

Treasury Issues Proposed Regulations under Section 382 That Would Ease Compliance Requirements for Tracking Small Shareholder Ownership

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INTRODUCTION

On November 23, 2011, the Internal Revenue Service (the "IRS") issued new Proposed Regulations under Section 382^[1] that, if adopted and finalized, would limit the application of the Section 382 segregation rules (discussed in detail below) to public groups in certain circumstances that the IRS has determined are unlikely to implicate the policy concerns underlying the provision.^[2] The Proposed Regulations generally reflect the IRS's first attempt at shifting the approach of the Treasury Regulations promulgated under Section 382 (the "Section 382 Regulations") away from a purely formalistic ownership tracking system and towards a more targeted approach that does not require ownership tracking in circumstances that are unlikely to result in abuses that implicate the provision's purpose, *i.e.*, stopping the inappropriate acceleration of a loss corporation's ability to utilize its net operating loss carryforwards ("NOLs") following a change in ownership.

If adopted and finalized, the Proposed Regulations would limit the application of the segregation rules to certain transactions by:

- creating an exception from the application of the segregation rules for certain small redemptions similar to the small issuance exception in the current Section 382 Regulations;
- making the segregation rules inapplicable to both (i) transfers of a loss corporation's stock to a non-5 percent shareholder from either a 5 percent Shareholder or a 5 percent Entity (each as defined below) and (ii) transfers of ownership interests in a 5 percent Entity to a non-5 percent Shareholder; and
- creating an exception from the segregation rules for transactions involving ownership shifts by non-5 percent Shareholders in a 5 percent Entity if, on the

testing date, the entity owns no more than 10 percent (by value) of the outstanding loss corporation stock and its investment in the loss corporation is no greater than 25 percent of the entity's gross assets.

The Proposed Regulations will not be effective for any testing dates occurring before the date on which they are finalized.[\[3\]](#) A general background discussion of Section 382 and a summary of the key changes contained in the Proposed Regulations follow. For more information about the application of these proposed changes, please contact any of the lawyers listed on this alert, or any member of the Proskauer Rose LLP Tax Group with whom you normally consult on these matters.

BACKGROUND

Under Section 382, a loss corporation's ability to utilize its NOLs following a "change in ownership" is subject to limitation.[\[4\]](#) A "change in ownership" occurs when the percentage of a loss corporation's stock that is owned by one or more 5 percent shareholders (*i.e.*, any shareholder that owns, in the aggregate after the application of certain attribution rules, 5 percent or more of the loss corporation) (any such shareholder, a "5 percent Shareholder") increases by more than 50 percentage points over the lowest percentage of such loss corporation's stock that was owned by such shareholders at any time during the testing period (which is generally a three-year period).[\[5\]](#) For this purpose, shareholders who own less than 5 percent of a loss corporation ("Small Shareholders") are treated as a single 5 percent Shareholder (any such 5 percent Shareholder, a "Public Group"), subject to the segregation rules discussed below.[\[6\]](#) Additionally, an entity that owns, directly or indirectly, at least 5 percent of the loss corporation (any such entity, a "5 percent Entity") is treated as having its own Public Group if all of its owners that are not themselves 5 percent Shareholders own, in the aggregate, 5 percent or more of the loss corporation.[\[7\]](#)

Under the segregation rules, certain transactions (such as, for example, mergers, equity issuances, redemptions, and transfers of loss corporation stock by either an individual 5 percent Shareholder or a 5 percent Entity to public shareholders) are treated as segregation events and require a loss corporation to segregate groups of Small Shareholders into new Public Groups, which are treated as 5 percent Shareholders separate and distinct from any other Public Group.[\[8\]](#) A loss corporation also is required generally to track these types of transactions undertaken by 5 percent Entities or owners of 5 percent Entities.

The new Public Groups created by the application of the segregation rules must be separately tracked by a loss corporation, and any changes in such Public Groups' ownership must be separately accounted for in calculating whether a change in ownership occurs. Generally, the formation of a new Public Group results in an immediate increase in that newly-formed Public Group's ownership in a loss corporation. [9] The practical consequence of the segregation rules is to increase the recordkeeping burden of a loss corporation, and to increase the likelihood of an ownership change with respect to any loss corporation that engages in transactions that trigger the application of the segregation rules.

The issuance of the Proposed Regulations was preceded by Notice 2010-49 (the "Notice"), [10] which requested public comment regarding possible modifications to the Section 382 Regulations relating to the treatment of Small Shareholders. In the Notice, the IRS stated that the acquisition of loss corporation stock followed by the contribution of income-producing assets or the diversion of income-producing opportunities (both of which inappropriately accelerate a loss corporation's ability to utilize its NOLs) is one of the primary abuses that Section 382 is meant to prevent, and outlined two different approaches that can be followed to carry out that purpose.

The first approach (the "Ownership Tracking Approach") addresses abusive transactions by tracking all changes in ownership regardless of whether the shareholders who increase their ownership are Small Shareholders or 5 percent Shareholders. Under the Ownership Tracking Approach, any transaction that readily allows a loss corporation to track an increase in ownership interests held by Small Shareholders is subject to the segregation rules and, accordingly, results in the creation of a new Public Group. According to the Notice, the existing Section 382 Regulations generally follow the Ownership Tracking Approach. In contrast, the second approach (the "Purposive Approach") recognizes that it is unnecessary to take into account all readily-identifiable acquisitions of stock by Small Shareholders, because Small Shareholders generally are not in a position to engage in the abuses that Section 382 is intended to prevent. The preamble to the Proposed Regulations states that, in light of the comments received in response to the Notice, the Proposed Regulations contain revisions that follow the Purposive Approach, while maintaining the overall existing regulatory framework. The Proposed Regulations would apply the Purposive Approach by providing new exceptions from the segregation rules for segregation events involving Small Shareholders where it is unlikely that the abuses Section 382 is meant to prevent will occur. Each of these exceptions is discussed below.

SUMMARY OF NEW EXCEPTIONS IN THE PROPOSED REGULATIONS

Exception for certain small redemptions

The Proposed Regulations provide an exception that would allow a loss corporation, at its option, to redeem up to either 10 percent or more of the total value of its stock at the beginning of the taxable year or 10 percent of the number of shares of the redeemed class outstanding at the beginning of the taxable year without triggering the application of the segregation rules.[\[11\]](#) For redemptions that the exception applies to, each Public Group existing immediately before the redemption would be treated as redeeming its proportionate share of exempted stock. In the preamble to the Proposed Regulations, the IRS notes that the exception is appropriate under the Purposive Approach because it would reduce the application of Section 382 and the resulting administrative burden with respect to small redemptions—which are transactions in which the abuses Section 382 is intended to prevent are unlikely to occur.

Exception for certain secondary transfers

The Proposed Regulations also provide an exception from the segregation rules that would apply to transfers of loss corporation stock to Small Shareholders by either a 5 percent Entity or an individual 5 percent Shareholder.[\[12\]](#) In such cases, the stock transferred would be treated as being acquired proportionately by the Public Groups existing at the time of the transfer. This exception also would apply to transfers of ownership interests in 5 percent Entities to public owners or 5 percent owners that are not 5 percent Shareholders. In the preamble, the IRS indicates that an exception for such transfers is appropriate because these transactions do not introduce new capital into the loss corporation and they result in direct or indirect ownership of the loss corporation becoming less concentrated, which diminishes the opportunity for loss trafficking.

Exception for certain ownership changes in 5 percent Entities

As discussed above, a loss corporation generally is required to track ownership changes that occur in a 5 percent Entity, and segregation events involving ownership changes by Small Shareholders in a 5 percent Entity generally are subject to the segregation rules. The Proposed Regulations provide for an exception from the application of the segregation rules for ownership shifts by Small Shareholders in a 5 percent Entity if, on the testing date, the entity owns no more than 10 percent (by value) of the outstanding loss corporation stock (the "Ownership Limitation") and its investment in the loss corporation is not greater than 25 percent of the entity's gross assets (the "Asset Threshold").[\[13\]](#)

A loss corporation may establish that a 5 percent Entity meets the Ownership Limitation through either actual knowledge or (absent actual knowledge to the contrary) by applying certain presumptions regarding stock ownership in the current Section 382 Regulations (*i.e.*, through reliance on the existence and absence of Schedule 13D and 13G filings if the stock is subject to regulation by the Securities and Exchange Commission, and through reliance on certain statements signed under penalties of perjury by a responsible person on behalf of a first-tier or higher entity regarding shifts in its ownership interests during the relevant testing period).[\[14\]](#) For purposes of applying the Asset Threshold test, an entity's cash and cash items (within the meaning of Section 382(h)(3)(B)(ii)) are not taken into account.

The IRS notes in the preamble to the Proposed Regulations that this exception was provided in response to one commentator's request for relief from the indirect ownership tracking requirements in light of the fact that it is often unduly burdensome (and sometimes impossible) for a loss corporation to obtain the information about indirect ownership changes that is necessary to comply with the requirements. Further, the IRS states that the exception is appropriate because the Asset Threshold makes it unlikely that the loss corporation's tax attributes motivate transactions resulting in a shift in the equity of a 5 percent Entity and the Ownership Limitation makes it unlikely that transactions among Small Shareholders one or more tiers removed implicate loss trafficking concerns.

REQUESTS FOR COMMENTS

In the preamble to the Proposed Regulations, the IRS states that in response to the Notice, it received comments requesting the expansion of the small issuance and cash issuance exceptions in the current Section 382 Regulations, which exempt certain amounts of stock issuances from the segregation rules. The small issuance exception generally applies to the total amount of stock issued during a taxable year to the extent it does not exceed either 10 percent of the total value of the corporation's outstanding stock at the beginning of the taxable year or 10 percent of the class of stock issued and outstanding at the beginning of the taxable year, but does not apply to any issuance that by itself exceeds the small issuance limitation.[\[15\]](#) Where stock is issued solely for cash, the cash issuance exception exempts a percentage of the total stock issued equal to 50 percent of the aggregate percentage ownership interest of the Public Groups of the corporation immediately before the issuance.[\[16\]](#) The IRS noted that all transactions that infuse new cash into a loss corporation, even those involving Small Shareholders, can implicate the intended purposes of Section 382 because the capital infusion can accelerate the use of the loss corporation's NOLs. However, comments specifically addressing whether it would be appropriate to refine either or both of the exceptions in the context of the exceptions provided in the Proposed Regulations were requested. Specific comments regarding the clarity of the Proposed Regulations and how they may be made easier to understand also were requested.

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To ensure compliance with requirements imposed by U.S. Treasury Regulations, Proskauer Rose LLP informs you that any U.S. tax advice contained in this communication (including any attachments) was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

[1] Unless otherwise stated, all references to "Section" hereafter are to the Internal Revenue Code of 1986, as amended.

[2] Application of the Segregation Rules to Small Shareholders, 76 Fed. Reg. 72362 (Nov. 23, 2011).

[3] Prop. Reg. Section 1.382-3(j)(17).

[4] Section 382(a).

[5] Section 382(g)(1).

[6] Section 382(g)(4)(A).

[7] Treas. Reg. Section 1.382-2T(j)(1)(iv).

[8] Treas. Reg. Section 1.382-2T(j)(2)(iii).

[9] Id.

[10] IRS Notice 2010-49, 2010-27 I.R.B. (Jun. 11, 2010).

[11] Prop. Reg. Section 1.382-3(j)(14).

[12] Prop. Reg. Section 1.382-3(j)(13).

[13] Prop. Reg. Section 1.382-3(j)(15).

[14] See Treas. Reg. Section 1.382-2T(k)(1).

[15] Treas. Reg. Section 1.382-3(j)(2).

[\[16\]](#) Treas. Reg. Section 1.382-3(j)(3).

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