions subject to Section 382(l)(1) be netted against the amount otherwise taken into account under Section 382(e)(2). This reduction is appropriate even when there is a similar netting of the capital contribution for purposes of the substantial nonbusiness asset adjustment. A capital contribution made before an ownership change can be on-hand and part of a corporation's nonbusiness assets at the time of the ownership change and thereafter distributed in connection with the ownership change, thereby implicating all three forms of reductions to the value of the loss corporation for purposes of computing the Section 382 annual limitation. As such, the regulations generally should permit adjustments under both Section 382(l)(4) and Section 382(e)(2) for the same dollars contributed.

B. General Approach of Notice 2008-78

We support the Service's approach to the two-year rule in the Notice, and recommend that future regulations employ the same approach. Specifically, we commend the Service's elimination of the two-year rule in the Notice, the employment of a general facts and circumstances approach to determining bad purpose, and the use of safe harbors for particular circumstances. Our suggestions for modification or expansion of the present safe harbors in future regulations are discussed in Part C below.

We considered whether the elimination of the two-year rule might encourage taxpayers to engage in contributions to loss corporations pursuant to a prohibited plan, as well as whether such elimination was consistent with Congress's intent. Section 382(l)(1) is a purpose-focused inquiry. With that in mind, we believe (on balance) that the facts and circumstances test outlined by the Service in the Notice with an enunciation of particular factors should adequately discourage taxpayers from using capital contributions to circumvent the limitations of Section 382. Part D below contains our recommended factors that may tend to show whether a contribution is or is not part of a prohibited plan.

C. *Safe Harbors*

1. Safe Harbors in Notice 2008-78

Subject to minor modification, we support the four safe harbors set forth in the Notice, and agree that the plan concepts and safe harbors from Treas. Reg. § 1.355-7 are useful principles for Section 382(l)(1) purposes. At this point, the Section 355 regulations have been thoroughly vetted and reflect a balanced approach to difficult considerations. In addition, we believe there is value in promoting consistency and uniformity in the interpretation of similar terms used in different provisions of the Code. Because of the length of the referenced provisions of Treas. Reg. § 1.355-7, though, we recommend that future Section 382(l)(1) regulations input the full language of the relevant definitions and safe harbors as applied to Section 382(l)(1), and not simply incorporate them by reference with instructions to make certain substitutions (as was done in the Notice).[46]

A condition of the first safe harbor set forth the Notice is that "no more than 20% of the total value of the loss corporation's outstanding stock is issued in connection with the contribution," and the second safe harbor contains a similar 10% condition with respect to contributions by related parties. We believe that, as currently drafted, there is some uncertainty as to whether this 20% or 10% limit is to be applied on an aggregate basis or a per-contributor basis when multiple taxpayers participate in the same overall contribution. For instance, if a loss corporation undertakes a public offering of 30% (by value) of its stock for cash, but no single taxpayer acquires more than 1% of its stock, is the 20% limitation of the first safe harbor satisfied? We believe that the better reading and the better view from a policy perspective is that the 20% and 10% limitations apply to all related contributions of which the contribution being tested is a part (*i.e.,* the aggregate rather than the per-contributor approach), and that the regulations should clarify this point.

There is also some uncertainty regarding whether and how the Notice's second safe harbor applies when the sole shareholder of a loss corporation does not receive any stock in exchange for a capital contribution (presumably because the receipt of stock would be a meaningless gesture). We believe that the applicability of this safe harbor in such a situation should depend on the percentage of stock that would economically have been issuable in respect of the capital contribution. The regulations should clarify this point.

With respect to the portion of the Notice's fourth safe harbor applicable to capital contributions preceding the existence of a tax attribute subject to Section 382, we recommend that the Service consider expanding this safe harbor in regulations so that it

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[46] Attached as an exhibit hereto are the referenced provisions of the Section 355 regulations with the described substitutions required by the Notice.

excepts capital contributions preceding the existence of a "material amount" (rather than *any* amount) of such tax attributes. We believe that there is no reason to deny a loss corporation the benefit of this safe harbor where a capital contribution is made at a time when an insignificant amount of tax attributes exists, although we recognize that the difficulties of determining in an objective manner what is material may make such a safe harbor unnecessarily cumbersome.

For purposes of consistency and uniformity, one possible measure of materiality might be similar to that standard of two times the annual Section 382 limitation set forth in the stock recharacterization rules of Temp. Treas. Reg. § 1.382-2T(f)(18)(ii)(C) and (iii)(C), determined as if an ownership change occurred immediately before the contribution in question (without applying Section 382(l)(1) to any prior capital contributions).[47] Measuring materiality in this manner, though, would require a loss corporation to determine its value at the time of the capital contribution in question in order to compute the hypothetical Section 382 limitation. Because of the difficulty of obtaining such a valuation, should the government adopt this expanded portion of the safe harbor with this objective measure of materiality, it might be appropriate to make this expanded portion of the safe harbor elective. This would protect loss corporations that do not want to (or do not have the resources to) undertake the valuation process at the time of a capital contribution and that treat their tax attributes as subject to a lower Section 382 limitation (since they believe Section 382(l)(1) applies) from a subsequent challenge that they should have applied a higher Section 382 limitation because, unbeknownst to them, the capital contribution qualified for this expanded safe harbor.

2. Additional Safe Harbors

Besides the safe harbors set forth in the Notice, we recommend that future regulations include three additional safe harbors:

First, we recommend that the regulations include a safe harbor for capital contributions the proceeds of which are traceable to funding basic operating expenses of the corporation's business that occur proximate in time to (*e.g.,* within six months of) the contribution, as long as the corporation has a bona fide need for outside funding for its operating expenses at the time of the contribution. This safe harbor would be consistent both with the legislative history of Section 382(l)(1), where Congress stated that such contributions should be an exception to the two-year rule,[48] and with the Service's private

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[47] Because this portion of the expanded safe harbor would apply only if the loss corporation has an immaterial amount of tax attributes at the time of the contribution in question, it can be presumed that any prior capital contributions were not motivated by a "bad" principal purpose.

[48] Conference Report at II-189.

rulings over the past 15 years.[49] Given the clarity of Congress's statement of intent and the bona fide need of many loss corporations for capital infusions to continue their operations, we believe that a safe harbor, rather than a factor indicating the absence of a prohibited plan, is the better vehicle for implementing the basic operations exception. Regardless of whether the Service chooses to embody the basic operations exception in a safe harbor or a non-plan factor, we recommend that the regulations provide an inclusive (rather than exclusive) list of uses of funds that fit within the basic operations exception. This list should include payment of a lawsuit settlement,[50] collateralization of letters of credit,[51] collateralization of existing repurchase agreements (repos),[52] research and development expenses,[53] supporting sales,[54] maintaining regulatory capital,[55] maintaining minimum recommended capitalization for rating agency purposes,[56] repayment of debt incurred within one year prior to the contribution to fund basic operations,[57] maintaining or replacing capital assets consistent with maintaining basic operations, and other working capital or general cash management purposes.[58] We further recommend that the government allow reasonable inferences in determining whether the proceeds of a capital contribution are traceable to funding basic operating expenses. For instance, when a capital contribution occurs pursuant to a stock offering, the offering document specifies that a certain amount of the proceeds will be used for working capital purposes, and the loss corporation demonstrates that an equal amount of funds was so used (or is still on

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[49] *See* T.A.M. 9332004 (Apr. 30, 1993); Ltr. Rul. 9508035 (Nov. 30, 1994); Ltr. Rul. 9541019 (July 10, 1995); Ltr. Rul. 9630038 (May 1, 1996); Ltr. Rul. 9706014 (Nov. 13, 1996); Ltr. Rul. 9835027 (May 29, 1998); Ltr. Rul. 200730003 (Apr. 27, 2007).

[50] *See* T.A.M. 9332004 (Apr. 30, 1993).

[51] *See* Id.

[52] *See* Ltr. Rul. 9541019 (July 10, 1995).

[53] *See* Ltr. Rul. 9630038 (May 1, 1996); Ltr. Rul. 9706014 (Nov. 13, 1996).

[54] *See* Ltr. Rul. 9630038 (May 1, 1996).

[55] *See* Ltr. Rul. 9835027 (May 29, 1998); Ltr. Rul. 200730003 (Apr. 27, 2007).

[56] *See* Ltr. Rul. 200730003 (Apr. 27, 2007).

[57] *Compare* Ltr. Rul. 9508035 (Nov. 30, 1994) (repayment of debt incurred less than 8 months before contribution qualified for basic operations exception), *with* TAM 9332004 (Apr. 30, 1993) (repayment of debt incurred more than 21 months before contribution did not qualify for basic operations exception).

[58] *See* T.A.M. 9332004 (Apr. 30, 1993); Ltr. Rul. 9508035 (Nov. 30, 1994); Ltr. Rul. 9541019 (July 10, 1995); Ltr. Rul. 9630038 (May 1, 1996); Ltr. Rul. 9706014 (Nov. 13, 1996); Ltr. Rul. 200730003 (Apr. 27, 2007).

hand waiting to be so used), this amount of the proceeds of the stock offering should be viewed as traceable to working capital.

Second, we recommend that the regulations include a safe harbor for capital contributions that occur more than two years prior to an ownership change, unless the ownership change occurs pursuant to an agreement entered into by the loss corporation or a controlling person (in the Section 355 sense), in which event the two years should be measured from the signing of the agreement. We believe that two years is a long time in this context and that it is highly unlikely that a capital contribution made more than two years before an ownership change (or the agreement pursuant to which the ownership change occurs) will have any connection to such ownership change. Additionally, when a taxpayer undergoes an ownership change and is trying to determine its annual limitation under Section 382, as a practical matter it is very difficult to find records regarding the facts and circumstances surrounding capital contributions that occurred more than two years ago, particularly the purpose of such contributions and the use to which such funds were put. Moreover, in practice over the last 20 years, most practitioners have viewed the two-year rule in this manner, without any evidence of any perceived abuse of the purpose of Section 382(l)(1). A two-year cutoff is also consistent with Congress's approach in Section 269(b), another purpose-oriented anti-avoidance rule. Absent the adoption of a two-year safe harbor, we recommend that the regulations create a "super factor" or a strong presumption that capital contributions occurring more than two years prior to an ownership change are not part of a prohibited plan.

Third, we recommend that the regulations include a safe harbor for capital contributions that occur before (even though within two years of) a prior ownership change. These contributions will have already been tested under Section 382(l)(1) in connection with that prior ownership change. If they were part of a prohibited plan with respect to the prior ownership change, then the amount of such contributions will already have been taken into account in determining any limitation under Section 382 caused by that prior ownership change. After such a "settling up," we believe that it is inappropriate to continue to apply Section 382(l)(1) with respect to these capital contributions to new tax attributes created after the prior ownership change. The incurrence of a prior Section 382 annual limitation should be a neutralizing event,[59] such that a capital contribution occurring before a prior ownership change should be treated no differently than a capital contribution occurring prior to the existence of any tax attributes to which Section 382 may apply. We recognize, as is the case with most safe harbors, that it is theoretically possible for a taxpayer to plan into the safe harbor with a principal purpose of increasing the Section 382 limitation. For example, if one knows that an ownership change is about to occur and that further losses are likely to be incurred thereafter, it may be possible to make a current capital contribution with the intent of having an increased value in the event a second ownership change occurs (even though

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[59] *See* Blue Book at 295-96 (discussing the neutrality principle underlying Section 382).

the capital contribution cannot be taken into account for the first ownership change). We believe, however, that such situations will be rare.

D. *Plan and Non-Plan Factors*

We recommend that the regulations adopt a facts and circumstances approach similar to that in Treas. Reg. § 1.355-7(b)(1), *i.e.*, that they include a list of factors, that the enumerated factors are inclusive (rather than exclusive), that the weight to be given each factor depends on the particular case, and that the existence of a prohibited plan does not depend on the relative number of applicable plan versus non-plan factors. With that in mind, the following are our recommendations regarding factors that may tend to show whether or not a capital contribution is made as part of a plan for purposes of Section 382(l)(1).

1. Plan Factors

The legislative history of Section 382(l)(1) suggests that the regulations take into account the existence of substantial nonbusiness assets on the change date.[60] This clearly encompasses the notion, as discussed above, that the value of nonbusiness assets that reduce the value of an old loss corporation under Section 382(l)(4) not be double counted by a second reduction under Section 382(l)(1). But based on this legislative history, we also recommend that the failure to use or deploy contributed assets in the business of the loss corporation constitute a plan factor, regardless of whether Section 382(l)(4) is applicable.

Consistent with the theme of importing concepts found in the Section 355(e) regulations to the extent applicable, we recommend that the regulations under Section 382(l)(1) adopt the plan factors set forth in Treas. Reg. § 1.355-7(b)(3)(i) and (ii). In other words, in the case of an ownership change that does not involve a public offering, the existence of an agreement, understanding, arrangement, or substantial negotiations regarding the ownership change or a similar ownership change during the two-year period preceding the contribution should constitute a plan factor, and this factor should be given substantial weight if an agreement, understanding, or arrangement exists at the time of the contribution. In the case of an ownership change involving a public offering, the existence of discussions by the loss corporation with an investment banker regarding the ownership change or a similar ownership change during the two-year period preceding the contribution should constitute a plan factor. We are mindful, though, that the Section 355(e) inquiry is essentially focused on whether there has been a disguised sale of a business to a *particular* party, whereas the Section 382(l)(1) inquiry into the purpose for a capital contribution is not dependent upon a specific nexus between the capital contribution and the ultimate ownership change. For this reason, we believe that the

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[60] *See* Conference Report at II-189.

concept of a "similar" ownership change should be applied without regard to whether the ownership change involves the same ultimate buyers.

We considered whether, in the case of an ownership change that does *not* involve a public offering, the existence of an agreement, understanding, arrangement, or substantial negotiations regarding the ownership change or a similar ownership change during the two-year period preceding the contribution should be necessary to find a prohibited plan for purposes of Section 382(l)(1), as it is under Treas. Reg. § 1.355-7(b)(2), but concluded that the policy of Section 382(l)(1) could be undermined by such a necessary condition. We can imagine situations, for example, where an owner makes a capital contribution to a loss corporation for the sole purpose of avoiding or increasing the Section 382 limitation, and a few days later initiates the process of seeking an acquiror of the loss corporation. Such situations, we believe, are properly within the purview of Section 382(l)(1) but would not be captured if such a necessary condition was adopted in the regulations.

The proximity in time between a capital contribution and an ownership change may suggest that the contribution was part of a prohibited plan, so we recommend that the Service adopt this as a plan factor. As discussed above, Congress presumably had this concern in mind when it created the two-year rule of Section 382(l)(1)(B). We considered whether the fact that a contribution is made within some minimum period preceding an ownership change – whether it be a six month period similar to the regulations under Section 108(e)(4) for indirect acquisitions of related party debt,[61] or some longer period – should constitute a "super factor" creating a rebuttable presumption that the contribution was made with an avoidance purpose, but concluded that it should not. In our experience, many loss corporations have a bona fide need for capital infusions, and it is not uncommon for ownership changes to occur shortly after such capital infusions.

Also, contributors may be more likely to make "bad" capital contributions to a loss corporation if they are shareholders of the corporation before the contribution. We therefore recommend that the contributor's pre-existing ownership of stock be a plan factor, but the weight of the factor should depend on the relative size of the shareholdings (so that relatively little weight would be given for a contribution by a small shareholder). Presumably a similar concern motivated the Service's conditioning of the Notice's first safe harbor on the contributor not being a "controlling shareholder" as determined immediately before the contribution.

2. Non-Plan Factors

A bona fide business need for a capital contribution suggests that the contribution is not part of a prohibited plan, so we recommend that the Service adopt this as a non-

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[61] *See* Treas. Reg. § 1.108-1(c)(3).

plan factor. We also recommend that the proximity in time between the contribution and the development of the business need increase the weight accorded this factor. We believe that adoption of these factors is important because not all bona fide capital contributions for business purposes will be captured by the basic operations safe harbor advocated above and discussed in the legislative history of Section 382(l)(1). For instance, a bona fide business purpose could include a merger or other business combination, long-term planning goals, or even funding basic operating expenses that do not fall within the scope of the recommended safe harbor (such as because it may be too difficult for a loss corporation to trace the proceeds of a specific capital contribution to a particular operating expense due to the fungibility of cash). As indicated above, we also recommend that the list of non-plan factors included uses of funds that fit within the basic operations exception.

Additionally, we believe and support (absent the inclusion of a specific safe harbor, see Part C.1 above) that a capital contribution is unlikely to be part of a prohibited plan when it is made at a time when the loss corporation possesses an insignificant amount of tax attributes.

Borrowing again from the Section 355(e) regulations, we recommend that the government adopt non-plan factors similar to those set forth in Treas. Reg. § 1.355-7(b)(4)(ii) and (vi). If the contribution would have occurred at approximately the same time and in similar form regardless of the impact of the contribution under Section 382, the regulations should indicate that this would be evidence that the contribution was not part of a prohibited plan. For example, it is a common practice, particularly within controlled groups, to fund a subsidiary with intercompany debt rather than equity. Later when the subsidiary is sold, it then becomes necessary to capitalize the debt as part of the sale, apart from the benefit it undoubtedly has on the Section 382 annual limitation.[62] Similarly, an identifiable, unexpected change in market or business conditions occurring after the contribution that resulted in the ownership change should also be considered strong evidence that the contribution is not part of a prohibited plan.

Where a capital contribution occurs pursuant to a debt restructuring (such as a debt-for-equity exchange or a forgiveness of debt), we recommend that the financial distress of the loss corporation constitute a significant non-plan factor. In Ltr. Rul. 200814004,[63] the Service ruled that Section 382(l)(1) did not apply to treat a debt-for-equity exchange and a cancellation of debt that occurred in a prior bankruptcy case in

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[62] We observe that this factor could create a bias in favor of funding subsidiary corporations using intercompany debt (rather than equity) in anticipation that the intercompany debt would be capitalized at the time of a sale of the company in any event. In the interim, the subsidiary would benefit from additional interest expense. (Of course, the parent would have additional interest income.)

[63] Jan. 2, 2008.

which no ownership changed occurred as part of a prohibited plan with respect to the ownership change in question. We view this ruling as supporting the principle that where an objective fact (like a bankruptcy) establishes the financial distress of a loss corporation, a capital contribution that occurs as part of a debt restructuring but does not involve an actual infusion of cash generally will not have a Section 382 avoidance purpose.

In the context of a capital contribution that occurs pursuant to the exercise of an option, warrant or stock right or the conversion of convertible debt (including mandatory convertible debt), we recommend that the fact that such option, warrant, stock right or convertible debt (each a "convertible instrument") either (i) was not issued as part of a prohibited plan, or (ii) was outstanding for more than two years, be adopted by the government as a non-plan factor. With respect to clause (i), we believe that if a convertible instrument was issued without a purpose of Section 382 avoidance, then it is unlikely that any subsequent exercise or conversion of the convertible instrument will have such a purpose. Clause (ii) is consistent with our recommendation of a two-year cutoff.

Next, we recommend that the regulations create a non-plan factor for circumstances in which a capital contribution is required by a creditor of the loss corporation. Where a creditor is demanding that a capital contribution be made, this normally indicates the presence of a business need justifying the contribution, rather than a prohibited plan. However, we recommend that the weight accorded this factor vary inversely with the equity ownership (including potential ownership through exercises of convertible instruments) of the creditor in the loss corporation and/or the likelihood that the creditor will become an equity owner of the loss corporation.

Where a capital contribution is made in connection with a distribution by a loss corporation in respect of its stock, it is less likely that such contribution is part of a prohibited plan, so we recommend that the Service adopt this as a non-plan factor. This is consistent with the suggestion in the legislative history of Section 382(l)(1) that the regulations take into account distributions to shareholders subsequent to capital contributions,[64] though we see no reason why the same rationale should not apply where a capital contribution is made in connection with a distribution but the distribution happens to occur first.

We also recommend that, if a taxpayer has a legitimate non-Section 382 tax reason for making a contribution (such as the elimination or reduction of an excess loss account that is permitted under the consolidated return regulations) and the non-Section 382 tax purpose is materially greater than the Section 382 purpose, the non-Section 382 tax purpose should be treated as a non-plan factor. Section 382(l)(1) by its terms polices only contributions with a principal purpose of avoiding or increasing any limitation under

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[64] *See* Conference Report at II-189.

Section 382. It follows that if there is another legitimate reason (including some other legitimate tax-motivated reason) for the contribution that is demonstrably a more significant reason than Section 382 avoidance, then this other reason should weigh against a finding of a prohibited plan.

Lastly, we recommend that the regulations include an observation that circumstances surrounding a capital contribution that are substantially similar to a safe harbor generally should suggest the absence of a prohibited plan. For instance, a capital contribution that would have qualified for the first safe harbor set forth in the Notice but for the fact that 21% of the total value of the loss corporation's stock is issued in connection with the contribution generally should not be viewed as part of a prohibited plan after applying all of the factors discussed above.

EXHIBIT

Relevant Treas. Reg. § 1.355-7 Language
With Substitutions Required by Notice 2008-78

Safe Harbors of Treas. Reg. § 1.355-7(d):

(8) Safe Harbor VIII.

(i) In general. If, in a transaction to which section 83 or section 421(a) or (b) applies, stock of the loss corporation is acquired by a person in connection with such person's performance of services as an employee, director, or independent contractor for the loss corporation, a related person, a corporation the assets of which the loss corporation or a related person acquires in a reorganization under section 368(a), or a corporation that acquires the assets of the loss corporation in such a reorganization (and the stock acquired is not excessive by reference to the services performed), any ownership change and the contribution will not be considered part of a plan. For purposes of this paragraph (d)(8)(i), a related person is a person related to the loss corporation under section 355(d)(7)(A).

(ii) Special rule. Paragraph (d)(8)(i) of this section does not apply to a stock acquisition if the acquirer or a coordinating group of which the acquirer is a member is a controlling shareholder or a ten-percent shareholder of the loss corporation immediately after any ownership change.

(9) Safe Harbor IX.

(i) In general. If stock of the loss corporation is acquired by a retirement plan of the loss corporation (or a retirement plan of any other person that is treated as the same employer as the loss corporation under section 414(b), (c), (m), or (o)) that qualifies under section 401(a) or 403(a), any ownership change and the contribution will not be considered part of a plan.

(ii) Special rule. Paragraph (d)(9)(i) of this section does not apply to the extent that the stock acquired pursuant to acquisitions by all of the qualified plans of the persons described in paragraph (d)(9)(i) of this section during the four-year period beginning two years before the contribution, in the aggregate, represents more than ten percent of the total combined voting power of all classes of stock entitled to vote, or more than ten percent of the total value of shares of all classes of stock, of the loss corporation.

Definitions of Treas. Reg. § 1.355-7(h):

(1) Agreement, understanding, arrangement, or substantial negotiations.

(i) An agreement, understanding, or arrangement generally requires either—

(A) An agreement, understanding, or arrangement by one or more officers or directors acting on behalf of the loss corporation, by controlling shareholders of the loss corporation, or by another person or persons with the implicit or explicit permission of one or more of such officers, directors, or controlling shareholders, with the acquirer or with a person or persons with the implicit or explicit permission of the acquirer; or

(B) An agreement, understanding, or arrangement by an acquirer that is a controlling shareholder of the loss corporation immediately after any ownership change that is the subject of the agreement, understanding, or arrangement, or by a person or persons with the implicit or explicit permission of such acquirer, with the transferor or with a person or persons with the implicit or explicit permission of the transferor.

(ii) In the case of an ownership change by a corporation, an agreement, understanding, or arrangement with the acquiring corporation generally requires an agreement, understanding, or arrangement with one or more officers or directors acting on behalf of the acquiring corporation, with controlling shareholders of the acquiring corporation, or with another person or persons with the implicit or explicit permission of one or more of such officers, directors, or controlling shareholders.

(iii) Whether an agreement, understanding, or arrangement exists depends on the facts and circumstances. The parties do not necessarily have to have entered into a binding contract or have reached agreement on all significant economic terms to have an agreement, understanding, or arrangement. However, an agreement, understanding, or arrangement clearly exists if a binding contract to acquire stock exists.

(iv) Substantial negotiations in the case of an ownership change (other than involving a public offering) generally require discussions of significant economic terms, e.g., the exchange ratio in a reorganization, either—

(A) By one or more officers or directors acting on behalf of the loss corporation, by controlling shareholders of the loss corporation, or by another person or persons with the implicit or explicit permission of one or more of such officers, directors, or controlling shareholders, with the acquirer or with a person or persons with the implicit or explicit permission of the acquirer; or

(B) If the acquirer is a controlling shareholder of the loss corporation immediately after any ownership change that is the subject of substantial negotiations, by the acquirer or by a person

or persons with the implicit or explicit permission of the acquirer, with the transferor or with a person or persons with the implicit or explicit permission of the transferor.

(v) In the case of an ownership change (other than involving a public offering) by a corporation, substantial negotiations generally require discussions of significant economic terms with one or more officers or directors acting on behalf of the acquiring corporation, with controlling shareholders of the acquiring corporation, or with another person or persons with the implicit or explicit permission of one or more of such officers, directors, or controlling shareholders.

(vi) In the case of an ownership change involving a public offering, the existence of an agreement, understanding, arrangement, or substantial negotiations will be based on discussions by one or more officers or directors acting on behalf of the loss corporation, by controlling shareholders of the loss corporation, or by another person or persons with the implicit or explicit permission of one or more of such officers, directors, or controlling shareholders, with an investment banker.

* * *

(3) Controlling shareholder.

(i) A controlling shareholder of a corporation the stock of which is listed on an established market is a five-percent shareholder who actively participates in the management or operation of the corporation. For purposes of this paragraph (h)(3)(i), a corporate director will be treated as actively participating in the management of the corporation.

(ii) A controlling shareholder of a corporation the stock of which is not listed on an established market is any person that owns stock possessing voting power representing a meaningful voice in the governance of the corporation. For purposes of determining whether a person owns stock possessing voting power representing a meaningful voice in the governance of the corporation, the person shall be treated as owning the stock that such person owns actually and constructively under the rules of section 318 (without regard to section 318(a)(4)). In addition, if the exercise of an option (whether by itself or in conjunction with the deemed exercise of one or more other options) would cause the holder to own stock possessing voting power representing a meaningful voice in the governance of the corporation, then the option will be treated as exercised.

(iii) If a contribution precedes an ownership change, the loss corporation's controlling shareholders immediately after the contribution are included among the loss corporation's controlling shareholders at the time of the contribution.

(4) Coordinating group. A coordinating group includes two or more persons that, pursuant to a formal or informal understanding, join in one or more coordinated acquisitions or dispositions of stock of the loss corporation. A principal element in

determining if such an understanding exists is whether the investment decision of each person is based on the investment decision of one or more other existing or prospective shareholders. A coordinating group is treated as a single shareholder for purposes of determining whether the coordinating group is treated as a controlling shareholder, a five-percent shareholder, or a ten-percent shareholder.

(6) Discussions. Discussions by the loss corporation generally require discussions by one or more officers or directors acting on behalf of the loss corporation, by controlling shareholders of the loss corporation, or by another person or persons with the implicit or explicit permission of one or more of such officers, directors, or controlling shareholders. Discussions with the acquirer generally require discussions with the acquirer or with a person or persons with the implicit or explicit permission of the acquirer. In the case of an ownership change by a corporation, discussions with the acquiring corporation generally require discussions with one or more officers or directors acting on behalf of the acquiring corporation, with controlling shareholders of the acquiring corporation, or with another person or persons with the implicit or explicit permission of one or more of such officers, directors, or controlling shareholders.

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(7) Established market. An established market is—

(i) A national securities exchange registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f);

(ii) An interdealer quotation system sponsored by a national securities association registered under section 15A of the Securities Act of 1934 (15 U.S.C. 78o-3); or

(iii) Any additional market that the Commissioner may designate in revenue procedures, notices, or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(8) Five-percent shareholder. A person will be considered a five-percent shareholder of a corporation the stock of which is listed on an established market if the person owns five percent or more of any class of stock of the corporation whose stock is transferred. For purposes of determining whether a person owns five percent or more of any class of stock of the corporation whose stock is transferred, the person shall be treated as owning the stock that such person owns actually and constructively under the rules of section 318 (without regard to section 318(a)(4)). In addition, if the exercise of an option (whether by itself or in conjunction with the deemed exercise of one or more other options) would cause the holder to become a five-percent shareholder, then the option will be treated as exercised. Absent actual knowledge that a person is a five-percent shareholder, a corporation can rely on Schedules 13D and 13G (or any similar schedules) filed with the Securities and Exchange Commission to identify its five-percent shareholders.

(9) Implicit permission. A corporation is treated as having the implicit permission of its shareholders when it engages in discussions or negotiations, or enters into an agreement, understanding, or arrangement.

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(11) Public offering. An ownership change involving a public offering means an ownership change of stock for cash where the terms of any ownership change are established by the loss corporation or the seller with the involvement of one or more investment bankers and the potential acquirers have no opportunity to negotiate the terms of any ownership change. For example, a public offering includes an underwritten offering of registered stock for cash.

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(14) Ten-percent shareholder. A person will be considered a ten-percent shareholder of a corporation the stock of which is listed on an established market if the person owns, actually or constructively under the rules of section 318 (without regard to section 318(a)(4)), ten percent or more of any class of stock of the corporation whose stock is transferred. A person will be considered a ten-percent shareholder of a corporation the stock of which is not listed on an established market if the person owns stock possessing ten percent or more of the total voting power of the stock of the corporation whose stock is transferred or stock having a value equal to ten percent or more of the total value of the stock of the corporation whose stock is transferred. For purposes of determining whether a person owns ten percent or more of the total voting power or value of the stock of the corporation whose stock is transferred, the person shall be treated as owning the stock that such person owns actually and constructively under the rules of section 318 (without regard to section 318(a)(4)). In addition, if the exercise of an option (whether by itself or in conjunction with the deemed exercise of one or more other options) would cause the holder to become a ten-percent shareholder, then the option will be treated as exercised. Absent actual knowledge that a person is a ten-percent shareholder, a corporation the stock of which is listed on an established market can rely on Schedules 13D and 13G (or any similar schedules) filed with the Securities and Exchange Commission to identify its ten-percent shareholders.