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Proposed section 382 regulations would provide taxpayer-favorable rules on small shareholders

The IRS recently issued proposed regulations under section 382(g) addressing application of the segregation rules of Reg. sec. 1.382-2T(j) to public groups. If adopted, the proposed regulations would render the segregation rules inapplicable to certain transactions involving less-than-five-percent shareholders (small shareholders).

The proposed regulations would apply prospectively from the date the regulations become final. Comments on the proposed regulations and requests for a public hearing must be submitted to the IRS by February 21, 2012.

Background

Section 382 imposes an annual limitation on the amount of a loss corporation's taxable income that can be offset by net operating losses (NOLs) and certain built-in losses (collectively referred to as "pre-change losses") that are attributable to the period preceding an ownership change. In general, the section 382 limitation for any post-change year equals the value of the loss corporation (reduced by certain items) multiplied by the long-term tax-exempt rate. The intended purpose of section 382 is to prevent "trafficking" of NOLs. Absent the limitation, new shareholders could contribute income-producing assets (or divert income opportunities) to the loss corporation, thereby accelerating the corporation's use of its NOL carryforwards.

An ownership change is defined generally as a greater-than-50-percentage-point increase (by value) in the ownership of stock by five-percent shareholders over a three-year period. The testing period ends after three years whether or not the ownership shifts result in an ownership change.

A five-percent shareholder is defined, under very complex rules, as any person or group holding 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 ownership interest in the loss corporation.

Under the aggregation rules, all small shareholders are aggregated into a public group that is itself viewed as a five-percent shareholder. The segregation rules, on the other hand, require additional segregated public groups to be created upon the occurrence of certain transactions, such as the issuance of loss corporation stock, the sale of stock by a five-percent shareholder, and redemptions or redemption-like transactions.

Issues under the current regulations

The aggregation and segregation rules contribute greatly to the complexity of identifying owner shifts and determining whether an ownership change has taken place. Those rules are particularly burdensome to loss corporations owned in part by investment advisors or institutional shareholders that participate in frequent selling and purchasing.

In Notice 2010-49, the IRS requested comments on two possible approaches to identifying and limiting application of the aggregation and segregation rules to small shareholders. Under the ownership tracking approach, taxpayers would track all changes in ownership without regard to the circumstances of the transaction. For example, if a five-percent shareholder sold stock to small shareholders, those small shareholders would be tracked in a new public group segregated from the existing public group(s). The IRS explained that this approach, which is consistent with the current regulations, would be intended to ensure that all abusive transactions are addressed.

Alternatively, the IRS introduced the purposive approach, which would seek to identify the circumstances in which abusive transactions are likely to arise and tailor the application of the aggregation and segregation rules accordingly. Thus, instead of tracking all changes in ownership, the purposive approach would not require the loss corporation to track acquisitions of stock by small shareholders. This approach would be based on the presumption that small shareholders generally are not in a position to engage in certain abusive transactions, such as contributing income-producing assets or diverting income-producing opportunities to the loss corporation to accelerate its use of NOL carryforwards.

Proposed changes to the current regulations

The proposed regulations, which generally adopt the purposive approach described in Notice 2010-49, would make three primary revisions to the current regulations.

- First, the proposed regulations generally would render the segregation rules inoperative to transfers of loss corporation stock by five-percent shareholders or five-percent entities to small shareholders. Instead of creating a new public group, the existing public groups at the time of the transfer would be treated as acquiring the transferred stock proportionately. The rule would also apply to transfers of ownership interests in five-percent entities to public owners and to five-percent owners who are not five-percent shareholders. The IRS reasoned that such transactions are not likely to be abusive because they do not introduce new capital into the loss corporation and because they result in the direct or indirect ownership of the loss corporation becoming less concentrated.

- Second, the proposed regulations would exempt from the segregation rules a certain amount of redemptions of loss corporation stock. This rule, which is modeled after the small issuance exception of Reg. sec. 1.382-3(j), was first suggested by PwC in a September 17, 2010, comment letter in response to Notice 2010-49. Specifically, the proposed regulations would exempt from segregation, at the loss corporation's option, either 10 percent of the total value 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 exception applies, each public group existing immediately before the redemption would be treated as redeeming its proportionate share of exempted stock.

- Third, the proposed regulations would provide relief from the need to track ownership shifts by small shareholders of five-percent entities. In that regard, the segregation rules would not apply if, on a testing date on which the rules otherwise would apply, the five-percent entity owns 10 percent or less (by value) of all the outstanding stock of the loss corporation (the ownership limitation) *or* the five-percent entity's direct or indirect investment in the loss corporation does not exceed 25 percent of the entity's gross assets (the asset threshold). The loss corporation would be able to establish the ownership limitation through actual knowledge or, absent actual knowledge to the contrary, the presumptions regarding stock ownership in Reg. sec. 1.382-2T(k)(1). For purposes of the asset threshold, the five-percent entity's cash and cash items within the meaning of section 382(h)(3)(B)(ii) would not be taken into account.

In addition, the IRS suggested in the preamble to the proposed regulations that finalization of the regulations may increase the significance of the coordinated acquisition rule of Reg. sec. 1.382-3(a). The IRS solicited comments as to circumstances under which a group of investors should be aggregated into a single entity based on their understandings or communications with each other or with third persons, such as the loss corporation or an underwriter.

Observations

The proposed regulations should be viewed as taxpayer-friendly. They would retain the current framework of the aggregation and segregation rules but reduce their administrative burden and complexity. The finalization of the proposed regulations would be particularly beneficial to loss corporations owned in part by investment advisors or institutional shareholders that otherwise would be required to apply the segregation rules to all purchases and sales of stock between and among investment advisors, institutional shareholders, and small shareholders.

Although the current, highly mechanical rules initially were developed to identify the vast array of circumstances in which an ownership change could occur, the proposed regulations reflect the IRS's shift to providing greater certainty and simplification to the existing section 382 regime while keeping in mind the policy considerations underlying it. The proposed regulations thus appropriately would limit the situations in which the segregation rules apply to those situations that potentially implicate the policies underlying section 382.

For more information, please do not hesitate to contact:

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