

IRS issues helpful 'small shareholder' regs under Section 382

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In brief

The IRS on October 21 issued final regulations (T.D. 9638) under Section 382 on application of the segregation rules to small shareholders. The final regulations are intended to ease the administrative burden and complexity of the segregation rules for loss corporations with small shareholders.

The final regulations provide three new taxpayer-favorable exceptions to the current segregation rules for small shareholders:

- the secondary transfer exception,
- the small redemption exception, and
- the general exception to the segregation rules for five-percent entities.

The final regulations adopt the proposed regulations (REG-149625-10) published on November 23, 2011, with certain amendments, and are generally effective for testing dates on or after October 22, 2013. Taxpayers have the option to apply the regulations to earlier testing dates (subject to specific restrictions discussed below, including that the final regulations neither create nor eliminate an ownership change).

In detail

Background

Section 382 generally restricts a loss corporation's utilization of its net operating losses (NOLs) after the loss corporation undergoes an ownership change. An ownership change occurs if one or more five-percent shareholders increase their ownership in the loss corporation's stock, in the aggregate, by more than 50 percentage points during a testing period, which generally is the three-year period preceding a testing date.

In the event of an ownership change, a loss corporation's utilization of its accumulated losses up to the date of the ownership change – so-called 'pre-change net operating losses' – is limited for periods after the ownership change. This limitation is often referred to as a 'Section 382 limitation.' The Section 382 limitation generally is computed by multiplying the value of the corporation immediately before the ownership change by the long-term tax-exempt rate.

Section 382 was enacted to prevent 'trafficking' in NOLs.

Absent a Section 382 limitation, an acquisition of the loss corporation's shares followed by either the contribution of income-producing assets or the diversion of income-producing opportunities to the loss corporation could accelerate the utilization of a loss corporation's NOL carryforwards.

A five-percent shareholder is defined generally as any person or group holding, directly or indirectly, five percent or more of the loss corporation's stock at any time during the testing period. A five-percent entity is defined as an entity through

which a five-percent shareholder owns an indirect interest in the loss corporation.

Aggregation and segregation rules prior to issuance of the final regulations

Under the former aggregation rules, all direct and indirect small shareholders of a loss corporation are aggregated into a public group that is itself viewed as a five-percent shareholder. Conversely, the former segregation rules, when applicable, create a new public group for purposes of determining whether an ownership change has occurred on the date of any segregation event (and on subsequent testing dates during the testing period). Segregation events include issuances of loss corporation stock, redemption or redemption-type transactions, and sales of stock by five-percent shareholders. The former aggregation and segregation rules also apply to equity transactions of a five-percent entity.

The former aggregation and segregation rules have contributed to administrative burdens and overall complexity in identifying owner shifts in determining whether an ownership change has occurred. These rules also are particularly burdensome to loss corporations owned in part by investment advisors or institutional shareholders that participate in frequent selling and purchasing.

The final regulations

The final regulations reduce the complexity and administrative burdens of the former segregation rules by providing the secondary transfer exception, the small redemption exception, and the general exception to the segregation rules for five-percent entities. **Note:** While acknowledging the issue in the proposed regulations, the IRS did not include any guidance in the final regulations on situations in which a

group of persons making a 'coordinated acquisition' of stock can constitute an entity within the meaning of Reg. sec. 1.382-3(a).

Secondary transfer exception

The secondary transfer exception renders the segregation rules inoperative to (1) direct transfers of loss corporation stock by a five-percent entity or a five-percent shareholder to public shareholders and (2) transfers of five-percent entity stock by a five-percent shareholder or a five-percent entity to public shareholders. Under these circumstances, each public group of the loss corporation or the five-percent entity, as the case may be, existing at the time of the transfer is treated as acquiring its proportionate share of the stock exempted from the segregation rules.

Small redemption exception

The small redemption exception, modeled after the small issuance exception of Reg. sec. 1.382-3(j), exempts from the segregation rules an amount of stock acquired in redemptions, at the loss corporation's option, equal to either 10 percent of the loss corporation's stock at the beginning of the tax year or 10 percent of the number of shares of the redeemed class outstanding at the beginning of the tax year. When the small redemption exception applies, each public group existing immediately before the redemption is treated as redeeming its proportionate share of exempted stock.

In addition, the final regulations provide that the small redemption exception applies to redemptions of stock by a five-percent entity. In these circumstances, the amount of redemptions exempted from the segregation rules is determined with reference to the stock value and the stock classes of the redeeming five-

percent entity and not with reference to the stock value and stock classes of the loss corporation.

General exception to the segregation rules for five-percent entities

The general exception to the segregation rules for five-percent entities turns off the segregation rules for transactions involving a five-percent entity if the five-percent entity owns 10 percent or less (by value) of all the outstanding stock of the loss corporation after applying the attribution rules of Section 318(a) and taking into account all transactions occurring on the date of the transaction being tested. Recognizing the difficulty taxpayers could encounter when attempting to verify the 25-percent asset threshold test as had been set forth in the proposed regulations, the IRS replaced that test with an anti-avoidance rule. Thus, this exception does not apply if the loss corporation, directly or through one or more persons, participated in planning or structuring the transaction with a view to avoid the application of the segregation rules.

Effective date

Taxpayers have the option to apply the new rules to testing dates that are included in a testing period beginning before and ending on or after October 22, 2013. Taxpayers, however, may not apply these rules to (1) any date on or before the date of an ownership change that occurred prior to October 22, 2013, and (2) any testing date if such application would result in an ownership change occurring on a date before October 22, 2013, that did not occur under the former segregation rules.

The takeaway

The final regulations are helpful guidance for loss corporations faced with the unduly burdensome and complex segregation rules as applied

to small shareholders. Because transactions involving these small shareholders pose no real Section 382 abuse potential, the final regulations allow loss corporations to disregard certain typical equity transactions,

thus limiting the application of the segregation rules and simplifying the overall analysis under Section 382.

The limited retroactive feature of the new final regulations provides

taxpayers with an immediate opportunity to apply these rules, thus reducing the likelihood of future ownership changes.

Let's talk

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